

# Department of Corporations

## It Needs Stronger Oversight of Its Operations and More Efficient Processing of License Applications and Complaints

REPORT NUMBER 2005-123, JANUARY 2007

### *Department of Corporations' response as of July 2007*

The Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits to review the operations of the Department of Corporations (Corporations) to ensure that it is effectively fulfilling its responsibilities. Generally speaking, we were asked to evaluate Corporations' progress toward meeting the goals and performance measures outlined in its strategic plan as well as its progress toward implementing any changes needed to fulfill its goals effectively. We were also asked to review Corporations' workload studies and fee analyses to determine the extent to which it has implemented any recommendations from these efforts. Furthermore, the audit committee requested that we evaluate Corporations' education and outreach efforts in achieving its goals.

We were also asked to evaluate Corporations' licensing policies and practices to determine if they are efficient, protect consumers, and prevent fraudulent applications from being processed. The audit committee requested that we review a sample of each type of license issued to determine whether the policies are applied consistently and to determine the length of time it takes to issue a license. It also asked that we assess Corporations' policies and practices related to the monitoring of licensees, including the number and frequency of licensee audits that are conducted and the effectiveness of the audits. Finally, we were asked to identify the number of complaints Corporations receives annually and to evaluate its policies and practices for handling complaints, including its process for monitoring the ongoing investigation of complaints, the types of enforcement actions taken, Corporations' ability to enforce actions taken as a result of complaints, and its criteria for deciding to reject a complaint or to turn it over to another enforcement agency.

### **Finding #1: The fees Corporations collects result in an inequitable distribution of charges among licensees and an excessive fund reserve.**

Corporations, which does not receive support from the State's General Fund, supports its operations through revenues earned from fees charged for processing applications for notices, registration certificates, permits, and the initial issuance and renewal of licenses. We found that since 2001, Corporations has not analyzed the licensing and examination fees it charges businesses to determine whether the fees matched its costs of providing the related services. As a result, certain licensees are subsidizing costs for others because Corporations overcharges for some fees and undercharges for others. For example, revenues from securities fees have exceeded the related service costs for six of the last seven fiscal years. The amount of excess revenues from these fees ranged from \$750,000 to \$9.1 million and totaled \$22.2 million during this time. By contrast, the service costs for nine other business activities Corporations regulates have exceeded

### **Audit Highlights . . .**

*Our review of the Department of Corporations (Corporations) revealed the following:*

- » *Corporations' current fee structure results in certain licensees subsidizing the administrative costs for others. For example, revenues from securities fees have exceeded the related service costs by \$22.2 million over the last seven years.*
- » *Corporations has taken important steps in strategic planning for its operations, however, these efforts are undercut by inaccurate statistical information about its actual performance as reported in its monthly and quarterly performance reports.*
- » *Corporations does not always process applications within the time limits set by state law. In fact, for applications submitted between January 2004 and May 2006, the average processing time exceeded the time allowed by law for many of the application types we reviewed.*
- » *Although there is no legal requirement dictating the length of time Corporations has to resolve complaints, we found examples of unnecessary delays in a sample of complaints we reviewed.*
- » *Corporations has three primary information systems for capturing complaint related data; however, none of them are reliable for determining the number, type, and status of its complaints because the systems contain too many blank fields, duplicate records, and errors.*
- » *Corporations did not conduct required examinations of at least 170 licensed escrow offices and 899 licensed finance lenders within its four-year goal.*

the revenues generated from their respective fees by \$21 million over the last seven fiscal years. The overcharging of certain licensees has not only covered the undercharges for other services but has also contributed to the buildup of a large reserve in the State Corporations Fund. We anticipate that this reserve will exceed statutory limits at the end of the current fiscal year.

Fees for the licenses processed by Corporations are generally set by statute. Although Corporations has limited authority to set fees below the statutory maximum for businesses that deal with certain securities transactions, offer investment advice, or act as broker-dealers, the only way it can increase fees above the statutory cap is to seek a change in the law.

To strengthen its operational oversight, we recommended that Corporations seek legislative authority allowing it to set fees by regulation. This legislative authority should require that Corporations annually assess its fee rates and establish fees that are reasonably related to its cost of providing the services supported by its fees. Corporations should also factor in the amount of any excess reserves when conducting its annual assessment.

***Corporations' Action: Partial corrective action taken.***

Corporations submitted a placeholder bill, AB 1516, which would have allowed the commissioner to adjust fees to reflect the actual cost of regulatory services for each law and program. However, although the Legislature preferred to maintain the existing structure outlined in statute, Corporations plans to submit a proposal in January 2008 that will change the statute to provide the commissioner limited authority to adjust fees while maintaining legislative oversight.

Corporations currently has statutory authority to make the adjustments necessary to eliminate deficits in some programs and indicated it has done so to the extent possible. For those programs where there is a cap on the assessed fee that limits its ability to make adjustments, Corporations stated it has adjusted the fee to eliminate the deficit in two fiscal years. Corporations also stated it will annually review its other rates to determine if the fees are sufficient to support program activities. If the attempt to obtain limited authority to adjust fees is denied, Corporations will request a fee adjustment from the Legislature for programs that have fees set in statute and have a deficit or surplus. Finally, Corporations stated it would review and adjust the reimbursement rate for examinations performed.

**Finding #2: Corporations has made a good start on its strategic planning but needs better information about its actual performance.**

Corporations has taken important steps in strategic planning for its operations, establishing a framework to identify its strengths and weaknesses with the goal of eliminating inefficiencies and increasing productivity through an examination of its current policies and procedures. Corporations' efforts include creating three interrelated documents—a strategic plan, a program-level action plan, and periodic statistical performance reports—designed to establish its goals and measure its effectiveness in meeting those goals. However, the effectiveness of its strategic planning effort is undercut by inaccurate statistical information about its actual performance as well as by the cumbersome methods used to compile the information for the performance reports. We found errors in the manual compilation of three of the 10 performance measures we reviewed. For instance, Corporations reported that the percentage of other securities regulation applications actually processed on time was 96.5 percent, but we calculated it to be 89.5 percent. Although this relatively small difference might not change Corporations' assessment of the need for change in the area, it does illustrate the need for more accurate reporting.

Corporations' systems for collecting its actual performance information are also cause for concern, because of inefficiencies and the potential for errors. Depending on the performance measure, Corporations uses both manual and automated systems to collect the information, and it then manually compiles that information for summary in a performance report. An automated system, with all necessary information accurately reported, would be more efficient and reliable. Currently, the

information used to produce the reports comes from a variety of sources, such as forms, data system queries, spreadsheets maintained by team leaders, and other documents that may or may not be reviewed for accuracy. We found one instance in which staff used informal notes, rather than standard time sheets, to report the time worked on applications. Each month, certain Corporations' staff must generate statistics by performing time-consuming manual calculations and then must input the results into a separate form for the report.

To improve the efficiency and effectiveness of its system for collecting actual performance measure information, we recommended that Corporations do the following:

- Consider assessing the need for new automated data systems or determining whether its current systems are capable of collecting the necessary information.
- Ensure the accuracy and completeness of the information in its automated systems by requiring staff to enter the information and requiring supervisors to review it periodically. For data not currently available in automated format, Corporations should develop stronger procedures to ensure that staff accurately report and supervisors accurately review the information. Corporations should consider calculating and reporting performance measures quarterly, rather than monthly, until it has a more efficient data collection system.
- To ensure that it has identified all necessary performance measures and appropriately focused its current performance measures, Corporations should continue to assess the reasons for performance deficiencies and add or adjust performance measures as needed.

***Corporations' Action: Partial corrective action taken.***

Corporations indicated it has met with the Department of Finance (Finance) to discuss the process to obtain or update its automated data systems and has issued a Request for Proposal for a needs assessment and feasibility study. Corporations also expects a contractor to soon begin the needs assessment and prepare a feasibility study report and expects to submit the report to Finance by January 2008. According to Corporations, databases have already been created to capture significant dates in the application process and the initial use of the databases began in June 2007.

Corporations indicated it has implemented procedures that require staff to confirm the accuracy of information posted in its automated systems prior to exiting the system. Further, Corporations stated that under its new procedures managers or supervisors will review source documents on a sample basis and ensure that information on the source documents matches information in the electronic file. The procedures also direct managers and supervisors to review their automated systems monthly for blank fields and request that staff research and complete the data fields with the appropriate information. Further, Corporations indicated that managers will counsel and provide training to employees who consistently make errors when posting information to the automated systems.

Additionally, Corporations stated that it modified its procedures that allowed more than one complaint file to be created in the data system for the same complaint. Among other things, these procedures require a supervisor to review the listing of complaints for duplicate files. Additional procedures are also being developed for the review of other data related to complaints. Finally, under its modified procedures Corporations stated its legal counsel will perform a monthly review of the data fields in the Enforcement Case Management System to ensure that all fields are completed and any deficiencies will be discussed with the assigned counsel and the correct information will be posted in the system.

Corporations indicated that the Securities Regulation Division (securities division) has completed an initial review of performance measures to identify deficiencies and determine what caused the deficiencies and develop corrective action plans to meet performance measures. According to Corporations, the securities division will also re-evaluate performance measures, baselines and targets for appropriateness and accuracy. Managers will evaluate and report quarterly to executive staff performance deficiencies and their corrective action plans.

Corporations stated that the Financial Services Division (financial division) will review and monitor processing times and compare them with benchmarks on a quarterly basis. Further, the financial division will develop corrective measures to address any issues identified and develop new, more appropriate measures that are achievable.

**Finding #3: The effectiveness of Corporations' outreach unit is uncertain.**

Corporations does not collect enough data or identify sufficient goals to effectively assess its education and outreach efforts. One of Corporations' Education and Outreach Unit's (outreach unit) primary programs is its Seniors Against Investment Fraud (seniors program), which is designed to educate senior citizens about investment fraud and how to protect their finances from predatory schemes. In its budget change proposal for fiscal year 2005–06, Corporations requested \$400,000 in ongoing permanent funding for the seniors program (and received \$225,000). The proposal identified 12 performance measures intended to aid Corporations in evaluating the achievement of the objectives of the seniors program. However, Corporations does not collect data for four of these measures. For example, when it sought funding for the program in fiscal year 2005–06, Corporations stated that it planned to track the number of seniors program volunteers by geographical area; it had not done so as of December 2006. Corporations does not track any data for three other performance measures because, according to the director of the outreach unit, the measures are not clear. Further, although Corporations collects data for eight of the 12 performance measures, it measures its effectiveness for only two—the number of publications disseminated and the number of presentations given—by comparing them to established goals. However, without sufficient data and relevant benchmarks, it is impossible for Corporations to effectively assess its overall performance in protecting senior citizens from investment fraud.

Moreover, Corporations has not developed any formal goals to effectively measure the success of its other primary program—the Troops Against Predatory Scams Investor Education Project (troops program). The troops program was funded by a grant that requires that Corporations collect data and report the results on seven performance metrics. However, Corporations has not established any formal benchmarks to gauge whether or not its efforts were successful. As a result, Corporations cannot assess whether the program is achieving the desired results.

To ensure that the outreach unit can effectively measure its success, we recommended that Corporations should ensure that it collects all of the necessary data and establishes reasonable benchmarks.

***Corporations' Action: Corrective action taken.***

According to Corporations, in January 2007, the outreach unit developed a monthly reporting form that will capture the number of seniors program partners and training kits distributed. Corporations also stated that the outreach unit also revised existing performance measures and benchmarks based on relevancy and accuracy. The outreach unit eliminated six of the existing 12 performance measures and replaced them with four new performance measures. Data will be collected monthly and measured against the benchmarks.

**Finding #4: Corporations does not always process applications within the time limits set by state law.**

State law requires Corporations to assess the completeness of applications and notify applicants in writing of any deficiencies in the applications within specific time frames, and either issue or reject the application within a specified time period. We found that Corporations does not always process applications within the time limits set by state law. For example, of the 35 applications we reviewed, we noted 10 instances where Corporations did not comply with the statutory time frame for processing applications. Delays could result in entities being unable to conduct business. Delays may also increase the likelihood that businesses will conduct unlicensed financial transactions. However, while Corporations is responsible for the delays in processing some license applications, other factors outside of its control also contribute to lengthy processing times. For instance, license applicants do

not always provide the required information when submitting applications. Deficiencies in applications and delays in correcting them create additional work for Corporations' staff and can substantially delay the issuance of licenses. We found that Corporations issued deficiency notices for 32 (91 percent) of the 35 applications we reviewed. Although application requirements can be somewhat daunting, they did not appear to be overly complex. According to Corporations, these delays generally occurred because of a backlog resulting from a large increase in the number of applications submitted in recent years and some applications requiring a more extensive review.

In addition, Corporations does not have complete data for some of its license applications. We found that the application system data related to corporate securities and franchises contain omissions and inaccuracies, hampering Corporations' ability to compile accurate performance statistics.

To ensure that all applications are reviewed promptly and sufficiently, we recommended that Corporations do the following:

- Continue to monitor the progress of applications through the review and approval process to identify any that have stalled, and investigate the reason for the delay.
- Follow the law in notifying applicants once their applications are complete.
- Follow up with applicants that do not promptly respond to deficiency notices.
- Assess whether it needs additional staff to process applications.
- Maintain all necessary data in its information management systems so that it can effectively calculate the number of days it takes to process applications.

***Corporations' Action: Partial corrective action taken.***

Corporations stated that it reviewed its procedures for processing applications submitted to its securities division in order to streamline the process to focus on the most critical factors in an application. According to Corporations, this process, along with hiring a retired annuitant, has significantly reduced the backlog of applications pending review.

Additionally, Corporations stated that the financial division has revised its procedures for processing applications to include having staff notify supervisors when an application has stalled. The reason for any delays will be determined and corrective action taken. Managers will also review a log or aging schedule to determine if any applications have stalled. These revised procedures will be written and included in an applications procedures manual. Further, Corporations indicated that it has developed and will maintain the data necessary to calculate the number of days it takes to process applications.

According to Corporations, it has revised the letter it sends to applicants notifying them that their application has been approved. The revised letter will now include both a reference that the application is complete and has been approved. Corporations also stated that it has developed a tracking mechanism that notifies staff at established intervals that an applicant has not responded to a deficiency notice. In these instances Corporations stated that staff will prepare a follow-up letter notifying the applicant that Corporations will close the application if the requested information is not received by a given date. A second notice will be sent if the information is not received and, if no response is provided, Corporations will close the application.

Corporations indicated that it is in the process of identifying the average number of staff needed to handle its normal workload. Corporations will also review the log of outstanding applications to determine if it is necessary to redirect resources, if possible, to prevent a further buildup of applications. Additionally, Corporations stated it is developing an overall plan to determine if additional resources are needed in various program areas and, if so, will seek those additional resources in the budget process.

Finally, Corporations stated that it has developed policies and procedures for ensuring that all applications received are logged for date of receipt, date approved/license issued, and the number of days for completion. The policies and procedures also require documenting the reasons for any extraordinary issues that delay processing.

**Finding #5: Corporations is working to improve its handling of complaints.**

Either the securities division or the enforcement division typically handles complaints related to securities regulation. Of the 20 complaints related to securities regulation we reviewed that were closed between May 20, 2005, and July 18, 2006, nine were referred to the securities division. It took the securities division an average of 312 days, ranging from 55 to 531 days, to resolve these nine complaints. The remaining 11 complaints related to securities regulation were referred to the enforcement division and took an average of 170 days to resolve, ranging from 20 days to 383 days.

The time Corporations takes to resolve complaints is contingent on many factors. For instance, the complexity of the case, the availability of staff, and the time it takes for complainants to respond to Corporations' inquiries all may contribute to the length of the process. Moreover, there is no legal requirement dictating the length of time Corporations has to resolve complaints. Thus, we expected the number of days Corporations took to resolve securities regulation complaints to vary depending upon the circumstances of each case. Nonetheless, during our review, we identified four complaints in which unnecessary delays increased the length of the process. For example, the securities division did not begin its investigation of one complaint until 277 days after the complaint was received. In another instance, the enforcement division took 176 days to refer a complaint to the securities division for further action, during which time nothing was done to address the complainant's concerns. Corporations' management could not explain these delays.

Moreover, we reviewed a sample of 20 complaints related to financial services that were closed between November 29, 2004, and August 8, 2006. We found that Corporations took between 35 and 232 days to close these complaints, averaging 106 days. Unlike its process for handling complaints related to securities regulation, Corporations handles financial services complaints by sending letters to licensees requesting them to respond in writing to the complaint allegations within 15 days. Delays can occur if the licensee does not respond within the 15-day time frame. However, we found some instances in which unnecessary delays on Corporations' part increased the length of the process. For example, in four of the 20 complaints we reviewed, Corporations took between 34 and 210 days to send letters to the complainants notifying them that it had begun its review, exceeding its 30-day goal. In two of the four cases, Corporations' staff did not forward the complaints to its financial division for handling for 28 and 38 days, respectively. However, Corporations' staff forwarded the two remaining cases in less than six days.

Corporations has recently modified its procedure for handling complaints. In addition to developing formal policies for rejecting and referring complaints, it has centralized the intake of all complaints by forwarding them to a new complaint team. Corporations believes that this new process will allow it to respond immediately to complaints and prepare each complaint for referral to the appropriate division. Because Corporations initiated this process near the end of our fieldwork, we were unable to test whether it will correct any of the weaknesses we identified. However, it appears that the process contains good business practices.

To improve the efficiency of its complaint-handling process, we recommended Corporations do the following:

- Develop procedures to track the progress of complaints to ensure that they continue to move through the process without unnecessary delay.
- Monitor its newly established complaint-referral process and develop procedures, if necessary, to decrease the length of time it takes to refer cases to the appropriate division.

***Corporations' Action: Corrective action taken.***

Corporations stated it established a complaint team in August 2006 that revised the processing of complaints. As a result, Corporations stated that the time to respond to a complaint has been shortened. The complaint team also developed a monthly report that tracks the number of complaints received, the backlog of complaints, responses to complainants, and the average number of days it takes to process complaints. Additionally, Corporations stated that the enforcement division has developed plans and goals that involve completing case investigations and either taking action or closing a case, as appropriate.

Corporations stated it will continue to monitor its complaint-referral process to look for additional ways to decrease the timeframes for processing complaints. Additionally, an executive staff member will review the complaint-referral procedures and protocols and provide recommendations to the commissioner on how to improve the process.

**Finding #6: Information systems containing data regarding complaints are unreliable.**

Although it has three information systems for tracking complaint data, Corporations undercuts these efforts by failing to ensure that any of the three systems contain reliable data. Several of the critical data fields in Corporations' Customer Relationship Management (CRM) system and Corporations' Customer Service System (CSS) were often left blank, limiting the usefulness of these systems as management tools. For example, the fields needed to calculate complaint processing times, such as date received, date assigned, and date opened, were blank 9.5 percent, 25 percent, and 68 percent of the time, respectively, for the CRM system. Consequently, these fields cannot be used to determine where a complaint is in the resolution process or to monitor and evaluate complaint-processing times. In addition, we found that the field identifying the specific law a complaint was related to was left blank for more than 24 percent of the 2,876 complaint records in the CSS and for 50 percent of the 2,461 complaint records in the CRM system. Without this information, Corporations cannot determine how many complaints it receives about alleged violations of various laws and cannot effectively identify problem areas or adjust its workforce to handle them.

Moreover, we found several types of data entry errors in Corporations' complaint systems. For example, the CRM system did not reflect the correct status for many of the complaints we reviewed. The status field can be used to indicate the disposition of a particular case, such as closed, in progress, or referred. However, the CRM system listed an incorrect status for 13 of the 20 complaints we reviewed. In each of these cases, the CRM system indicated that the case was still in progress, even though all of them had been closed. Thus, Corporations cannot rely on the system to determine the number of complaints still in progress, completed, or referred to another division. We also found that the CRM system did not reflect the correct date received for eight of the 20 complaints we reviewed. Specifically, the date entered into the CRM system as the date received did not agree with the supporting documentation for four of these complaints, and it was left blank for the others. Similarly, we found data entry errors for the field intended to capture the date a complaint was received in three of the 20 complaints we reviewed in the CSS. In addition, six of the 34 enforcement actions we tested in the Enforcement Case Management System reflected an incorrect date for when the action occurred, limiting the usefulness of the system as a management tool.

To improve the usefulness of its information systems, we recommended that Corporations review its existing complaint records and eliminate duplicates and correct any inaccurate fields. Further, Corporations should maintain accurate and complete data to ensure that the information systems can be used more effectively as management tools.

***Corporations' Action: Pending.***

Corporations did not fully address our recommendations in its response. Specifically, it noted that the enforcement division is reviewing its case management system to determine how to improve it. Options include using more fields of data and creating reports that would capture data to assist management using trends and workload issues. However, its response did not directly address our recommendation to review its existing complaint records and eliminate duplicate records and correct any inaccurate fields.



**Finding #7: Corporations failed to perform required examinations of some licensees.**

Corporations did not conduct examinations of many of its escrow licensees within the time frames required by law. Additionally, Corporations did not conduct examinations of its licensed finance lenders as frequently as required by its internal policy. Consequently, Corporations' ability to protect consumers against potential fraudulent lending and financing scams was weakened.

The California Financial Code requires Corporations to conduct examinations of licensed escrow offices and mortgage lenders at least once every four years. In addition, although not required by law, Corporations has established a goal for examining every licensed finance lender at least once every four years. However, Corporations did not conduct examinations of many escrow offices and finance lenders within the last four years. Specifically, we found that at least 170 licensed escrow offices and 899 licensed finance lenders—representing 37 percent and 35 percent, respectively, of all such licensees that required examinations—have not had an examination for at least four years. Corporations was more effective with its examinations of mortgage lenders; only two licensed mortgage lenders—less than 2 percent—did not receive the required examination within at least the last four years.

Corporations also lacks clear guidance for conducting examinations and following up on the deficiencies it identifies. For example, it does not have any policies or procedures on the time frames within which examiners must follow up on licensees' responses to deficiencies identified during an examination. In a sample of 20 examinations performed by the financial division, Corporations' examiners identified a total of 112 deficiencies related to 17 of the examinations; the remaining three did not identify any deficiencies. The identified deficiencies included improper charges, unauthorized disbursements from accounts, and altered checks. When we followed up on six of the 17 examinations that identified deficiencies, we found that in four cases the examiners took between 79 days and 187 days to provide a response to the licensees after they had responded to the deficiencies. We expected Corporations to have established response time frames to ensure the prompt resolution of any deficiencies.

We recommended that Corporations develop a plan to conduct examinations of licensees in accordance with state law and its own internal policy. Corporations should also establish clear guidance and response time frames for following up on deficiencies identified in examinations.

***Corporations' Action: Partial corrective action taken.***

Corporations stated that it has identified the number of licensees that need to be examined based on statutory requirements or internal policy, as well as the average hours per exam. Additionally, Corporations received 30 additional examiner and enforcement positions in the fiscal year 2007–08 budget. Nevertheless, Corporations stated it will evaluate current staffing levels to determine whether sufficient staff exists to perform the required exams. If staffing levels are insufficient after staff redirections from other programs, Corporations stated it will pursue additional staffing through the budget process. Corporations also indicated that it developed procedures in September 2007 to review enforcement actions taken to determine compliance by licensees, to evaluate the enforcement action, and to identify high-risk candidates for follow-up non-routine examinations.