

**November 1998**

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**MONEY PENALTIES****Securities and Futures  
Regulators Collect  
Many Fines But Need  
to Better Use  
Industrywide Data**

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**General Government Division**

B-275115

November 2, 1998

The Honorable Alfonse M. D'Amato  
Chairman  
The Honorable Paul S. Sarbanes  
Ranking Minority Member  
Committee on Banking, Housing, and  
Urban Affairs  
United States Senate

The Honorable Richard G. Lugar  
Chairman  
The Honorable Tom Harkin  
Ranking Minority Member  
Committee on Agriculture, Nutrition, and Forestry  
United States Senate

The Honorable Thomas J. Bliley, Jr.  
Chairman  
The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Commerce  
House of Representatives

The Honorable Robert F. Smith  
Chairman  
The Honorable Charles W. Stenholm  
Ranking Minority Member  
Committee on Agriculture  
House of Representatives

This report provides the results of our review of fine imposition and collection activities by the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and securities and futures self-regulatory organizations (SRO).<sup>1</sup> SEC, CFTC, and SROs may levy fines as part of the sanctions they impose on firms and individuals who have violated securities and futures laws and regulations and SRO rules. Officials of these organizations said that they use fines to remedy the

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<sup>1</sup>SEC and CFTC delegate responsibility to the SROs to enforce financial and reporting requirements and legal and ethical standards for SRO members. SROs include the national securities and futures exchanges, registered securities and futures associations, registered clearing agencies, and the Municipal Securities Rulemaking Board. We do not include the latter two groups in this report.

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current violation and deter future violations. The objectives of our self-initiated review were to determine (1) the extent to which SEC, CFTC, and SROs collected fines; (2) the guidance they used to determine fine amounts; and (3) how SEC and CFTC assess the appropriateness of fines across their respective industries.

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## Results in Brief

SEC, CFTC, and securities and futures SROs collected most of the over \$400 million in fines imposed for disciplinary cases closed from January 1992 through December 1996. However, the percent of fine amounts collected and the percent of fines paid in full varied among these agencies. SEC and CFTC, with federal regulatory authority, both collected over 80 percent of the total amount of fines for the cases closed during this period; 92 percent of SEC's and 60 percent of CFTC's fines for these cases were paid in full.<sup>2</sup> Securities and futures SROs that operate exchanges collected over 75 percent of the amount of fines for the cases they closed, except for one futures exchange that had written off two large fines, which reduced its total amount collected to 54 percent. For the closed cases we reviewed at all seven exchanges, at least 90 percent of the fines had been paid in full; five exchanges had over 95 percent paid in full.<sup>3</sup> Exchange members who do not pay fines risk having the exchange sell their membership, or "seats," to cover the fines.

The National Association of Securities Dealers (NASD) and the National Futures Association (NFA) collected less than 30 percent of the amount of fines for the cases they closed.<sup>4</sup> NASD and NFA fines paid in full totaled 67 percent and 54 percent, respectively. NASD and NFA do not have the federal regulatory authority of SEC and CFTC or seats to sell to cover unpaid fines. NASD and NFA officials told us they recognize that, in some cases, the fines they impose are not likely to be paid, especially when the fines are high for such conduct as egregious violations or repeat violators. Violators may leave the industry either to avoid the fine or because they are suspended or barred as part of their sanctions. In either case, the

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<sup>2</sup>CFTC officials told us that the large difference in fines paid in full between SEC and CFTC may be attributed to the difference in the amount of time each has had the authority to impose fines. SEC has had civil monetary penalty authority only since 1990 (Securities Enforcement Remedies and Penny Stock Reform Act of 1990), but CFTC has had this authority since its inception in 1975. Thus, CFTC had older cases in the inventory of cases closed during the period 1992 through 1996 than SEC, and these cases had a greater chance of being written off. According to CFTC officials, the cases CFTC closed during this period included 45 cases for which the fines had been uncollectible for a number of years. Excluding these cases would increase the percent of cases paid in full to over 85 percent.

<sup>3</sup>As explained later, although we reviewed all or a representative sample of cases at six exchanges, we only reviewed judgmentally selected closed cases at NYMEX.

<sup>4</sup>NASD and NFA have disciplinary authority over all member securities and futures firms, respectively, and the firms' sales representatives.

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officials said fines help remove violators from the industry and keep them from returning until they pay their fines.

Some SROs did not maintain automated records to document that their fines were paid. Such documentation could provide an important internal control to ensure fines are collected and accounted for.

The extent of guidance for setting fines varied among SEC, CFTC, and the SROs. SEC and CFTC had statutorily established maximum fines for civil actions and administrative proceedings. In addition, CFTC published the factors it considers in setting fines for use by futures SROs in conjunction with a one-time, congressionally mandated study of futures industry penalties. All the securities and futures exchanges had prescribed fine amounts for minor violations of exchange rules and policies. NASD was the only SRO that had written guidance specifying ranges of fine amounts for more serious violations. Despite the differences in guidance, SEC, CFTC, and SRO officials told us they considered specific factors in setting fine amounts, which were common to them all. These factors included the seriousness of the violation, the number of repeat violations, and the precedent set by similar cases.

SEC and CFTC reviewed the adequacy of sanctions at their respective SROs as part of their regular oversight. When they found inadequate sanctions, including fines, they recommended actions meant to ensure that future sanctions would be appropriate. However, each takes a different approach to analyzing the comparative adequacy of SRO sanctions across their respective industries.

SEC officials told us that they did not analyze industrywide sanctions data because such data are not easily quantified and are not meaningful without additional review. The officials said that they evaluate the comparative adequacy of SRO sanctions through their routine inspections and regular meetings with senior SRO officials. However, our analysis of industrywide sanctions data for the time period we examined showed large differences in the average fine amounts and number of cases closed among securities SROs and among futures SROs. These differences cannot be specifically explained without further reviewing the data. Such an analysis could serve to indicate the differences between and among SRO performance over time and could provide SEC an additional systematic, fact-based way to assess industrywide sanctions.

In contrast, CFTC maintained data and produced reports that could be used to analyze industrywide sanctions. For example, CFTC's reports

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showed that the difference we found in average fines at the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT)—\$5,300 versus \$23,800, respectively—could be attributed to three fines at CBOT that were unusually large. CFTC officials told us that they reviewed industrywide information periodically to identify patterns or trends that may require further review. However, they did not document the results of these reviews.

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## Background

SEC and CFTC are responsible for (1) administering and enforcing federal securities and futures laws and regulations and (2) fostering fair and efficient markets for the trading of securities and futures. Securities and futures laws allow SEC and CFTC to delegate authority to SROs to regulate and operate the markets in which securities and futures are traded. SEC and CFTC are responsible for oversight and regulation of the operations and activities of their respective securities or futures SROs. Securities and futures SROs operate designated markets, or exchanges, for the trading of securities or futures. In addition, two SROs—NASD and NFA—are regulatory associations of registered securities or futures industry professionals and firms. SEC, CFTC, and the SROs have enforcement and disciplinary programs and processes for taking actions against violators of federal securities or futures laws and regulations and applicable SRO rules. Fines may be imposed as all or part of the sanctions for these violations.

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## SEC, CFTC, and the SROs Have Statutory Authority to Impose Fines

SEC and CFTC have statutory authority to investigate and prosecute alleged violations of federal securities and futures laws. Securities SROs have authority to enforce securities laws, regulations, and their own rules on their members; futures SROs have authority to enforce their own rules. Violators may be subject to a variety of sanctions, including fines. Other sanctions include censures, injunctive orders, bars or suspensions, rescissions of illegal contracts, disgorgements, and restitutions to customers.<sup>5</sup>

SEC has the authority to bring actions against violators of securities laws in federal district courts or through SEC administrative proceedings.<sup>6</sup> These actions may result in money penalties, or fines, against the

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<sup>5</sup>Disgorgement orders require securities and futures law violators to surrender the profits gained or losses avoided from their illicit activities.

<sup>6</sup>The 1990 amendments to federal securities laws provided SEC authority to impose civil money penalties under the Securities Act of 1933, the Securities Exchange Act, the Investment Company Act of 1940, the Investment Advisors Act of 1940, and the rules of the Municipal Securities Rulemaking Board.

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violators.<sup>7</sup> Depending upon the seriousness of the violation and whether it was committed by an individual or a firm, the fines can range from \$5,500 to \$1,100,000 or up to three times the gross amount of pecuniary gain from the violation.<sup>8</sup> If the penalty is not paid within a prescribed time, SEC may request contempt proceedings in federal district court to compel payment or may refer the matter directly to the Department of the Treasury for collection.

Similarly, CFTC is provided authority by the Commodity Exchange Act (CEA) to discipline violators of the act and CFTC regulations through civil actions in the federal district courts and through administrative actions. CEA states that fines resulting from these actions may be up to \$100,000, or triple the monetary gain, for any person; or up to \$500,000 for any contract market (futures exchange), officer, or employee. Under a 1992 amendment to CEA, violators are to have their trading privileges automatically suspended until their fines are paid. CFTC also may initiate contempt proceedings or may refer unpaid fines to the Attorney General for collection through actions in federal district court. CFTC officials told us that they are considering whether to enter into an agreement with Treasury under which CFTC would refer unpaid debt to Treasury for collection in accordance with the Debt Collection Improvement Act of 1996.

Securities and futures laws also provide authority for SROs to impose fines. Section 6 of the Exchange Act provides authority for any registered securities exchange, such as the New York Stock Exchange (NYSE) or the American Stock Exchange (Amex), to impose fines and other sanctions on members who violate securities laws and regulations and SRO rules. In addition, section 15A provides NASD similar authority as a registered securities association.

Futures SROs have authority under CEA to discipline and penalize members for violations of SRO rules. Sections 5a(a)(8) and (9) and 5a(b) of CEA, in part, require futures exchanges, such as CBOT, CME, or the New York Mercantile Exchange (NYMEX), to enforce their rules, take appropriate disciplinary actions, and impose penalties on violators. Similarly, section 17(b)(8) of CEA authorizes NFA to appropriately

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<sup>7</sup>As discussed later, SEC, CFTC, and the SROs may settle a case, including the fine amount, before the court or administrative proceeding reaches a final decision.

<sup>8</sup>All federal agencies must adjust civil monetary penalties for inflation as prescribed by statute (28 U.S.C. § 2461).

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discipline its members, including imposing penalties for violations of its rules.

SEC and CFTC enforcement actions and disciplinary decisions of all securities and futures SROs can be appealed. For example, SEC and CFTC administrative cases can be appealed to the respective Commission,<sup>9</sup> the federal courts, and ultimately to the Supreme Court. Securities and futures SRO cases can be appealed to higher authorities within the SRO; SEC or CFTC, respectively; the federal courts; and the Supreme Court.

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## How Fines Are Imposed

SEC, CFTC, and SROs may impose fines and other sanctions against violators through their specific enforcement or disciplinary processes. SEC or CFTC may bring actions in federal court or in administrative proceedings before an administrative law judge (ALJ). SRO disciplinary proceedings normally are heard by a disciplinary committee or hearing panel, which may include SRO members; a professional hearing officer; or a member of the public, depending on the SRO.<sup>10</sup>

SEC and CFTC enforcement actions may be initiated after investigations by their respective enforcement staffs of alleged violations of laws or regulations. Allegations may be identified from customer complaints; examinations; market surveillance; or referrals from other federal, state, or foreign agencies. After an investigation, enforcement staff prepare memorandums to the commission that include the charges against the alleged violators, any evidence of violations, and recommendations as to whether further action should be taken. If the commission decides that a case warrants further action, it can either file a civil suit against the alleged violator in the federal district court or issue a complaint against the alleged violator and order a public hearing on the matter before an ALJ. If either the court or ALJ finds a violation of laws and regulations, it can impose sanctions, including fines, against violators. According to an SEC official, determining whether a case is referred to the courts or an ALJ depends largely on the type of sanction staff want to obtain. For example, a bar from the industry could be obtained from an ALJ, but only a court could issue an injunctive order. Many cases are settled before the court or ALJ renders a final decision when the alleged violator submits a settlement offer agreeing to sanctions without admitting or denying liability. The types and amounts of sanctions, including fines, are usually negotiated

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<sup>9</sup>Both SEC and CFTC have five-member commissions headed by chairpersons who are appointed by the President for 5-year terms.

<sup>10</sup>Under the Futures Trading Practices Act of 1992, futures SRO hearing panels must have a nonmember for certain types of proceedings.



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between enforcement staff and the alleged violators. Offers of settlement are not final until approved by SEC or CFTC.

SRO disciplinary cases usually begin as a result of a customer complaint, compliance examination, market surveillance activity, regulatory filings, or even an item reported in the press. SROs generally have enforcement authority over only their members and employees. An SRO's enforcement or regulation division is responsible for investigating and prosecuting disciplinary cases. The enforcement or regulation division is to investigate possible violative activity and prepare a memorandum outlining the facts and evidence found by its investigation. The disciplinary committee, SRO staff, or other authorizing entity is to review the matter and decide whether to issue a formal complaint against the alleged violator. If they issue a complaint, a written statement of charges is to be sent to the alleged violator to which he or she may be required to respond in writing, either admitting or denying each charge. Upon receiving this response, the enforcement staff is to schedule a hearing before a hearing panel. In the hearing, the enforcement staff, acting as prosecutor, and the respondent can present evidence and witnesses. The hearing panel must then examine the evidence and decide on each charge and the appropriate sanction. A written statement of the panel's decision and sanctions is to be sent to the respondent.

SRO disciplinary cases also can be settled with the respondent agreeing to sanctions without admitting or denying liability. SRO officials told us that settlements are common and are often preferred because they enable the SRO to conserve investigative and legal resources and still remedy violations.

In 1997, SEC approved an NASD proposal that cases be heard by a hearing panel presided over by a professional hearing officer assisted by two securities industry professionals, instead of being heard by members of NASD district business conduct committees. The hearing panel's decisions may be appealed to NASD's National Adjudicatory Council (formerly called the National Business Conduct Committee), SEC, and the federal courts. Also, in 1996, the Chicago Stock Exchange (CHX) proposed to institute a disciplinary committee structure, which SEC was considering as of June 1998. Until this proposal is approved, CHX disciplinary decisions are to be made by its president and can be appealed to its Executive Committee.

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## Scope and Methodology

Our work focused on the imposition and collection of fines through the enforcement and disciplinary programs of SEC and CFTC and the securities and futures SROs. The SROs we reviewed included Amex, Chicago Board Options Exchange (CBOE), CBOT, CME, CHX, NASD, NFA, NYMEX, and NYSE. CHX officials told us that CHX and the other regional securities exchanges delegated their authority to examine the sales practices of registered broker-dealers to Amex, CBOE, NASD, or NYSE and administered few disciplinary actions. As a result, we excluded other regional securities exchanges. We also excluded some futures exchanges located in New York and those in Minneapolis, MN; and Kansas City, KS, because they generally administered few disciplinary actions; or most of their actions involved minor rules violations. Minor violations included floor conduct, decorum, and recordkeeping violations that normally do not undergo disciplinary proceedings. The exchanges generally referred to these violations as “traffic ticket” violations, which are handled through summary proceedings and involve smaller fine amounts.

We interviewed officials at SEC, CFTC, and the SROs to obtain information about their enforcement and disciplinary programs and processes, including their imposition of fines. We obtained copies of SEC and CFTC regulations, SRO rules, and other documents regarding their enforcement and disciplinary programs and the imposition of fines. We also obtained data from SEC, CFTC, and the SROs on cases closed during the 5-year period January 1992 through December 1996 that included a fine among other disciplinary actions. Fines collected included cases that were either paid in full or in part. We used these data to calculate fine collection rates and other statistics for SEC, CFTC, and the SROs.

SEC, CFTC, and most of the SROs provided us with databases of their records of fines administered during the 1992 through 1996 period. One exchange, CBOT, did not maintain its fine collection records for past years on a computer but provided us with monthly records on hard copy. We drew a representative sample of 208 CBOT cases for 1992 through 1996 from a database of SRO disciplinary cases maintained by CFTC and NFA. We then asked CBOT to provide us with the amounts of fines collected on these sample cases. Another exchange, NYMEX, could not provide us summary information on fines collected from 1992 through 1996 because it did not maintain records on its fine collection activity apart from individual case files. Using the CFTC/NFA database, we drew a representative sample of NYMEX cases and asked NYMEX officials to provide the amounts collected. However, they said that it would be very burdensome for NYMEX to go back to all of the case files to obtain this information. Therefore, we limited our sample selection to 31 cases from

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the 1992 through 1996 period and asked NYMEX officials to provide us case documents and copies of checks so that we could develop information on NYMEX collection activity. As a result, we could comment only on the specific NYMEX cases reviewed, which are not representative of the universe of NYMEX cases for this period. Amex, CBOT, and NYMEX data also included some records on summary fines imposed for minor violations that were not provided by other SROs.

To assess the reliability of the fine collection data that SEC, CFTC, and the SROs provided, we asked officials at each agency whether they had application controls in place to supervise data entry and safeguard the data from unauthorized changes. We also asked whether they performed data verification and testing. Although controls varied across the agencies, the level of controls seemed adequate for our purposes. In addition, we performed limited testing on SEC, CFTC, and SRO fine collection data sets. We examined data fields for illegal entries (out-of-range values) and illogical relationships between fields in the same data records. We found a number of deficiencies in individual entries, such as inconsistencies in how violators' names were spelled, but they were not material to our analysis.

To verify that fines reported as paid actually were paid, and to further assess the accuracy and completeness of fine collection data, we obtained copies of checks, deposit statements, or other documents showing that fines had been paid for a small, judgmentally selected sample of closed fine cases at each agency. We selected cases to provide a range of fine amounts. To determine the reasons for which fines were waived, voided, or written off as uncollectible, we reviewed a judgmentally selected sample of cases involving these attributes at each agency where applicable.

To determine the guidance SEC, CFTC, and SROs used in setting fines for serious violations, we selected judgmental samples of cases in which the same violator had been fined more than once during 1992 through 1996. Our samples may not be representative of all SEC, CFTC, and SRO cases for 1992 through 1996. For the sample cases, we reviewed complaint documents, investigative memorandums, decision memorandums, and other case documents.

To determine the extent to which SEC and CFTC assessed the results of their disciplinary actions, including the fines they imposed, we interviewed officials at each agency. We also reviewed SEC inspection reports and CFTC rule reviews.

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We requested comments on a draft of this report from the Chairman, SEC; the Chairperson, CFTC; and the heads of the SROs. Their written and oral comments are discussed near the end of this letter.

We did our work in accordance with generally accepted government auditing standards between October 1996 and October 1998. We performed our work in Washington, D.C.; New York, NY; and Chicago, IL.

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## SEC, CFTC, and the SROs Collected Most Fines, but Collection Rates Varied

SEC, CFTC, and the SROs collected most of the over \$400 million in fines for cases they closed from 1992 through 1996. The percentage of total fine amounts collected and the percentage of fines paid in full were relatively consistent among agencies grouped according to their authorities to collect fines—SEC and CFTC; the SROs that operate securities and futures exchanges; and the two remaining SROs, NASD and NFA. SEC and CFTC have federal regulatory authority to collect fines. Securities and futures exchange members who do not pay their fines risk having the exchange sell their membership, or “seat,” to cover the fine. NASD and NFA have neither federal regulatory authority nor seats to sell to cover unpaid fines. NASD and NFA officials said they often impose fines that they never expect to collect because violators leave the industry. For the cases we reviewed, most fines reported as paid actually were paid, and SEC, CFTC, and the SROs took action when payment was considered unlikely. However, some SROs lacked automated recordkeeping systems to capture and maintain their fine collection activity.

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## SEC and CFTC Have Federal Regulatory Authority to Collect Fines

As shown in table 1, SEC collected over 80 percent of the total dollar amount of fines for cases it closed during 1992 through 1996. It collected the full amount of the fine in over 90 percent of the cases. CFTC collected over 80 percent of the dollar amount of fines for cases it closed during 1992 through 1996, and 60 percent of the fines were paid in full. The percentage of dollars CFTC collected was influenced by two cases with fines totaling \$7.25 million that were paid in full. These two fines accounted for about one-third of the total dollars fined for the period. CFTC officials told us that CFTC’s lower percentage of fines paid in full may be attributed to the longer time its fines may have been outstanding. SEC has had civil monetary penalty authority only since 1990 (Securities Enforcement Remedies and Penny Stock Reform Act of 1990), but CFTC has had this authority since its inception in 1975. Thus, CFTC had older cases than SEC in the inventory of cases closed during the period 1992 through 1996. These older cases had a greater chance of being written off.

Unlike the SROs, SEC and CFTC may bring enforcement actions in federal court or institute administrative proceedings before an ALJ. SEC and

CFTC also have the ability to seek court injunctive orders to impose fines and to collect interest from violators who do not pay. In addition, SEC and CFTC can refer unpaid fines to the Treasury Department and the Attorney General for centralized debt collection.

**Table 1: Fine Collection Rates for SEC and CFTC for 1992 Through 1996**

Federal regulator	Number of closed cases	Percent of cases paid in full	Percent of cases all/part written off	Total dollar amount of fines	Dollar amount collected	Percent of dollars collected
SEC	534	92%	8%	\$258,607,797	\$215,163,074	83%
CFTC	147	60 <sup>a</sup>	40	21,883,384	17,763,569	81

<sup>a</sup>According to CFTC officials, the cases CFTC closed during this period included 45 cases for which the fines had been uncollectible for a number of years. Excluding these cases would increase the percent of cases paid in full to over 85 percent.

Source: GAO analysis of data provided by SEC and CFTC.

## Securities and Futures SROs that Operate Exchanges Collect a Large Amount of the Fines They Imposed

Overall, as shown in tables 2 and 3, securities and futures exchanges generally collected a high percentage of fines during 1992 through 1996. Among the securities exchanges, CHX, NYSE, and CBOE collected 95 percent or more of the dollar amount of fines on their closed cases, and Amex collected 75 percent. Amex officials told us that all of the amounts uncollected were written off because the cases related to firms or individuals that filed bankruptcy or that, as a result of not paying the fine, were permanently barred or suspended from trading at Amex until the fine is paid. They said the total dollar amount of fines uncollected included three large fines of \$100,000 each, which reduced the percentage of dollars collected for Amex. However, Amex, like the other securities SROs, collected the full amount for 90 percent or more of its fines.

**Table 2: Fine Collection Rates for NYSE, Amex, CBOE, CHX, 1992 Through 1996**

Exchange	Number of closed cases	Percent of cases paid in full	Percent of cases all/part written off	Total dollar amount of fines	Dollar amount collected	Percent of dollars collected
CHX	11	100%	0%	\$87,350	\$87,350	100%
NYSE	195	95	5	9,887,000	9,731,000	98
CBOE	267	90	10	2,629,972	2,487,724	95
Amex	251	93	7	1,721,501	1,298,788	75

Source: GAO analysis of data provided by each exchange.

As shown in table 3, CME collected 85 percent of the amount of the fines on its closed cases, but CBOT collected only 54 percent. The percentage of dollars collected was lower for CBOT because of large fines that were written off. CBOT considered fines in two cases totaling \$2.25 million to be uncollectible, substantially reducing the percentage of total dollars collected. Excluding these two fines, CBOT's collection rate for the dollar

amount of fines would have been about 99 percent. We do not show information on fine amounts for NYMEX because the 31 cases we reviewed may not be representative of its actual collection activity. CME, CBOT, and NYMEX each collected the full amount of 96 percent or more of the fines they imposed for the cases we reviewed.

**Table 3: Fine Collection Rates for CBOT, CME, and NYMEX for 1992 Through 1996**

Exchange	Number of closed cases	Percent of cases paid in full	Percent of cases all/part written off	Total dollar amount of fines	Dollar amount collected	Percent of dollars collected
CME	521	96%	4%	\$2,776,650	\$2,366,950	85%
CBOT	208 <sup>a</sup>	97	3	4,953,800	2,672,438	54
NYMEX	31 <sup>b</sup>	97	3	N/A	N/A	N/A

<sup>a</sup>Representative sample selected from 477 cases closed from 1992 through 1996. The estimated sampling error is ±5 percent at the 95 percent confidence level.

<sup>b</sup>Judgmental, nonrepresentative sample selected from about 600 cases.

Source: GAO analysis of data provided by the exchange or NFA.

Members of securities and futures exchanges risk losing their membership and membership privileges, including access to the exchange trading floor, if they do not pay these fines.<sup>11</sup> Exchange rules generally allow the exchanges to revoke, suspend, expel, or otherwise terminate and sell a violator’s membership if fines are not paid within the time period allowed. Depending on the fine amount, the value of the membership, and the proceeds from its sale, the proceeds can be used to offset unpaid fines. In addition, CBOE requires members that lease seats to make a \$500 deposit that can be applied towards any unpaid fines.

### NASD and NFA Officials Said They Never Expected to Collect Many Fines Imposed

As shown in table 4, collection rates for NASD and NFA were generally lower than those shown in tables 1, 2, and 3 for SEC, CFTC, and the exchanges. NASD and NFA officials told us they recognize that in some cases fines imposed are not likely to be paid, especially when the fines are high for conduct such as egregious violations or repeat violators. Violators may leave the industry either to avoid the fine or because they are suspended or barred as part of their sanctions. In either case, fines would help remove violators from the industry and keep them from returning until they pay their fines. SEC officials told us that NASD may actually waive a fine unless the respondent attempts to reenter the industry, and therefore the fine is not actually collectible except as a reentry fee. Should

<sup>11</sup>Exchange officials told us that some seats are leased, and they would not pursue the seat owner for violations of the lessee. Therefore, the threat of having the seat sold to pay a fine is not always available.

the violators apply to reenter the industry, they would first have to pay any outstanding fines.

NASD collected 24 percent of the total dollar amount of fines on its closed cases, but 67 percent of the fines collected were paid in full. Similarly, NFA collected 27 percent of the dollar amount of fines on its closed cases, but 54 percent of the fines collected were paid in full. We could not directly verify whether these lower collection rates were due to fines that NASD and NFA never expected to collect or other reasons because we could not (1) identify cases with unpaid fines and disbarments from the data NFA provided; or (2) electronically identify these data from the over 4,000 cases NASD provided. However, NASD cases that were not paid had disproportionately larger fines than its cases that were paid, an indication that unpaid fines were set at relatively higher levels. NASD's average dollar amount for cases that were not paid was about \$59,900 compared to \$12,500 for cases that were paid. About 70 percent of the cases that were not paid had fines of \$15,000 or greater; only about 10 percent of the cases that were paid had a similar level of fines.

We found similar collection results at NFA. For example, NFA collected 2 of 11 fines that were \$100,000 or greater. A CFTC official told us that if cases involving both an unpaid fine and a disbarment were excluded from our calculations, NFA's fine collection rate would be similar to other futures SROs.

**Table 4: Fine Collection Rates for NFA and NASD for 1992 Through 1996**

Regulatory association	Number of closed cases	Percent of cases paid in full	Percent of cases all/part written off	Total dollar amount of fines	Dollar amount collected	Percent of dollars collected
NASD	4,076	67%	33%	\$113,857,938	\$27,068,247	24%
NFA <sup>a</sup>	91	54	46	3,221,050	881,300	27 <sup>b</sup>

<sup>a</sup>Data cover cases closed July 1992 through June 1997.

<sup>b</sup>NFA officials said that NFA's collection rate should be 35 percent. They said the primary difference in the rates is attributable to open regulatory fine invoices, which NFA includes as paid and we excluded. NFA cited one firm that had a \$200,000 regulatory fine invoice open at June 30, 1997, that we considered uncollected. NFA reported that it has subsequently collected \$155,000 of the fine and anticipates it will collect the balance.

Source: GAO analysis of data provided by the SROs.

Exchange memberships, or seats, are limited in number and thus have a monetary value, the loss of which can be used as leverage to enforce the payment of fines. NASD and NFA memberships are basically unlimited in number and do not involve seats. Therefore, they do not have a financial interest that can be sold to pay a fine. However, NASD and NFA registrations can be suspended or revoked or their members expelled.

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Once violators lose their membership privileges, they have little or no incentive to pay their fines. According to an NASD official, high fines effectively remove violators from the industry because the violators have no intention of paying such fines to stay in, or later returning to, the securities industry. An NFA official stated that violators who fail to pay their fines also tend to allow their memberships to terminate uncontested.

In an effort to ensure that more fines are paid, NFA has proposed a rule change that would require respondents who request hearings on disciplinary charges to post bond, which would be applied toward the payment of any pending fines. According to CFTC officials, CFTC staff objected to the proposal because the bond would be used to secure payment of the fine rather than ensure appearance at a hearing. Further, the officials said that respondents could be automatically suspended for failure to post bond, whether they were guilty or not, which could violate the respondents' right to due process. As of June 30, 1998, NFA had not resubmitted the bond proposal to CFTC for its reconsideration.

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**SEC, CFTC, and the SROs  
Had Collected Most Fines  
Reported as Paid and Took  
Action When They  
Considered Collection  
Unlikely**

For the selected cases we reviewed at SEC, CFTC, and the SROs, most fines reported as paid actually were paid. When SEC, CFTC, and the SROs determined that collection was unlikely, they took action to write off, waive, or void fines.

**Selected Fines Reported as Paid  
Actually Were Paid**

For the selected cases of fines reported as paid (see table 5), we verified that the amounts actually had been collected. We accepted as documentation that the fine was paid either a copy of a check that had been remitted to SEC, CFTC, or an SRO for payment; or other pertinent documentation, such as a bank deposit slip. We found that in most cases SEC, CFTC, and SROs had collected the full amount of the fine assessed. In some cases, SEC and CFTC even collected amounts that exceeded the assessed fine amount because of interest payments or disgorgements. For example, three cases at SEC and one case at CFTC involved amounts collected that exceeded the fine amounts assessed, each of which involved the payments of interest or disgorgements. However, 3 futures SROs could not provide documentation to show fines were paid in 4 of the 46 total cases we reviewed.

Appropriately documenting that fines are paid provides an important internal control to ensure that the money is collected and accounted for.



Although most SROs recorded fine collection activities for past and current years on computer files, CBOT kept records on a computer file only for the current year; records for past years were kept only on hard copy. Amex kept records of its fine collection activity in a hard copy ledger. Amex responded to our request for information by incorporating these data into a computer spreadsheet. NYMEX did not consolidate its records of fine collection activity but kept records in individual case files. CHX, which had only 11 disciplinary cases from 1992 through 1996, also had no computerized records.

Table 5 shows the fine amounts reported as paid and the amounts paid.

**Table 5: Amount of Fines Reported as Paid and Amount Documented as Actually Collected for Cases Reviewed**

Regulator	Number of cases reviewed	Amount of fines reported as paid	Amount documented as actually collected
SEC	20	\$8,949,768	\$8,967,850 <sup>a</sup>
CFTC	20	6,316,000	6,483,442 <sup>b</sup>
Securities exchange			
Amex	20	312,500	312,500
CBOE	21	645,246	642,698 <sup>c</sup>
CHX	3	27,000	27,000
NYSE	20	3,748,500	3,748,500
Futures exchanges			
CBOT	19	15,600	14,350 <sup>d</sup>
CME	16	110,600	108,600 <sup>e</sup>
NYMEX	15	6,700	5,750 <sup>f</sup>
NASD	15	270,998	270,998
NFA	9	267,050	258,550 <sup>g</sup>

<sup>a</sup>The amount paid includes \$6,728 in interest on two fines and \$11,354 in disgorgements and interest on another fine.

<sup>b</sup>The amount paid includes (a) \$17,000 interest on a fine of \$200,000, (b) a \$300,000 fine that had doubled to \$600,000, and (c) a \$150,000 fine that had not been paid because it had been vacated on appeal.

<sup>c</sup>The amount paid includes a \$10,948 fine that the violator was paying in installments. The violator still owed \$2,548.

<sup>d</sup>CBOT could not provide documentation for one fine of \$1,000 and another of \$250.

<sup>e</sup>CME waived parts of four fines totaling \$3,500. CME also collected \$1,500 that had been previously waived.

<sup>f</sup>The amount collected includes a fine that had been reduced from \$1,000 to \$250 on appeal. The amount paid includes a \$500 fine of which only \$300 had been paid.

<sup>g</sup>NFA could not provide documentation for one fine of \$7,500 and another for \$1,000.

Source: GAO analysis of documents provided by SEC, CFTC, and the SROs.

When SEC, CFTC, and SROs assess fines, they give violators a specific time period in which to pay. For settled cases, SEC, CFTC, and the SROs generally demand payment at settlement. In cases that are not settled, the time periods to pay fines varied. SEC said it gives violators 30 days to pay; CFTC officials said payment dates are subject to negotiation, but they

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typically give 10 days to pay. SRO rules prescribe when fines are due. For example, NYSE gives violators 45 days to pay. Other SROs give violators from 15 to 30 days to pay. These time frames can be delayed or suspended when violators request an appeal of the fines imposed. Also, SEC, CFTC, and some SRO officials told us that when the situation warrants, they can allow installment plans for payment.

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### Regulators Took Action When They Considered Payment Unlikely

SEC, CFTC, and the SROs continued to seek collection of unpaid fines using their own internal collection methods when fines were not paid within the allotted time frame.<sup>12</sup> They also initiated other disciplinary actions for the lack of payment, such as suspensions or temporary expulsions. When they determined that payment was unlikely, they wrote off, waived, or voided the fines.

For each case we reviewed in which fines had not been paid in full, the case files documented why the fines could not be collected. This documentation showed that the primary reasons that fines were unlikely to be collected were bankruptcy or failure to locate the respondents. According to an SRO official, most bankruptcy courts consider SRO fines to be unsecured debt, which usually has a low priority for payment. This official said fines owed to SROs in these cases are often discharged by the courts, making the violators no longer responsible for paying the fines. The case files also showed other reasons why fines were considered uncollectible, including that violators had been suspended or barred from the industry, had their registration revoked, or had been expelled from membership.

Two SROs, Amex and CME, had voided or waived fines. Amex officials told us that as a routine recordkeeping practice they void appealed cases from the Amex database until the appeals process is completed. Before late 1997, Amex reopened cases under new case numbers when respondents contested fines.<sup>13</sup> We reviewed 11 randomly selected Amex voided cases and found that 6 of the cases were contested fine amounts that were assigned new case numbers. Amex voided two cases because the respondents filed bankruptcy. Amex voided the remaining three cases because it had mistakenly fined persons for failure to file specific year-end reports who were not members of the exchange at that time.

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<sup>12</sup>A few of the SROs had used professional collection agencies to collect fines. However, SRO officials said the costs to collect fines using these agencies were high, and the collection agencies' success rates were minimal.

<sup>13</sup>An Amex official told us that in late 1997, instead of assigning new file numbers, Amex began to retain the same identification numbers, adding a letter "A" designation to indicate cases had been appealed.

CME officials told us that they use waivers mostly for computerized trade reconstruction (CTR) violations. Waivers release violators from payment of all or part of their fines, on the condition that they do not commit the same violation for a given time period. According to a CME official, CME's rules do not provide for the use of waivers, but its committees have found waivers to be an effective compliance mechanism. Waivers are initiated and granted by a hearing committee on the basis of violators' presentation of mitigating evidence and their historical record with the exchange. If the violators have another violation during this period, the original fines become due and additional fines can be imposed. CME is to advise CFTC of its decisions, and the violators are to report the disciplinary action to NFA. Waivers have worked well for CTR violations, said the official, because these violations are measurable and can be monitored by computer. He said that these violations have declined since 1996.

## SEC, CFTC, and the SROs Have Considered a Variety of Factors in Setting Fines

Securities and futures laws set maximum fines for civil actions and administrative proceedings, but fines can be higher than these maximums when they involve many violations or when they are based on the profits generated by the illegal activity. The courts and ALJs set fines, with input from agency enforcement staff, after considering such factors as the seriousness of the violation, the number of repeat violations, and the precedent set by similar cases. These factors were generally documented in the SEC and CFTC case files that we reviewed. All the securities and futures exchanges had prescribed fine amounts for minor violations of exchange rules and policies. For more serious violations, one SRO, NASD, had written guidance that specified ranges of fine amounts. The factors that officials from the other SROs told us they used were the same as those that SEC and CFTC considered in setting fines. At the time of our review, we could not determine the factors some SROs considered in setting fines for more serious violations because documentation was not routinely included in case files. Subsequently, the SROs provided additional documentation to show the factors they considered in setting fines for these violations.

## Maximum Fines Set by Law for SEC and CFTC

The federal securities laws provide maximum penalties in a three-tiered structure for SEC civil actions and administrative proceedings to address violations of the laws and regulations. The principal penalty provisions are Section 20 of the Securities Act, Sections 21A and 21B of the Exchange Act, Sections 9 and 42 of the Investment Company Act, and Sections 203 and 209 of the Investment Advisers Act. In the first tier, the amount of the fine is not to exceed the greater of \$5,500 for a natural person or \$55,000

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for any other person,<sup>14</sup> or the gross amount of pecuniary gain to the defendant as a result of the violation.<sup>15</sup> If the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the second tier provides that the amount of the fine is not to exceed the greater of \$55,000 for a natural person or \$275,000 for any other person, or (in civil actions only) the gross amount of pecuniary gain to the defendant as a result of the violation. If the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or (in administrative proceedings only) resulted in substantial pecuniary gain to the person who committed the violation, the third tier provides that the amount of the penalty is not to exceed the greater of \$110,000 for a natural person or \$550,000 for any other person, or (in civil actions only) the gross amount of pecuniary gain to the defendant as a result of the violation. The provisions governing the imposition of fines in a judicial proceeding and an administrative proceeding are generally the same, with differences relating to the consideration of pecuniary gain, noted above. Civil penalties for insider trading violations are defined separately and are not to exceed three times the amount of the profit gained or loss avoided by the inside trader. A person who controls an inside trader may be liable for a penalty not to exceed the greater of \$1,100,000 or three times the amount of the profit gained or loss avoided by the inside trader.

Section 6 of CEA provides CFTC the authority to impose fines in administrative proceedings of not more than the higher of \$100,000 or triple the monetary gain resulting from the violations. Section 6c provides CFTC the authority to seek penalties of \$100,000 or triple the monetary gain for each violation of the futures laws and regulations through civil actions in federal district court. In addition, Section 6b provides CFTC the authority to impose fines of up to \$500,000 for failure of a contract market (an exchange or board of trade) to enforce its rules or for any official or employee of a contract market who violates the futures laws and regulations.<sup>16</sup> In setting a civil penalty, CEA requires CFTC to consider the appropriateness of the penalty to the gravity of the violation.

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<sup>14</sup>As defined in Section 3(a)(9) of the Exchange Act, the term "person" means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

<sup>15</sup>All penalties were increased to adjust for inflation as required by the Debt Collection Improvement Act of 1996.

<sup>16</sup>In determining the amount of the penalty under this section, CFTC must consider the gravity of the offense and, in the case of a contract market, whether the amount of the penalty will materially impair the market's ability to carry on its operations and duties.

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## Factors SEC Considered in Setting Fines Were Generally Documented in Case Files Reviewed

SEC officials told us that courts and ALJs primarily consider the seriousness of the violation, the number of repeat violations, and the precedent set by similar cases in setting fines for securities law violations. In addition, securities laws provide guidance on factors to consider in setting fines. In administrative proceedings, the amount of the fine SEC may impose is to be based upon the level of intent of the violator and a determination that the fine is in the public interest. In SEC's determination of whether the imposition of the fine is in the public interest, the statute provides that it may consider the following: (1) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to others, resulting either directly or indirectly from the act or omission; (3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior; (4) previous violations; (5) the need to deter the defendant and other persons from committing such acts or omissions; and (6) such other matters as justice may require.<sup>17</sup> Further, the statute provides that SEC may consider the respondent's ability to pay on the basis of evidence submitted by the respondent in determining whether the penalty is in the public interest. In a civil proceeding, the statute does not contain the public interest test.

We found documentation in the case files for 12 of 14 judgmentally selected SEC cases that showed the courts and ALJs used a variety of these factors to set fines. However, the documentation for each of the 12 cases showed that the courts and ALJs primarily considered the violators' illicit financial gain and the precedent set in other cases to set the fines. For example, one firm was fined \$1.9 million because SEC established that this was the amount of the pecuniary gain the firm illicitly obtained from its customers. In another case, the court fined a large brokerage firm \$850,000. SEC documents showed that the court set the fine at this level because other brokerage firms had been fined similar amounts for similar violations. Most of the case files contained documentation showing that SEC considered the sanction imposed, including the fine, appropriate to deter repeat violations and to deter others from committing the same violation.

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<sup>17</sup>15 U.S.C. § 78u-2(c).

**Factors CFTC Considered Were Generally Documented in the Case Files Reviewed**

CFTC has identified certain factors that it considers when determining the amount of a fine. In November 1994, CFTC completed a study of the futures industry’s fines and provided the report to Congress.<sup>18</sup> In conjunction with this study, CFTC published a policy statement containing the major factors that have influenced CFTC in its civil money penalty assessments. These include the gravity of the offense, financial condition of the violator, and other considerations. Table 6 lists each major consideration and its influencing factors. CFTC published this list to provide a coherent statement of what it considers in setting fines, to enhance the public’s awareness of these considerations, and to provide insight into the possible future application of such authority.

**Table 6: Factors CFTC Considers in Setting Fines**

<b>Major considerations</b>	<b>Influencing factors</b>
Gravity of the offense	<ul style="list-style-type: none"> <li>—whether the violation involved fraud, manipulation, or affected market integrity</li> <li>—whether the violator acted intentionally or willfully</li> <li>—whether the violator acted in concert with others</li> <li>—number and duration of violations</li> <li>—whether the violator benefitted from wrongdoing</li> <li>—whether the violations resulted in harm to victims</li> <li>—whether the violator attempted to cure violation, disclosed wrongdoing, or provided restitution</li> </ul>
Financial condition	<ul style="list-style-type: none"> <li>—net worth of the respondent</li> <li>—business viability</li> </ul>
Other considerations	<ul style="list-style-type: none"> <li>—sanctions imposed in similar cases</li> <li>—prior misconduct</li> <li>—collectibility of the penalties</li> <li>—double jeopardy</li> <li>—conservation of CFTC resources</li> </ul>

Source: CFTC Policy Statement Relating to Its Authority to Impose Civil Money Penalties and Futures SROs’ Authority to Impose Sanctions, Nov. 1994.

Our review of a judgmental sample of 16 CFTC cases showed that CFTC followed these guidelines in setting fine amounts. Eleven of the 16 cases had documentation showing that CFTC considered the precedent set in similar cases, the violator’s net worth, or various other case circumstances to determine fine amounts. In most cases, CFTC accepted the alleged violators’ offers of settlement because the agreed-upon fine amounts and other sanctions were deemed appropriate given the violations and because the offers were similar to amounts accepted in previous cases. For

<sup>18</sup>A Study of CFTC and Futures Self-Regulatory Organization Penalties, Commodity Futures Trading Commission (Washington, D.C., November 1994).

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example, CFTC fined one large firm \$925,000 for various violations, including failure to properly segregate customer funds and failure to diligently supervise employees and their trading activities. CFTC stated that the fine was appropriate because the violations were more significant than similar violations committed by another large firm that had previously been fined \$725,000.

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### Securities and Futures Exchanges Have Fine Schedules for Minor Violations

Securities and futures exchanges have rules that contain specific fine amounts for violations of exchange rules and policies, referred to as minor violations. These minor violations include infractions of reporting, record retention, or floor decorum requirements. Minor violations are subject to smaller fines and are not considered serious violations of securities and futures laws because they do not cause the same financial harm.

The fines for minor violations on securities and futures exchanges generally ranged from \$25 to \$5,000, and in exceptional cases may be as high as \$10,000. For example, at Amex individuals violating recordkeeping requirements are to be fined \$500 for the first violation, \$1,000 for the second violation, and \$2,500 for subsequent violations. For member firms, fines for this violation and its reoccurrence were \$1,000, \$2,500, and \$5,000, respectively. At CBOT, individuals violating floor conduct rules could be fined, depending on the activity, from \$25 to \$500, with fines increasing for subsequent offenses. CBOT's Floor Conduct Committee has discretion to increase fines when minor rule violations are excessively repeated, up to a maximum fine of \$5,000.

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### NASD Has Written Guidance for Setting Fine Amounts for Serious Violations

NASD was the only SRO that had written guidelines, NASD Sanction Guidelines, for setting fine amounts for more serious violations. NASD officials told us that NASD has had these guidelines for over 10 years. The 12 NASD districts are to use these guidelines to decide appropriate sanctions, including fines, for particular violations. In May 1993, NASD made the guidelines available to its members to provide them the fine schedule and information on other actions to be taken for specific types of violations. NASD revised these guidelines, effective May 1998.

The old guidelines, which were effective for the cases included in our review, provided specific fines and other sanctions for 47 securities industry violations. For example, the guidelines provided fines that ranged from \$5,000 to \$50,000 for unauthorized transactions. For the sale of unregistered securities, the guidelines provided fines ranging from \$2,500 to \$50,000. The actual fine to be imposed generally depended upon several mitigating or aggravating factors that could increase or decrease the fine beyond the limits set forth in the guidance. For example, when NASD

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considered the specific fine amount to set for unauthorized transactions, it was to evaluate 10 factors, including whether the violator attempted to conceal the misconduct or repeated the violation. The objective of the guidelines was to guide the various district committees in an effort to achieve greater consistency, uniformity, and fairness when imposing sanctions, not to prescribe fixed fine amounts or sanctions for particular securities violations.

NASD's revised guidelines increased maximum fine amounts for some violations. For example, maximum fines for unauthorized transactions increased from \$50,000 to \$75,000. Other maximum fine amounts, for violations such as the sale of unregistered securities, remained the same. The new guidelines also grouped particular violations under 11 summary categories.

We reviewed 19 NASD cases to determine if the fines imposed fell within the ranges prescribed by NASD guidelines. We found that in 17 of the 19 cases, the fines imposed fell within the range prescribed. For example, one case involved a broker who had been fined \$50,000 and barred from the securities industry for repeated unauthorized transactions violations. These are the maximum sanctions prescribed by the guidelines. In this case, NASD noted that the two actions imposed will serve to deter any future or similar conduct by others who may be inclined to engage in similar violations.

In one case in our sample that fell outside the fine range set by the guidelines, we found a \$225,000 fine that had been imposed against a broker-dealer for unauthorized transactions and failure to supervise its employees. The maximum fine amount established for unauthorized transactions is \$50,000 and \$25,000 for the failure to supervise. NASD's files showed that NASD had noted various deficiencies in three separate examinations of the broker-dealer; thus, it had imposed a higher fine than the guideline amounts. In the other case, we found that NASD imposed a \$400,000 fine on a brokerage firm for extensively selling various securities, including derivatives, which were unsuitable for clients. The maximum fine for this violation, according to NASD sanction guidelines, was \$50,000. The case file also noted that the firm lacked written supervisory procedures and failed to adequately supervise its registered representatives, which had a maximum fine of \$25,000. The case file referred to potential losses for this firm's customers of about \$14 million, which may have influenced the fine amount, but the case file did not document a specific reason why the fine exceeded the NASD prescribed amounts.



## Other Securities and Futures SROs Allow More Flexibility in Setting Fine Amounts

Unlike NASD, other securities and futures SROs do not have specific written guidance for setting fines for more serious violations. Officials at these SROs told us that they prefer to have flexibility when setting fine amounts for violations. The officials said they set fines on a case-by-case basis, relying on the recommendations of enforcement attorneys and the discretion of an ALJ or disciplinary committee, rather than on prescribed guidelines. They said that they consider a variety of factors to determine fine amounts, including the type and seriousness of the violation; the respondent's prior disciplinary history; the monetary precedent set by other similar or like cases; and the illicit financial gain, if any.

## Securities SROs

For the judgmentally selected cases we reviewed at Amex, NYSE, CBOE, and CHX to determine how they set fines for their more serious violations, the documentation these SROs initially provided us did not always show that they considered the factors listed above. SRO officials told us that in many cases, particularly involving settlements, the internal discussions that lead to agreed-upon fine amounts are not documented. Amex, CBOE, and NYSE officials told us they prepared memorandums for each case, which provide the basis for the sanctions imposed. The officials said that the memorandums discuss possible sanctions, including ranges of fines, the current violation, the violator's disciplinary history, and precedent set in similar cases. At the time of our review, Amex, CBOE, and NYSE did not provide us these memorandums for various reasons, including that they were contained in the complete case files, which had already been archived offsite; or that they contained sensitive information. Subsequently, Amex and NYSE provided sections of these memorandums that showed the reasons why fines were assessed for the cases not already documented. CBOE did not prepare these memorandums until 1996 and did not have them for the cases we reviewed.

Of the 16 cases we reviewed at Amex, 13 files had supporting documentation to show the factors Amex considered when setting fine amounts. Each of the 13 cases involved Amex Rule 590 violations, which Amex considers minor rule violations. For example, Amex fined a broker \$50 and \$300, respectively, for his first two decorum violations and imposed a \$500 fine when he failed to wear the proper attire a third time. Documentation in the file showed that Amex considered that the latest violation was a repeat occurrence. The broker was assessed the highest amount established by the minor rule violations fines schedule for decorum violations. The remaining three Amex cases had fine amounts of \$30,000, \$50,000, and \$200,000 and involved serious violations of Amex rules or the federal securities laws. Apart from noting the type and seriousness of the violations, the case file information we reviewed for

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these three cases did not show how Amex arrived at each fine amount. However, the precedent memorandums that Amex provided us later showed the reasons why the fines were set, including precedent set in similar cases and the respondent's disciplinary history.

All of the 13 cases we reviewed at NYSE were for violations of securities laws. Six of the 13 cases had documentation to show how NYSE arrived at the fine amounts set in each case. Subsequently, NYSE provided precedent memorandums for each case that showed the reasons why fines were set for the remaining seven cases. Specifically, NYSE considered the firms' disciplinary history and precedents set in similar cases to determine the current fine amounts. For example, one broker-dealer firm was assessed a \$250,000 fine and an undertaking for failing to maintain appropriate procedures of supervision and for failing to register its securities representatives and traders.<sup>19</sup> The documentation in this case file showed that NYSE considered the firm's prior investigative and disciplinary history, which included a previous fine of \$5,000 for the same violation and the firm's continuing and repeated failures to comply with previous compliance stipulations.

Of the 20 case files we reviewed at CBOE, none of the cases contained documentation to show how CBOE arrived at setting the fine amounts. The documentation in the case files detailed only the types of violations and other sanctions imposed, such as undertakings. For example, as a result of a joint CBOE and NYSE investigation, one firm had been fined \$450,000 for various securities violations. The case file contained information on the violation and sanctions imposed, which also included an undertaking to retain an outside consultant to review and report on the firm's systems and procedures. CBOE files contained no documentation to show what factors were considered when the \$450,000 fine was set. CBOE officials told us that since late 1996, they have required each case to have a precedent memorandum that documents the reasons fines are set.

The three cases we reviewed at CHX did not contain documentation to show how the exchange set the fines.<sup>20</sup> CHX officials told us that the files did not contain documentation because CHX cases are normally concluded after the respondent makes a monetary offer to settle the case. They said

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<sup>19</sup>An undertaking is a specific action that the violator is required to take, such as prepare written supervision procedures.

<sup>20</sup>CHX had 12 cases involving fines over the 5-year period we reviewed. One of these cases was pending and 11 were settled. Because CHX officials told us that these cases had no documentation for fine amounts, we reviewed only three to verify the lack of documentation.

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they accept only settlements that are based on precedent set in previous cases.

## Futures SROs

CFTC's policy statement published after its 1994 penalties study included factors that futures SROs are to consider as guidance in determining fines. The SRO guidance contains the same factors that CFTC reported it considers in determining fines (see table 5). The policy statement also identifies other factors that the SROs indicated to CFTC that they consider, including the particular commodity involved or any pending disciplinary actions by CFTC or another SRO concerning the same offense. It states that these factors together should guide the SROs in determining the sanctions to impose on a case-by-case basis. It also suggests that futures SROs develop criteria consistent with their own regulatory experience and minimal standards of fairness for the fines they impose. For the cases we reviewed at CBOT, CME, and NFA, we found little documentation to show how these SROs set fines, including whether they considered the factors CFTC suggested. All nine cases we reviewed at NYMEX included documents showing the factors considered in setting fines. Also, CME was the only SRO that had developed additional criteria.

Two of the four cases we reviewed at CBOT had documentation that showed CBOT explicitly considered the disciplinary history of respondents to set fines as suggested by CFTC. Other than listing the type of violation, the factors that CBOT considered in setting fine amounts for the remaining two cases were not documented.

In addition to CFTC's guidance, CME has rules that list the sanctions available for major offenses, including a maximum fine of not more than \$250,000. However, CME's rules do not address the method for determining the dollar amount of fines or for choosing which sanctions to impose. Only 1 of the 10 case files we reviewed at CME contained documentation that provided some rationale for the fine imposed. In that case, CME imposed an automatic fine of \$5,000 on a violator who repeatedly exceeded a trading limit. Upon review, CME later reduced the fine to \$1,000 because the violator exceeded the limit by only 0.3 percent and took corrective actions. We could not determine what factors CME considered in the remaining nine cases.

In each of the nine cases we reviewed at NYMEX, documentation showed that NYMEX considered the seriousness of the violation and the disciplinary history of the respondents as suggested by CFTC. For example, one case involved a member firm that had been fined \$240,000 in 1994 for being undercapitalized. Documentation in the case file showed

that NYMEX considered that the firm had been warned of its undercapitalization since 1992. The file showed that NYMEX levied the \$240,000 fine because the member firm had failed to notify it of the firm's continued adverse financial status and also failed to meet the capital requirements required of NYMEX member firms.

NFA officials told us that they use CFTC guidance to set fines. Only 6 of the 14 cases we reviewed at NFA had documentation of the rationale for the fines imposed. For example, the hearing panel reduced a fine in one case, although the offense was serious and it was a repeat violation, because the violator had taken mitigating actions.

## SEC Does Not Analyze Fines Industrywide, and CFTC Does Not Document its Industrywide Analysis

Both SEC and CFTC, as part of their regular SRO oversight, reviewed the adequacy of disciplinary program sanctions and found some inadequate sanctions. However, each takes a different approach to analyze the comparative adequacy of SRO sanctions across their respective industries. SEC officials told us that they do not analyze industrywide data but instead use the results of their regular SRO inspections and meetings with senior SRO officials to assess overall SRO performance. However, analyzing industrywide data to identify changes in SRO performance over time could provide SEC an additional systematic, fact-based way to assess the comparative adequacy of SRO sanctions. In contrast, CFTC officials told us that they reviewed industrywide sanctions data periodically to identify patterns or trends in futures SRO performance that may require further review. However, they said that CFTC did not document the results of these reviews.

## SEC and CFTC Oversight Reviews Found Inadequate Sanctions

SEC officials told us that they review the disciplinary program of each securities SRO during their regular oversight inspections. They said they review a selected sample of cases to identify patterns of inadequacy in disciplinary sanctions, including fines. CFTC officials said that they review every disciplinary case included in their inspection period at each futures SRO during routine rule enforcement reviews. The reports for the reviews we examined showed that both agencies found patterns of inadequacy and recommended actions the SROs could take to improve their disciplinary programs including preventing future inadequate sanctions.

For example, 18 of the 19 SEC inspections of SRO enforcement departments performed in 1995 and 1996 included reviews of the adequacy of sanctions imposed by Amex, CBOE, NYSE, and 11 NASD Districts.<sup>21</sup> The

<sup>21</sup>During the 2-year period one inspection was completed for enforcement departments of Amex, NYSE, CBOE, and NASD Districts of San Francisco (District 1), Los Angeles (District 2), Kansas City (District 4), Dallas (District 6), Atlanta (District 7), and Boston (District 11). Two inspections were completed

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reports for 11 of the 18 inspections indicated that SEC either found SRO sanctions to be adequate or found no deficiencies. Reports for six inspections found some sanctions inadequate and recommended ways to ensure that future sanctions would be adequate. One inspection found the SRO improperly accepted an offer of settlement by a violator who had already ignored the terms of settlement and denied his guilt. SEC inspection reports completed on the market surveillance departments at NYSE, Amex, NASD, CBOE, and the regional exchanges (Boston, Cincinnati, Chicago, Pacific, and Philadelphia Stock Exchanges) also included comments on the adequacy of sanctions imposed. For example, in a 1996 inspection report, SEC found that an exchange's sanctions were inadequate in three cases, and it recommended ways to ensure that future sanctions would be adequate. SRO officials told us that they have taken actions to correct the deficiencies SEC identified in both enforcement and market surveillance departments.

CFTC reviewed the adequacy of sanctions, including fines, during at least one rule enforcement review for each of the nine futures exchanges.<sup>22</sup> CFTC found that fines were adequate at six of the exchanges and inadequate at one exchange, for which it recommended ways to improve future fines. Two of the exchanges had no disciplinary actions. Futures SROs told us that they had taken action to correct the deficiencies identified.

Apart from these reviews, CFTC officials told us that they also review all SRO disciplinary action notices filed with CFTC to evaluate the adequacy of the sanction. If the sanction appeared inadequate, they said they conduct a further review and may take action, if necessary. In one case, CFTC reviewed the sanctions imposed by CBOT at the expiration of the March 1996 wheat futures contract. CBOT had issued letters of reprimand to six members for trading after the close of the market. CFTC concluded that (1) the letters of reprimand were inadequate because they were not commensurate with the gravity of the violation, and (2) CBOT failed to follow CFTC guidance on imposing effective penalties. CBOT responded that the Commission lacked authority under CEA to institute a review of a CBOT disciplinary proceeding and that the CBOT disciplinary committee

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for NASD Districts of Chicago (District 8), Denver/Seattle (District 3a/3b), New Orleans (District 5), New York (District 10), and Philadelphia/Washington, D.C. (District 9). According to SEC officials, SEC completed one inspection for each regional exchange during this period.

<sup>22</sup>These nine exchanges included the Chicago Board of Trade; Chicago Mercantile Exchange; Coffee, Sugar, and Cocoa Exchange; New York Cotton Exchange; Kansas City Board of Trade; New York Futures Exchange; New York Mercantile Exchange; Minneapolis Grain Exchange; and the Philadelphia Board of Trade.

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did consider the CFTC guidance in imposing the penalties. In an opinion and order issued November 6, 1997, the Commission concluded that the letters of reprimand issued by CBOT were inadequate in light of the seriousness of the violations alleged. CFTC directed CBOT to reopen the proceedings against the violators and either reach new settlements or augment its prior investigations, as appropriate, and conduct full disciplinary hearings consistent with the requirements of CFTC rules.

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### SEC and CFTC Approaches to Assessing Sanctions Industrywide Differed

SEC officials told us that they do not use industrywide data to assess comparative SRO sanctions because such data are not easily quantified and are not meaningful without additional review. They said that they use routine inspections of the surveillance, investigatory, and enforcement programs of securities SROs and discussions with SRO officials to determine the comparative adequacy of sanctions. They described SEC's routine inspections of SROs' enforcement programs as follows:

SEC reviews randomly selected files of SRO enforcement cases. For each case file reviewed, SEC analyzes, among other things, the adequacy of the resolution of the disciplinary action. In assessing the adequacy of the resolution, SEC considers a number of factors, including the existence of previous violations by the subject, the level of cooperation, and the amount of financial losses caused by the violation. SEC also reviews any fine schedule contained in the SRO's rules, either as a part of the SRO's minor rule plan or general disciplinary rules. If SEC considers that the fine or sanction imposed in the case is questionable, SEC ensures that the sanction is consistent with the SRO's own fine schedule. If SEC still believes that the fine or sanction is inadequate, although consistent with the SRO's schedule, SEC will compare the SRO's fine schedule with the fine schedules of other SROs and will determine whether the fine is consistent with industry norms. In addition, in concluding whether the sanction is inadequate for purposes of the inspection report, SEC gathers information on past fines at the SRO and on current and past fines at other SROs for the type of violation. Such information is found in current and past inspection files maintained by SEC and also may be periodically requested from the SROs.

In addition, SEC officials told us that they meet quarterly with senior SRO officials to discuss, among other things, recent enforcement actions of the SROs. They said that because SEC meets with all the SROs on a regular basis and routinely inspects each SRO's enforcement program, SEC is able to assess the consistency of the enforcement and disciplinary activities both within each SRO and among the SROs.

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The industrywide information we collected for table 2 shows large differences among the securities SROs in the number of cases closed and the average dollar amount of fines imposed. For example, CBOE and Amex had over 250 cases closed from 1992 through 1996; NYSE had 195 cases closed and CHX had 11. Also, the average amount of NYSE fines was about \$51,000; the average for CHX was \$8,000. These disparities may represent differences in SRO rules, relative size, and the types of violations and other sanctions involved, or the presence of a few unusual fines. SEC officials told us that each securities SRO is an individual membership organization with its own rules, whose disciplinary committees impose sanctions, including fines, based primarily on the precedents of cases within that SRO, and differences are to be expected. However, without an analysis of the information, the disparities cannot be specifically explained.

SEC officials said their periodic inspections and meetings with SRO officials provide a more substantive, although subjective, view of the industry. This “bottom-up” approach analyzes and compares the results of individual SRO inspections to identify differences among the SROs. Although we agree that industrywide data may be difficult to quantify and need further review to be meaningful, as discussed above, the data can still be used as an indicator of the differences between and among SRO performance over time. Analyzing industrywide data could provide SEC a “top-down” approach that could supplement SEC’s reviews and provide a systematic, fact-based way to assess industrywide sanctions.

CFTC officials told us that they use industrywide data to supplement their oversight reviews of the futures SROs. They said that they have maintained a computerized database of SRO disciplinary actions since 1986.<sup>23</sup> They said they use the database to assist them in their oversight of futures SRO disciplinary programs and to analyze and assess performance between and among SROs. CFTC produces 42 statistical reports and 3 summary reports from the database, which can be sorted and analyzed in a number of ways: by respondent; SRO; type of violation; or the sanction imposed, including fines.

CFTC officials said they do biweekly reviews of these statistical and summary reports to identify patterns or trends in individual or industrywide SRO disciplinary actions that might call for further CFTC review. The officials said that some differences in sanctions across the industry can be attributed to an SRO’s size. However, when one SRO’s

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<sup>23</sup>CFTC officials said they updated the database in 1995, and the new database contains all futures SRO disciplinary actions since 1990.

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sanctions relative to other SRO's sanctions change, they said CFTC examines the data further to determine if the differences can be readily explained or they notify CFTC examiners to closely review the individual SRO's sanctions in subsequent examinations, called rule enforcement reviews. However, these officials said that they do not document their industrywide reviews of SRO sanctions data and, thus, had no evidence to show the effects of such reviews.

In its one-time 1994 study to assess the consistency of fines for various violations industrywide, CFTC reported that it could not do so because such an analysis was difficult using econometric means. However, CFTC had not yet updated its database of disciplinary actions, and the study did not focus on particular types of violations. Instead, it focused on broad categories of violations that could make the violations too unlike each other to allow anyone to reach conclusions about consistency of fines.

For our review CFTC used its database to produce the 42 statistical reports for the same 1992 through 1996 time period we selected, which showed all the sanctions imposed by each futures SRO, including the total amount of fines. A CFTC official said the data showed that CBOT fines, which are fairly consistent from year to year, were unusually high during this period because of three fines totaling about \$4.25 million. This information helps to explain the large differences that we found in the average fine amounts at CME (about \$5,300) and at CBOT (about \$23,800) during this period, which we developed from information in table 3. However, this does not indicate the appropriateness of the fines at either SRO.

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## Conclusions

SEC, CFTC, and the majority of the SROs collected most of the total dollar amounts of the fines they imposed and took action when fines could not be collected. NASD and NFA officials attributed their lower fine collection rates to the many fines they imposed that they did not expect to collect because violators leave the industry. However, they did not have readily available data for us to verify this assertion. Automated recordkeeping systems would not only provide improved verification but could help SROs, particularly those with large numbers of disciplinary cases, more efficiently capture and maintain the information necessary to track and analyze their fine collection activities.

Evaluating the relative benefits of having specific guidelines for fine amounts, as NASD does, or allowing discretion in setting fine amounts based on the facts and circumstances of a particular case, as the other regulators do, was beyond the scope of our review. We noted that the



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specific guidelines made it easier for us, as reviewers, to assess the fines for compliance. However, most SROs prefer flexibility and do not always provide complete documentation on the basis for the fines imposed. Therefore, it becomes more important to ensure that this flexibility is resulting in fines that are appropriate to the facts and circumstances of particular cases.

SROs in the same industry basically do similar business and have many overlapping members, despite the differences in their rules and membership requirements. The large differences that we found in the number of closed cases and average fine amounts among the SROs may be readily explained by such factors as the relative size of the SRO; the types of violations and the other sanctions involved; or the presence of a few very large fines, as CFTC demonstrated. On the other hand, determining the reasons for the disparities may require further, more detailed reviews. Analyzing industrywide data could provide SEC an additional tool to identify disparities among SROs that may require further review. In contrast, CFTC has the information it needs to do industrywide reviews and says it does them. However, because it does not document the results, CFTC cannot ensure that any questionable patterns or trends in overall disciplinary actions are appropriately addressed in follow-up reviews and any needed corrective actions are taken. One way for CFTC to document the results of its industrywide reviews would be to prepare periodic reports to the Chairperson or other interested CFTC commissioners and staff.

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## Recommendations

We recommend that the Chairman, SEC, analyze industrywide information on disciplinary program sanctions, particularly fines, to understand possible disparities among the SROs and identify ways to improve SRO disciplinary programs. We also recommend that the Chairpersons, SEC and CFTC, require that the results of these analyses be appropriately documented. Further, we recommend that the Chairpersons encourage SROs to maintain automated records of their fine collection activities that are appropriate for the number of fines they impose.

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## Agency Comments and Our Evaluation

SEC provided oral technical comments on a draft of this report, which we have incorporated where appropriate. In addition, SEC provided written comments (see app. I), in which it generally agreed with our findings and conclusions. However, SEC stated that comparing SRO performance based on its detailed inspections provided more substantive results than analyzing industrywide sanctions data. SEC also stated that the enforcement and disciplinary programs of the SROs vary too widely in subject and scope to be amenable to quantitative analysis of industrywide

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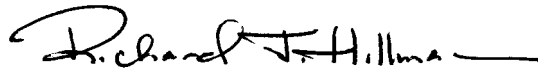
sanctions data. We recognize that such quantitative analysis, by itself, would not provide information necessary to recommend improvements in SRO disciplinary programs and would need to be supplemented by detailed inspections. However, analyzing such data can provide a systematic, fact-based way to identify disparities or changing trends among SRO disciplinary programs, such as those we demonstrated, that may indicate areas that need additional review. It might also be used, as CFTC demonstrated for the statistics we developed on futures SROs, to dispel concerns about seemingly large differences in outcomes. Further, over time, differences in the subject and scope of SRO disciplinary programs are likely to be identifiable in the statistics, and any further analysis could focus on variances from these identified relationships in the sanctions data among the SROs.

CFTC officials provided oral comments on a draft of this report. In addition to technical comments, which we incorporated where appropriate, they provided information to explain their low rate of fines paid in full relative to SEC. We have included this information in the report. Also, CFTC officials provided an explanation of how they use the futures SRO's sanctions data they collect, which we included in the body of the report. We also adjusted our draft recommendation accordingly. Further, in commenting on our draft recommendation to require SROs to maintain automated records of fines, they said that they could encourage but could not require the SROs to maintain automated records. We revised our draft recommendation language accordingly. CFTC agreed with our revised recommendations.

We also obtained oral comments from all the SROs included in our review, except NYMEX, which did not respond to our request. The SROs provided technical comments, which we incorporated where appropriate. In addition, the securities SROs provided documentation not previously made available to us to explain how they set fines. Amex and NFA commented that our methodology understated their fine collection rates. We incorporated their explanations for the differences in the report.

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We will provide copies of this report to SEC, CFTC, the SROs, and other interested committees and organizations. We will also make copies available to others on request. Major contributors to this report are listed in appendix II. Please call me on (202) 512-8678 if you have any questions about the report.

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman  
Associate Director, Financial Institutions  
and Markets Issues

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## Abbreviations

ALJ	administrative law judge
Amex	American Stock Exchange
CBOE	Chicago Board Options Exchange
CBOT	Chicago Board of Trade
CEA	Commodity Exchange Act
CFTC	Commodity Futures Trading Commission
CHX	Chicago Stock Exchange
CME	Chicago Mercantile Exchange
CTR	Currency Transaction Report
NASD	National Association of Securities Dealers
NFA	National Futures Association
NYMEX	New York Mercantile Exchange
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

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# Comments From SEC



OFFICE OF  
THE SECRETARY

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

September 25, 1998

Mr. Richard J. Hillman  
Associate Director, Financial  
Institutions and Markets Issues  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Hillman:

Thank you for providing us with an opportunity to review and comment on your draft report entitled "Money Penalties: SEC, CFTC, and SROs Collect Many Fines But Need to Better Use Industrywide Data." The report provides the results of your review of the fine imposition and collection activities of the listed organizations. It also offers recommendations on how the information obtained via the disciplinary process and collection efforts of the various agencies could be used to fulfill the respective Federal agencies' oversight responsibilities.

In general, the draft report finds that the "percent of fine amounts collected and the percent of fines paid in full varied among these agencies."<sup>1</sup> The report finds that the SEC has successfully collected 92% of the fines imposed in cases closed by the agency from January 1992 through December 1996<sup>2</sup>.

The draft report discusses in detail the statutory basis for agency fines, the process for imposing fines, the factors considered in setting amounts and the means used to track and collect fines. In this regard, the draft report notes that the SEC maintained appropriate documentation in its case files to support the decision to set a fine amount. Its fine payment records also contained documentation to support its record that fines were, in fact, paid. When a

<sup>1</sup> Draft Report, page 2

<sup>2</sup> The results obtained in this study are higher than figures reported elsewhere. This is not an inconsistency but rather reflects the fact that this study examined fines only, it did not include disgorgement awards, and it reviewed only cases formally closed by the agency. Open cases, where the agency is still pursuing collection, were not included.

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determination was made that the fine was uncollectable, the amount was written off or waived and the decision recorded.

#### Industrywide Analyses of Fines Imposed and Collected

The principal finding and recommendation in the report pertains to SEC review of the fine imposition and collection practices of the SROs it oversees. The draft report notes that different SROs have different patterns and practices with regard to the amount of fines assessed and collected. The draft report states that “Analyzing industrywide data could provide SEC an additional tool to identify disparities among SROs that may require further review.”<sup>3</sup> Accordingly, the draft report recommends that the Commission “analyze industrywide information on disciplinary program sanctions, particularly fines, to understand possible disparities among the SROs and identify ways to improve SRO disciplinary programs ... require that the results of these analyses be appropriately documented ... [and] ... encourage SROs to maintain automated records of their fine collection activities.”<sup>4</sup>

The systematic review of the disciplinary programs of the SROs is an essential component of the SEC inspection program, and we agree that comparing sanctions among SROs is an important part of that review.

While we do not believe that comparing simple numbers industrywide would be helpful, since the enforcement and disciplinary programs of the SROs vary too widely in subject and scope to be amenable to quantitative analysis, we believe the comparison can be accomplished through more substantive review during the inspection process. Currently, the SEC conducts routine inspections of the surveillance, investigatory and enforcement programs of all SROs. In addition, we have recently added to our program inspections of the SROs that focus specifically on their disciplinary programs and sanctions. These inspections include evaluations of the comparative adequacy of sanctions. For example, the staff reviews any fine schedules contained in SRO rules. If these schedules appear inadequate, they are compared with the comparable schedules of other SROs. In addition, staff routinely gather sample information on sanctions from inspected SROs and utilize this information in preparation of the inspection

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<sup>3</sup> Draft Report page 58.

<sup>4</sup> *Id.*

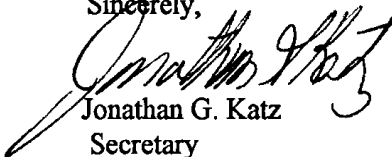
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reports and recommendations for action that are transmitted back to the SRO inspected. As with all of our inspections, we expect to continue to enhance and improve the program for review of the disciplinary process, as appropriate, and will further document our comparative reviews. In addition, we will encourage SROs to maintain automated records of their fine collection activities, as recommended.

We appreciate the careful research, care and thought that has gone into the preparation of this report. As indicated above, we agree with the substantive findings it contains and the recommendation to ensure that we fulfill our statutory mandate to effectively oversee the SROs.

Thank you for the opportunity to comment on the report. We request that this letter be appended to the final report delivered to Congress.

Sincerely,



Jonathan G. Katz  
Secretary



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