LOST AND STOLEN SECURITIES PROGRAM

EXECUTIVE SUMMARY

Section 17(f)(1) of the Securities and Exchange Act of 1934 (Exchange Act), 17 U.S.C. § 78q(f)(1), which was added in 1975, requires the Securities and Exchange Commission to administer a Lost and Stolen Securities Program (LSSP or Program). The Program's objective is to curtail trafficking in lost, stolen, missing and counterfeit securities certificates. To achieve the Program's objective, the Commission awarded a contract to the Securities Information Center (SIC) to operate a computerized database of lost, stolen, missing and counterfeit certificates.

Under the Program, most financial institutions, including securities firms, banks and transfer agents, are required to report lost, stolen, missing or counterfeit securities certificates to the LSSP database. These financial institutions must also inquire about any securities certificates valued at more than $10,000 that comes into their possession or keeping, to determine whether the certificate has been reported as lost, stolen, missing or counterfeit. Financial institutions may, on a voluntary basis, report or inquire about other securities certificates, such as cancelled securities certificates.

Beginning in 2000, Program members began voluntarily adding reports of cancelled securities certificates to the database as a result of an industry-wide initiative to make the database more complete and to assist Program participants in determining whether securities certificates that come into their possession are valid. The addition of cancelled certificates to the database has benefited the Program but has also resulted in significant increases in Program costs.

We found that the Division of Market Regulation (MR), which is responsible for overseeing the Program, and members of the LSSP Advisory Board (an informal discussion group) are generally satisfied with the operation of the Program. We also found that SIC, the contractor since the Program's inception in 1977, generally appears to be in compliance with the most recent contract (awarded in 2003).

We are making several recommendations for improvements in the Program. We are recommending that MR take appropriate steps to ensure banks' compliance with the Program's registration requirements. MR should also suggest to SIC that it expand the membership of the LSSP Advisory Board to include bank regulatory agencies and increase the frequency of LSSP Advisory Board meetings. We are also recommending that MR request additional Program information from SIC, review the current allocation of Program fees among participants (which has not changed since 1977) to determine if it should be revised, and ensure that fees charged for

making voluntary reports to the LSSP database are reasonable and consistent with the Commission's contract with SIC.

In addition, we are recommending that the Offices of Information Technology (OIT), Filing and Information Services (OFIS), and Financial Management (OFM) determine the applicability of Federal Information Technology (IT), records management, and financial management laws and regulations to the LSSP.

OBJECTIVES AND SCOPE

Our objectives were to evaluate the effectiveness of the Commission's LSSP and SIC's compliance with its contract with the Commission. During the audit, we interviewed Commission and SIC staff, staff from the Federal Reserve Board (FRB)[1], the Federal Deposit Insurance Corporation (FDIC), the National Association of Securities Dealers (NASD), the Securities Industry Association (SIA), the Federal Bureau of Investigations (FBI), clearing corporations and Program participants, such as banks, broker-dealers and transfer agents. We also reviewed relevant documentation, including Commission contract files, SIC annual statistics reports, and other documents provided by MR and the contractor. We also met with the contractor on site.

The audit was performed from September 2003 to February 2004 in accordance with generally accepted government auditing standards, except that we did not evaluate the validity and reliability of the data in SIC's LSSP database.

BACKGROUND

Description of the Program

In 1975, Congress enacted Section 17(f)(1) of the Exchange Act, 15 U.S.C. 78q(f)(1), requiring the Commission to operate the LSSP. The purpose of the Program was to curtail trafficking in lost, stolen, missing, and counterfeit securities certificates. Rule 17f-1 under the Exchange Act, 17 C.F.R. 240.17f-1, first adopted in 1976, governs LSSP operations. The Program consists primarily of a database of securities that have been reported as lost, stolen, missing, or counterfeit.

The LSSP has two major components: "reports" and "inquiries." Most financial institutions (including exchanges, banks, brokers, clearing agencies and transfer agents) are required to report any certificates that they discover to be lost, stolen, missing or counterfeit.[2] These financial institutions must also inquire about any securities certificate valued at more than $10,000 that come into their possession or keeping to determine whether the certificate has been reported as lost, stolen,

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[1] Abbreviations also listed in Appendix.

[2] See Rule 17f-1(c).

missing or counterfeit.[3] In addition to the mandatory reports and inquiries, financial institutions may voluntarily report or inquire about any other securities certificates, such as cancelled securities certificates.[4]

The Commission has chosen to operate the LSSP through a contractor, the Securities Information Center (SIC). SIC, a component of the Thomson Corporation, has administered the Program since the Program's inception in 1977. The contract is re-competed every five years and was last competed in May 2003. SIC receives all reports and inquiries, responds to inquiries, and maintains the Program's database. The contract is cost-free to the Commission. SIC earns annual revenues of approximately $6 million from operating the LSSP by assessing fees to the Program's participants. In 2002, Program participants paid costs of approximately $5.5 million, compared to industry savings of $18 million, as estimated by SIC.[5]

As of December 31, 2003, the Program had 25,714 participants, consisting of 13,855 banks, 10,927 securities organizations and 932 non-bank transfer agents. During 2003, 1,074,251 reports of lost, stolen, missing or counterfeit certificates were added to the database, and inquiries were made on 4,710,852 certificates. If an inquiry about a certificate results in a match or "hit," the inquiring financial institution is alerted that the certificate has been reported as lost, stolen, missing, or counterfeit and is not eligible for transfer. In 2003, there were "hits" on 172,200 certificates that had been reported as lost, stolen, missing or counterfeit. An additional 292,274 "hits" occurred on certificates that had been reported as cancelled.

Program Oversight

MR oversees SIC's performance of the contract. MR receives and reviews contract deliverables and consults with SIC.

MR also participates on a LSSP Advisory Board, an informal discussion group that meets periodically to discuss industry trends, challenges and Program enhancements. Other participants on the Board include representatives from the SIC, brokers, banks, transfer agents, clearing corporations, SIA and FBI. The Board has no official standing and was organized in 1995, following a suggestion by MR. SIC calls and hosts the Board's meetings.

Trends

The number of inquiries to the LSSP database has declined significantly in recent years. The number of inquires to the database, on a yearly basis, between 1999 and 2003, was 8 million, 7.3 million, 6.2 million, 5.2 million and 4.7 million, respectively. This decline is due to the reduced movement of physical certificates and increased reliance on electronic records. As dependence on physical certificates continues to decline, use of the Program to identify lost and stolen certificates will likely decrease further.

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[3] See Rule 17f-1(d).

[4] See Rule 17f-1(e).

[5] We did not verify SIC's estimate of industry savings.

Beginning in 2000, as part of an industry-wide initiative by the SIA, Program members began voluntarily adding reports of cancelled, stopped and escheated securities certificates to the LSSP database. The purpose of the initiative was to make the database more complete and to assist Program participants in determining whether securities certificates that come into their possession are valid. The vast majority of the voluntary reports in the database are reports of cancelled securities.[6] The voluntary reporting of cancelled securities appears to be consistent with the goals of the LSSP, as there have been a number of cases where cancelled securities have re-entered the market place and defrauded banks and brokers, as well as individuals.[7]

In recent years, the number of voluntary reports to the LSSP database has far exceeded the number of mandatory reports.[8] As of December 31, 2003, voluntary reports comprised 79% of total reports in the LSSP database, while mandatory reports comprised 21% of total reports in the LSSP database. Tables 1 and 2 in the Appendix reflect the composition of the database by year (1998-2003) and the type of reports added during each of those years.

Since the addition of voluntary reports to the LSSP database, the total number of hits resulting from inquiries to the database has increased significantly. (See Table 6 in the Appendix.) The number of "hits" as a percentage of certificates checked against the database also increased from approximately 4% in 2000 to nearly 10% in 2003. The addition of voluntary reports has also significantly contributed to total LSSP annual costs rising from approximately $3 million in 1999 to an estimated $8 million in 2003. (See Table 7 in the Appendix.)

AUDIT RESULTS

The Division of Market Regulation, which is responsible for overseeing the Program, and members of the LSSP Advisory Board that we contacted, are generally satisfied with the operation of the Program. SIC, the contractor since the Program's inception in 1977, generally appears to be in compliance with the most recent contract (awarded in 2003). We are making several suggestions for improvement in the Program.

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[6] The Commission has amended Rule 17f-1 to clarify that cancelled certificates that were lost, stolen, missing or counterfeit, must be reported to the LSSP. See Securities Exchange Act Release No. 34-48931 (December 23, 2003). Thus, the voluntary reporting of cancelled certificates applies only to cancelled certificates that have not been discovered to be lost, stolen, missing or counterfeit.

[7] See Securities Exchange Act Release No. 34-48931 (December 23, 2003).

[8] In 2000, some transfer agents began to add their entire inventories of cancelled certificates to the LSSP database. Once this effort is complete (which SIC estimates will occur at the end of 2005), the number of voluntary reports added to the database should decrease significantly. At that time, transfer agents will only be making voluntary reports of cancelled securities that presently come into their possession.

LSSP OVERSIGHT

Non-Registration

Unlike banks, all broker-dealers and transfer agents must register with the LSSP as a condition of registering with the Commission. This helps ensure that all broker-dealers and transfer agents are registered with the LSSP.

However, staff at the Commission, SIC and the LSSP Advisory Board agreed that not all banks required to register with the LSSP have actually registered with the LSSP.[9] Banks under the jurisdiction of the FRB and banks whose deposits are insured by the FDIC are required to register with the LSSP, absent any exemptions.[10] Some banks, particularly small FDIC banks, may incorrectly believe they are exempt from registration, while others may be unaware of the Program's requirements.

The Commission has authority to enforce §17(f)(1) and Rule 17f-1 against all entities that are required to register with LSSP under the rule, including banks. MR has communicated with the FRB and FDIC regarding the operation of the Program.

Recommendation A

MR should encourage the FRB and FDIC to ensure that their applicable member banks register with and utilize the LSSP, as required by law and regulation.

LSSP Advisory Board

The bank regulatory agencies are currently not represented on the LSSP Advisory Board. Such representation could assist MR in encouraging increased bank participation in the Program.

In addition, the Commission's procurement staff in the Office of Human Resources and Administrative Services (OHRAS) and OIT staff do not attend LSSP Advisory Board meetings and are not consulted concerning those meetings. The procurement staff have ultimate responsibility for the contract, while OIT staff could provide technical expertise on technical issues being discussed by the Board.

Recommendation B

MR should ask SIC to invite representatives from the bank regulatory agencies to participate in Board meetings. MR should also inform OHRAS and OIT of issues affecting the contract and any technical issues covered in the Board meetings.

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[9] We were unable to ascertain an approximate number or percentage of banks not registered with the Program.

[10] For example, reporting institutions that have not handled securities certificates within the last six months are exempt from registering with the Program. See Rule 17f-1(b).

The last LSSP Advisory Board meeting was more than two years ago (February 2002). Some Advisory Board members told us that semi-annual or annual meetings would be beneficial. More frequent meetings would also provide MR with additional opportunities to coordinate with the bank regulatory agencies (provided they attend).

Recommendation C

MR should suggest that SIC hold LSSP Advisory Board meetings on a semi-annual or annual basis.

CONTRACT OVERSIGHT

Reporting

SIC currently reports certain revenues as aggregate figures in its annual statistics report. This report could be more useful to MR if SIC also provided separate figures showing revenues received from each of the following sources:

- Processing inquiries;
- Adding reports of lost, stolen, missing, counterfeit, cancelled, stopped and escheated securities certificates (separate figure for each);
- Participant registration and usage fees (separate figure for each);
- Performing mandatory operations;
- Performing voluntary operations; and
- Any other significant revenue sources.

This report could also be more useful to MR if it listed the number of lost, stolen, missing, counterfeit, cancelled, stopped, and escheated reports that SIC adds to the database each year (separate number for each) and the dollar value of the certificates associated with each type of report that SIC adds to the database.

Recommendation D

MR should determine what additional annual report information would be useful and request this information from SIC. In making this determination, MR may wish to consult with the LSSP participants, bank regulators, OHRAS procurement staff, and OIT staff.

Information Technology

The LSSP contract requires certain IT-related contract deliverables (*i.e.*, risk analysis reports, system change reports and operational environment change reports) to be provided to both MR and OIT. However, only MR currently receives these documents. The MR staff that receive these documents do not have IT backgrounds. Having IT staff review the documents would help ensure that they comply with applicable security standards and IT best practice guidance.

Recommendation E

The Commission's Chief Information Officer, in consultation with MR, should designate OIT staff to review the IT-related contract deliverables (*i.e.*, risk analysis reports, system change reports and operational environment change reports) received from SIC.

FEES AND BILLING PRACTICES

Equity of Fee Allocations Among Direct Inquirers

Participants in the LSSP must register as either direct or indirect inquirers and may change their status at any time. Direct inquirers contact SIC directly to ascertain the status of a security. Indirect users make their inquiries through a direct inquirer for a fee (charged by the direct inquirer at its discretion). As of December 2003, the Program had 1,430 direct inquirers and 24,284 indirect inquirers.

Under the contract, direct users pay all Program costs. These include nominal registration and maintenance fees that are assessed for all direct and indirect inquirers. Additionally, on a semi-annual basis, the aggregate amount of all fees charged for adding reports and making inquiries (usage fees) are divided among the direct users based on their size and type of institution. This billing allocation was designed so that larger institutions (presumably larger users) paid higher fees.

The billing allocation has not changed since the Program's inception in 1977. As a result, institutions that are not considered large by current market standards may still be charged the highest level of fees. For example, a broker-dealer with $25.1 million in revenue (considered "small" by current market standards) pays the same fee as a broker-dealer with $500 million in revenue (considered "large" by current market standards). For this reason, the current billing methodology appears to be inequitable. Some direct inquirers believe that the fees they pay unfairly subsidize other larger direct inquirers.

Recommendation F

MR, in consultation with SIC and other interested parties (*e.g.*, bank regulatory agencies, NASD, the Securities Transfer Association and the Commission's Office of Economic Analysis), should review the Program's current allocation of fees to determine whether it should be revised to make it more equitable among the Program's direct inquirers, and take appropriate action.

Reasonableness of Assessing Voluntary Report Fees Among all Direct Inquirers

SIC charges all of the Program's direct inquirers for the cost of adding voluntary (as well as mandatory) reports to the database. The fees charged for adding voluntary reports are the same as the fees charged for adding mandatory reports. While fees charged for adding mandatory reports are provided for in the Commission's contract with SIC, we believe that the contract does not expressly provide for the assessment of fees for voluntary reports.

SIC and MR believe that if SIC billed only the participants that added the voluntary reports to the LSSP database, these participants would not add the reports to the database. The availability of reports of cancelled certificates in the database benefits Program participants because it assists them in determining if physical securities that come into their possession are invalid because they have been cancelled.

The addition of voluntary reports has significantly contributed to total LSSP annual costs rising from approximately $3 million in 1999 to an estimated $8 million in 2003. (See Table 7 in the Appendix.) Costs are expected to remain elevated through 2005, when SIC estimates the addition of inventories of cancelled certificates to the database will be complete.

Recommendation G

MR, in consultation with OHRAS and OGC, should review SIC's practice of billing all direct inquirers for adding voluntary reports to the system to determine if it is reasonable. MR should then determine whether the billing practice and/or the contract should be revised and the appropriate disposition of fees paid to date for adding voluntary reports.

COMMISSION COMPLIANCE WITH POLICIES AND LAWS

Information Technology

Investment Portfolio

The Commission's IT Investment Portfolio is defined as "all of its IT assets, resources, and investments owned or planned by an organization in order to achieve its strategic goals, objectives, and mission."[11]

The Commission's LSSP is not included in its IT Investment Portfolio. Including it in the Portfolio would make the Portfolio more complete and ensure that the Program is accounted for among the Commission's various IT activities.

Investment Decision-Making

The Commission's Information Officers Council (IOC) and Capital Planning Committee (CPC) review IT investment proposals of $25,000 or more. The IOC consists of senior managers from Commission divisions and major offices. The CPC is comprised of division directors. The IOC makes recommendations to the CPC on which IT projects to fund; the CPC is the final decision maker.

The IOC and CPC reviews are intended to ensure that Commission IT projects meet Federal IT requirements and are consistent with agency business processes and objectives. The IOC and CPC did not review the LSSP upon contract renewal in

[11] Commission draft SECR 24-1.1, version 1, June 2002, page 5.

May 2003. MR believed this review was unnecessary because the LSSP contract is cost-free to the Commission.

The LSSP contract cost Program users $5.5 million in 2002. Additionally, the Commission makes significant financial decisions upon contract renewal, owns the data that the contractor collects, approves user fees and negotiates contract requirements. Moreover, the contract is an IT-based contract because it involves maintaining a database, having backup and recovery procedures, and ensuring that appropriate technology is utilized.

Security

The Federal Information Securities Management Act (FISMA) enacted in December 2002, requires each Federal agency to develop, document, and implement an agency-wide program to provide information security for the information and information systems that support the operations and assets of the agency, including those provided or managed by another agency, contractor, or other source. FISMA also provides a framework for developing and maintaining minimum controls required to protect Federal information and information systems. We believe that the LSSP database may be subject to FISMA.

Recommendation H

OIT, in consultation with MR and OGC, should review the applicability of the IT Investment Portfolio, the IOC and CPC reviews, and FISMA to the LSSP and take appropriate action.

Records Management

According to OFIS, the Program's data constitutes a Federal record. As a result, OFIS should account for this data in its inventory of Commission records and establish a retention period for the Program's data.[12]

Recommendation I

OFIS, in consultation with MR and OGC, should review compliance with applicable Federal record-keeping requirements and take appropriate action.

Financial Management

Although the LSSP contract does not use appropriated Commission funds, the Commission may be required to reflect the LSSP in its financial statements.

Recommendation J

OFM should review the LSSP and determine if it should be accounted for in the Commission's financial statements, and take appropriate action.

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[12] SIC, however, may choose to retain the Program data for a longer period of time than is required under Federal record-keeping laws.

ABBREVIATIONS

CPC	Capital Planning Committee
FBI	Federal Bureau of Investigations
FDIC	Federal Deposit Insurance Corporation
FISMA	Federal Information Security Management Act
FRB	Federal Reserve Bank
IOC	Information Officers Council
IT	Information Technology
LSSP or Program	Lost and Stolen Securities Program
Mandatory Reports	Refers to reports of lost, stolen, missing and counterfeit securities certificates added to the LSSP Database
MR	Division of Market Regulation
NASD	National Association of Securities Dealers
OFIS	Office of Filings and Information Services
OFM	Office of Financial Management
OHRAS	Office of Human Resources and Administrative Services
OIT	Office of Information Technology
SIA	Securities Industry Association
SIC	Securities Information Center
Voluntary Reports	Refers to reports added to the database, other than lost, stolen, missing and counterfeit securities certificates (e.g., reports of cancelled, stopped and escheated securities certificates)

TABLES

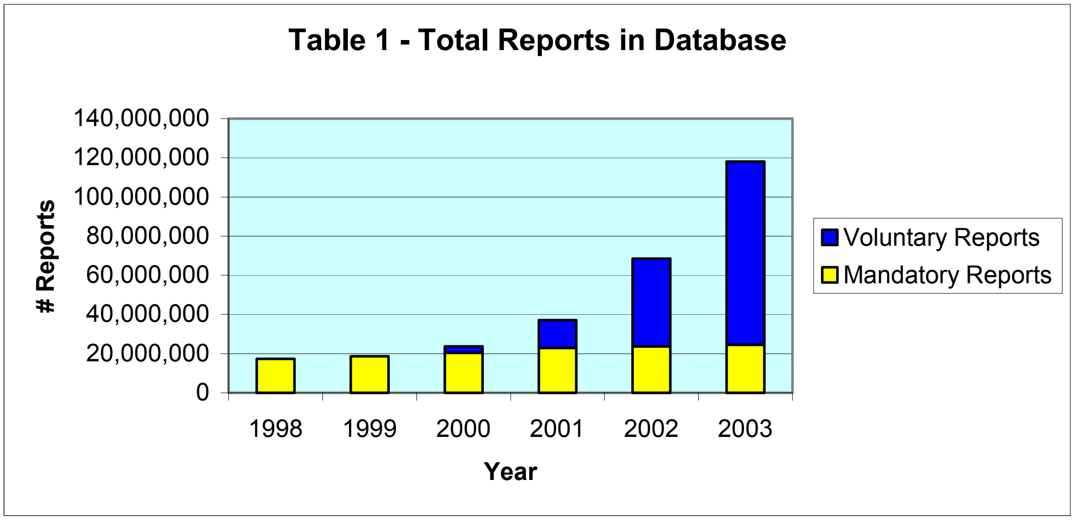


Table 1 - Total Reports in Database
140,000,000
120,000,000
100,000,000
80,000,000
60,000,000
40,000,000
20,000,000
0
Reports
1998
1999
2000
2001
2002
2003
Year
Voluntary Reports
Mandatory Reports

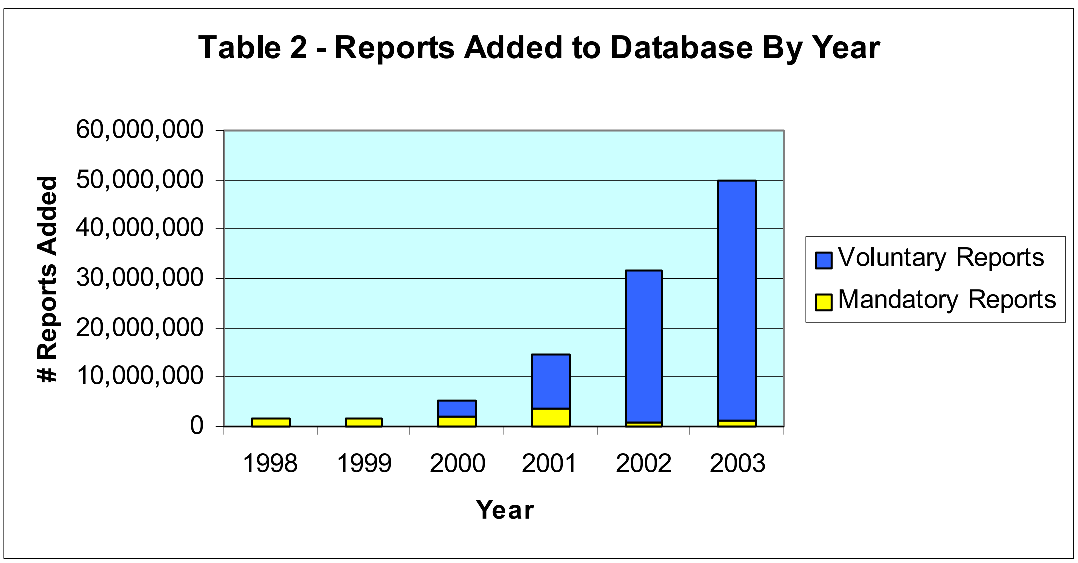
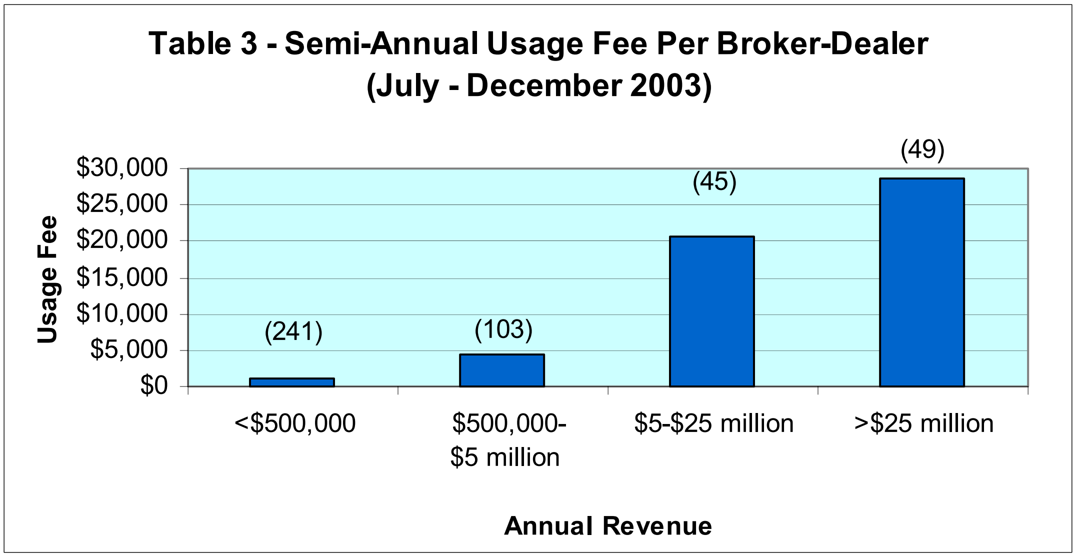
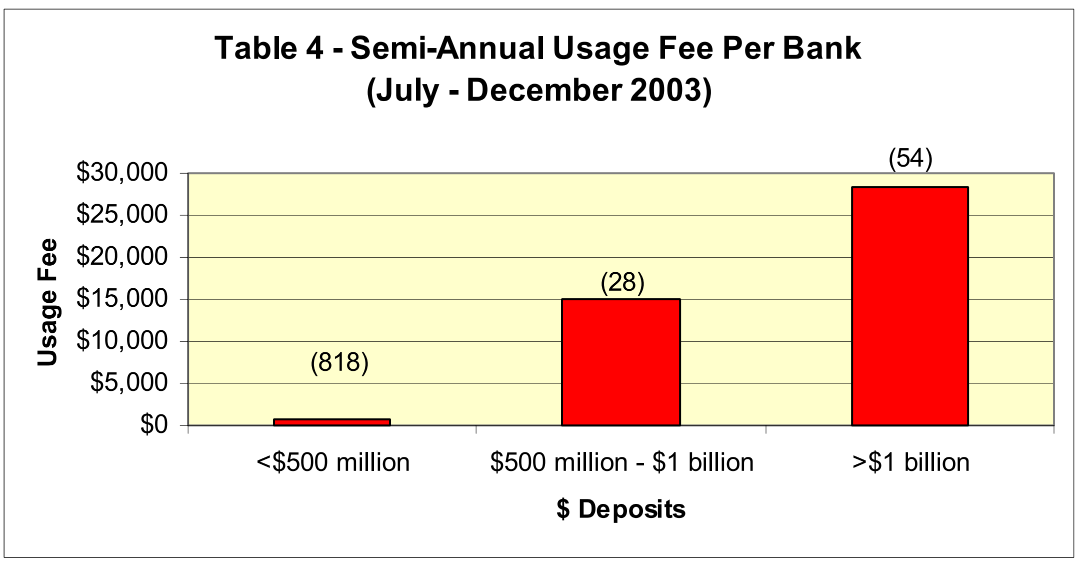


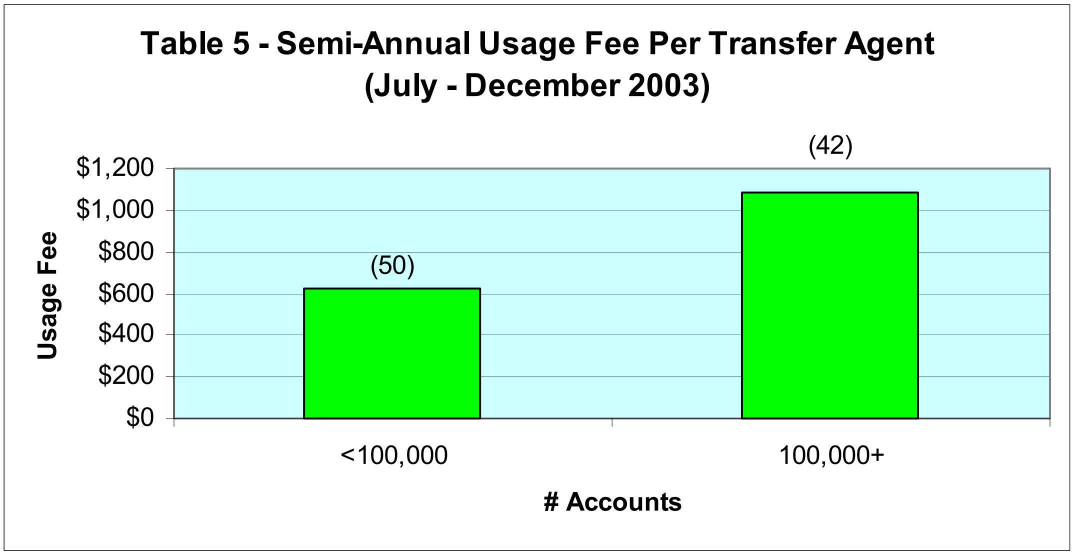
Table 2 - Reports Added to Database By Year
60,000,000
50,000,000
40,000,000
30,000,000
20,000,000
10,000,000
0
Reports Added
1998
1999
2000
2001
2002
2003
Year
Voluntary Reports
Mandatory Reports



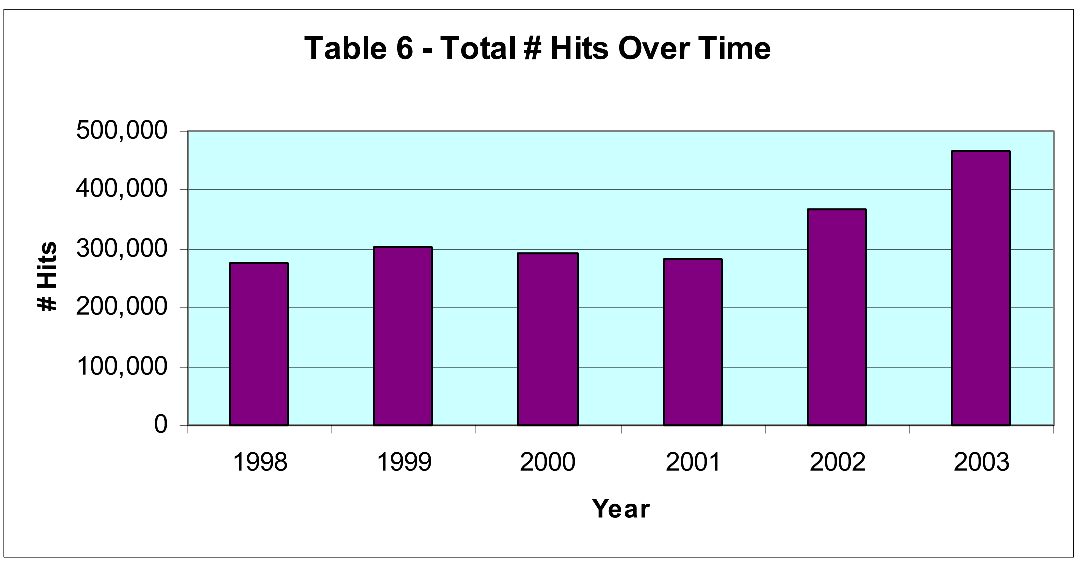
Figures in parenthesis show the number of broker-dealers registered as direct inquirers.



Figures in parenthesis show the number of banks registered as direct inquirers.



Figures in parenthesis show the number of transfer agents registered as direct inquirers.



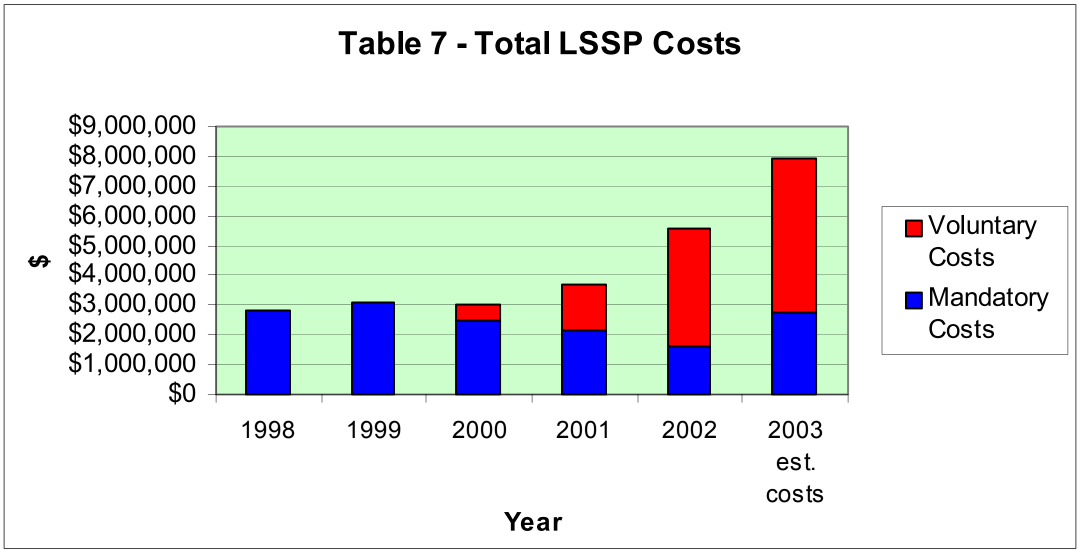


Table 7 - Total LSSP Costs
$9,000,000
$8,000,000
$7,000,000
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
$
1998
1999
2000
2001
2002
2003 est. costs
Year
Voluntary Costs
Mandatory Costs