



THE CHAIRMAN

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

December 22, 2004

The Honorable George W. Bush
President of the United States
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20501

Dear Mr. President:

I am pleased to report that, overall, the management controls of the Securities and Exchange Commission (SEC) for the fiscal year ending September 30, 2004 are adequate and effective and are achieving their intended objectives in accordance with the standards prescribed by the Comptroller General. This letter fulfills the reporting requirements of the Federal Managers' Financial Integrity Act of 1982 as they apply to the SEC. A detailed discussion of the evaluation and review process supporting this conclusion is at Enclosure A.

I can provide qualified assurance, based on (1) the knowledge of the operations and evaluations conducted by the staff, (2) assurances by appropriate SEC officials, (3) the audits conducted by SEC's Office of Inspector General and the Government Accountability Office, (4) the staff and the information security program under the Federal Information Security Management Act of 2002 (FISMA), and (5) other information provided that, taken as a whole, the agency's system of controls is achieving its intended objectives under Section 2 of the Act. This qualified statement of assurance considers the following exceptions, which were reported previously and remain pending.

- The SEC has made significant progress in capturing financial information related to penalties and disgorgements ordered as a result of SEC enforcement actions. Since the beginning of 2003, it has developed a tracking system for those orders to support the SEC's fiscal 2004 financial statements. However, certain documentation and data entry issues need to be reexamined and resolved. In addition, coordination and communication among offices need further strengthening. Hence, senior management has decided to resume tracking the accounting and controls for disgorgement as a material weakness.

The SEC staff has documented a large majority of moneys owed and paid in open enforcement cases. Since the beginning of 2003, it has identified data needed for SEC financial reports, designed and instituted a system to record and report on collected data, designated and trained reporting and reviewing staff, developed manuals and procedures, and entered data on over 12,000 parties to Commission

enforcement actions. Issues concerning some large, complex or aged cases remain to be resolved. Data entered on all parties is now being reviewed for completeness and accuracy.

- Information system and security controls should be enhanced, strengthened, and communicated to all SEC staff. Many of the security administration processes performed by the SEC are not standardized or formalized. Those that are formalized have no sanctions for noncompliance. The agency also needs to ensure compliance with OMB Circular A-130, Appendix III, regarding accreditation of applications and FISMA.

The SEC is continuing to make progress in developing, implementing, and maturing its information security program. During the year, the SEC hired a Chief Information Security Officer to centrally manage and implement the various components of the program. In addition, the agency began a certification and accreditation project to ensure that all SEC major operating systems are secure. The staff also began revising information security control documents and all policies, procedures and guidelines to conform to National Institute of Standards and Technology guidelines as mandated by FISMA. The agency successfully continued its security awareness training program—4,200 SEC employees and contractors were trained in fiscal 2004—and implemented a specialized security training program for technical staff. The program is expected to be brought into compliance with all federal requirements by the end of fiscal 2006.

The SEC's financial management systems in use during 2004 were reviewed as required by Section 4 of the Act. The review was based on the principles and standards developed by the Comptroller General and implemented through OMB Circular A-127.

The results of reviews conducted of the agency's financial management systems, assurances given by agency officials, and other information provided indicate that the accounting systems, taken as a whole, are generally in conformance with the principles and standards developed by the Comptroller General and implemented through OMB Circular A-127.

The following instance of material non-conformance was identified previously and remains pending:

- During fiscal 2003, Commission officials replaced the Disgorgement and Penalties Tracking System with an upgrade to the CATS 2000 system. The financial

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components were added in fiscal 2003 and populated in fiscal 2003-2004. However, further adaptations are needed to provide more financial data integrity support, and to assure clear reporting on complex monetary aspects of judicial and administrative orders.

Late in fiscal 2004, the SEC's Office of Financial Management assumed new responsibilities for recording much of the financial data in CATS 2000. The financial management and enforcement staffs are working together to assure that the data in the replacement system is accurate, timely, and properly reported. A requirements analysis is planned for 2006 for replacement of CATS 2000.

Additional information regarding the agency's compliance with the Act and proposed corrective actions is contained in Enclosures B through D to this letter.

I would like to emphasize that the SEC is committed to the effective and efficient management of the resources entrusted to the agency.

Sincerely,

A handwritten signature in black ink, appearing to read "William H. Donaldson". The signature is written in a cursive style with a large initial "W".

William H. Donaldson
Chairman

Enclosures

Enclosure A

SECURITIES AND EXCHANGE COMMISSION
REVIEW PROCESS

Description of Organization and Structure of Review Process

The Office of the Executive Director is responsible for coordinating and overseeing the management control review process (OMB Circular A-123) and evaluations of financial management systems (OMB Circular A-127). The evaluation process is carried out by the management control officer assigned in each component, based upon instructions provided by the Executive Director. The Office of the Executive Director monitors correction of material weaknesses.

Twenty-six divisions and offices are designated as components for purposes of the management control review process. The components range in size from 8 to 643 positions with an average of 152 positions within a component at the end of fiscal 2004.¹ Agency components were identified by evaluating the organization and budgetary allocations of the SEC and its activities. This segmentation ensures comprehensive coverage of all components.

2004 Statistical Data for Review Process

	<u>Planned</u>	<u>Conducted</u>
Management Control/SEC Operations Reviews	1	1
Alternative Reviews	23	24

Percentage of Assessable Components Reviewed: 100%

Comment on Results Versus Plan

As the SEC began to hire more than 800 new staff, the Managing Executive for Operations and Management and the Executive Director determined the need to establish agency-wide guidelines for organizational structure and managerial responsibilities in order to accommodate the new staff effectively. The two executives led the SEC's Executive Review Board (ERB), which is responsible for overseeing the use of the agency's human resources, through a process to examine the current and proposed organizational structure of each division and office and to identify any necessary changes. The review process included a thorough assessment of the management responsibilities of all supervisors, managers, and senior officers, and it involved developing a framework that would ensure adequate supervision of staff and equitable distribution of responsibility and workload among supervisors and managers.

¹ All figures include overstrengths.

Enclosure A
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In addition, the Office of the Inspector General completed 23 alternative reviews in 2004. Most Commission components were reviewed. Some components underwent multiple reviews.

Finally, GAO conducted an audit of the SEC's financial statements. GAO's procedures included audits of the financial statements, the management controls over the financial systems and operating procedures affecting the statements, and the SEC's compliance with all laws and regulations applicable to the management of financial resources.

Enclosure B

SECURITIES AND EXCHANGE COMMISSION
STATISTICAL SUMMARY OF PERFORMANCE

Section 2, Management Control System

Overall Compliance Yes No Year Achieved
1983
(and all subsequent years)

Number of Material Weaknesses

<u>Period Reported</u>	<u>Reported (New)</u>	<u>Corrected</u>	<u>Year-End</u>
Prior Years	34	32	2
2000	0	0	2
2001	0	1	1
2002	2	0	3
2003	0	2	1
2004	1	0	2

Pending Material Weaknesses

<u>Category</u>	<u>Number</u>
Program Management:	
Program Execution	0
Systems Development & Implementation	0
Asset Disposition	0
Environmental Impact	0
Safety, Health-Related	0
Other (Specify)	0
Functional Management:	
Procurement	0
Grant Management	0
Personnel & Organizational Management	0
IT Security	1
Payment Systems & Cash Management	0
Loan Management & Debt Collection	1
Document Management	0
Property Management	0
Total Pending	2

Section 4, Financial Management Systems

Compliance Assurance

Overall Compliance with Section 4	<u>Yes</u>	<u>No</u>	<u>Year Achieved</u>
• Conformance with Financial Information Standards	X		1989
• Conformance with Systems Functional Standards	X		1989

Number of Material Non-conformances

<u>Period Reported</u>	<u>Reported (New)</u>	<u>Corrected</u>	<u>Pending at Year-End</u>
Prior Years	6	5	1
2000	0	0	1
2001	0	1	0
2002	1	0	1
2003	0	0	1
2004	0	0	1

Enclosure C

SECURITIES AND EXCHANGE COMMISSION
MATERIAL WEAKNESSES/CORRECTIVE ACTION

1. Information System and Security Controls

Functional Category in Statistical Summary: IT Security

Bureau/Appropriation/Account Number: Office of Information Technology

Administrative Activity/Program Activity: Data Processing--Nationwide

Pace of Corrective Action:

Year Identified: 1989

Original Targeted Correction Date: 1990

Targeted Correction Date in Last Year's Report: 2003

Current Target Date: 2006

Reason for Delay: Information security control documents, policies, and procedures are being revised to conform to National Institute of Standards and Technology guidelines. In addition, a major effort is underway to certify and accredit existing major applications and general support systems.

Description of Agency Impact: Information system and security controls should be enhanced, strengthened, and communicated to all SEC staff. Many of the system and security administration processes performed by the SEC are not standardized or formalized. Those that are formalized have no sanctions for noncompliance. The agency also needs to ensure compliance with OMB Circular A-130, Appendix III, regarding accreditation of applications and the Federal Information Security Management Act of 2002 (FISMA). The lack of formalized policies and standards for security administration leaves the SEC vulnerable to fraud, mismanagement, and abuse of government resources. In addition, failure to certify sensitive application systems may result in loss of sensitive information if a problem goes undetected due to lack of timely review.

Source of Discovery of Material Weakness: Management identified the weakness during the 1989 annual certification process, and an outside auditor noted it in a 1995 review. Additionally, a financial management system audit performed in 2002 confirmed that security controls for certain financial systems were not adequate, and that the security management role did not have sufficient authority to enforce compliance of security policies and procedures.

Critical Milestones in Corrective Action:

<u>Critical Milestone</u>	<u>Original Plan</u>	<u>Current Plan</u>	<u>Actual</u>
Final IT Security Policy	5/92	1998	12/98
Final Information Security Manual (Technical Bulletins)	6/92	2005	--
Educate Program Officials	2002	2002	2002
Revise IT Security Policy	2005	2005	
Enhance Training Awareness Program	2005	2005	
Certification and Accreditation (IT Security Review Program)	6/92	2006	--

A. Completed actions/events: The following is a sampling of completed actions in 2004:

- Hired a Chief Information Security Officer to centrally manage and implement various components of the program.
- Implemented a specialized security training program for technical staff.
- Successfully continued the security awareness program—in 2004, 4,200 SEC and contractors were trained.
- Began a certification and accreditation project to ensure that all SEC major operating systems are secure.
- Began revising information security control documents and policies, procedures and guidelines.

B. Planned actions/events (short-term, *i.e.*, next 12 months): A set of security control documents will be issued to assist in implementing the IT Security Program. Both SEC general support systems and financial applications will be accredited by the end of calendar year 2005.

C. Planned actions/events (long-term): The remaining sensitive systems will be certified and accredited. We will continue to improve the IT Security Program.

2. Disgorgement, Fines and Penalties

Functional Category in Statistical Summary: Loan Management and Debt Collection

Bureau/Appropriation/Account Number: SEC/Division of Enforcement and Office of Financial Management

Administrative Activity/Program Activity: Collections--Nationwide

Pace of Corrective Action:

Year Identified: 2004

Original Targeted Correction Date: 2006

Targeted Correction Date in Last Year's Report: N/A

Current Target Date: 2006

Reason for Change of Date(s): N/A

Description of Agency Impact: The SEC has made significant progress in capturing financial information related to penalties and disgorgements ordered as a result of SEC enforcement actions. Since the beginning of 2003, it has developed a tracking system for those orders to support the SEC's fiscal 2004 financial statements. However, certain documentation and data entry issues need to be reexamined and resolved. Coordination and communication among offices also need further strengthening.

Source of Discovery of Material Weakness: This weakness was identified by SEC officials during the preparation for the audit of the Commission's financial statements.

Critical Milestones in Corrective Action:

<u>Critical Milestone</u>	<u>Original Plan</u>	<u>Current Plan</u>	<u>Actual</u>
Review Policies and Procedures; Revise and Expand as Appropriate	2005	2005	
Conduct a Comprehensive Review of Files and Data	2005	2005	
Design and Implement Improvements to Reporting/Recordation Process	2006	2006	
Conduct Requirements Analysis for Upgraded Financial Reporting System	2006	2006	

A. Completed actions/events:

- Replaced the Disgorgement and Penalties Tracking System with an upgrade to the Commission's CATS 2000 system in 2003.

In 2004:

- Documented a large majority of moneys owed and paid in open enforcement cases.
- Identified data needed for financial reports.
- Designated and trained reporting and reviewing staff.
- Developed manuals and procedures.
- Entered data on over 12,000 parties in Commission enforcement issues.

B. Planned actions/events (short-term, *i.e.*, next 12 months): The SEC will continue work to assure that the data in the replacement system, CATS 2000, is accurate, timely and properly reported. In 2005, the staff will:

- Conduct a comprehensive review of files and data.
- Review policies and procedures, and revise as appropriate.
- Strengthen coordination and communication among offices.

C. Planned actions/events (long-term):

- Periodic evaluations of internal controls and data.
- Replace financial functions of CATS 2000 with an upgraded financial reporting system.

Enclosure D

SECURITIES AND EXCHANGE COMMISSION
MATERIAL NON-CONFORMANCE/CORRECTIVE ACTION

CATS 2000 (replacement for Disgorgement and Penalties Tracking System)

Bureau/Appropriation/Account Number: SEC/Division of Enforcement and Office of Financial Management

Administrative Activity/Program Activity: Track and monitor matters under inquiry, investigations, and enforcement actions, including moneys ordered, collected and distributed in enforcement actions.

Pace of Corrective Action:

Year Identified: 2003

Original Targeted Corrective Action Date: 2004

Targeted Corrective Date in Last Year's Report: 2004

Current Target Correction Date: 2006

Reason for Change in Date(s): The audit of the fiscal 2004 financial statement brought to light issues that still need to be addressed.

Description and Agency Impact: In response to a contractor review prepared for the Inspector General and prior reports from the GAO, management determined that the Disgorgement and Penalties Tracking System should be replaced with an upgrade to the CATS 2000 system. While CATS 2000 was adapted to accommodate tracking of moneys ordered, paid, and distributed in Commission actions, further adaptations are needed to provide further financial data integrity support and to assure clear reporting on complex monetary aspects of judicial and administrative orders.

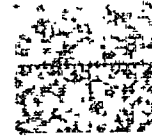
Source of Discovery of Non-conformance: The non-conformance was identified by the Office of Financial Management and Division of Enforcement during the management control review process and during the financial statement audit.

Critical Milestones in Corrective Action:

<u>Critical Milestone</u>	<u>Original Plan</u>	<u>Current Plan</u>	<u>Actual</u>
Design and Install Replacement for DPTS	2003	2003	2003
Complete Data Input Phase	2004	2004	2004
Expand System to Accommodate Tracking Moneys Ordered, Collected & Distributed	2004	2004	2004
Comprehensive Review of Data	2005	2005	
Design and Implement Improvements to CATS 2000 Recording and Reporting Capabilities	2006	2006	
Requirements Analysis	2006	2006	

- A. Completed actions/events: The following is a sampling of corrective actions completed by the SEC in 2004.
- Modified CATS 2000 system to include financial components.
 - Populated financial components.
 - Designated and trained reporting and reviewing staff.
 - Entered data on over 12,000 parties to Commission enforcement actions.
 - Transferred responsibilities for recording much of the financial data in CATS 2000 to the Office of Financial Management.
- B. Planned actions/events (short-term, *i.e.*, next 12 months): During fiscal 2005, the Enforcement Division and the Office of Financial Management will work together to assure that the data in the replacement system is accurate, timely, and properly reported.
- C. Planned actions/events (*i.e.*, long-term): In the longer-term, a requirements analysis will be conducted for an upgraded system.

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SECURITIES AND EXCHANGE COMMISSION
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