



State of Nevada
Governor's Finance Office
Division of Internal Audits

Audit Report

**Office of the Secretary of State
Securities Division**

Report No. 17-02
February 2017

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Office of the Secretary of State,
Securities Division

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Objective: Can the Secretary of State, Securities Division Improve Effectiveness of Operations?

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Modifying statute to designate a portion of registration fees to fund enforcement operations will provide a more effective way to budget costs. Modifying statute to exclude penalties and fines from funding enforcement operations will ensure greater transparency and eliminate potential conflicts of interest. Currently, the division relies on penalties and fines to fund enforcement operating costs. However, trends show declining penalties and fines that are not covering operating costs. The current funding statute allows for a potential conflict of interest. The administrator is given recommendations from investigative staff for penalties and fines; however, the administrator has final determination of penalties and fines for enforcement cases and has knowledge of the division's operating costs. Consequently, this may present a conflict of interest as the administrator has the authority to impose penalties and fines to cover enforcement operating costs.

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Improving documentation and monitoring of division reports on inspections and investigations will help ensure reporting on enforcement cases is complete and cases are processed in a timely manner. Based on our sample testing, we found case completion took about 17 months for inspections and up to 26 months for investigations. The division reports staffing shortages may have affected case completion rate and have recently filled two long term vacancies.

We also found incomplete monitoring reports used by management to monitor cases. Investigators and supervisors do not consistently document their status and actions on reports used by management to monitor cases. Lack of complete monitoring reports hinders management's ability to quickly access and assess the status of an enforcement case. Until the division acquires a comprehensive case management system or improves documentation with current monitoring reports, management may continue to be hindered in effectively monitoring the progress of enforcement cases.

The division's effort to field a comprehensive case management system will provide a centralized system that will also allow managers to collect and assess the progress of cases, including cost information, and help determine an appropriate standard for completing different kinds of inspections and investigations.

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INTRODUCTION

At the request of the Secretary of State, we conducted an audit of the Office of the Secretary of State (office), Securities Division (division). Our audit focused on the division's fee structure and enforcement section. The audit's scope and methodology, background information, and acknowledgements are included in Appendix A.

Our audit focused on the following objective:

- ✓ Can the Secretary of State, Securities Division improve effectiveness of operations?

Office of the Secretary of State Response and Implementation Plan

We provided draft copies of this report to the Office of the Secretary of State for its review and comments. The office's comments have been considered in the preparation of this report and are included in Appendix B. In its response, the office accepted our recommendations. Appendix C includes a timetable to implement our recommendations.

NRS 353A.090 specifies within six months after the final report is issued to the Executive Branch Audit Committee, the Administrator of the Division of Internal Audits shall evaluate the steps the office has taken to implement the recommendations and shall determine whether the steps are achieving the desired results. The administrator shall report the six month follow-up results to the committee and office officials.

The following report contains our findings, conclusions, and recommendations.

Can the Secretary of State, Securities Division Improve Effectiveness of Operations?

The Secretary of State, Securities Division (division) can improve the effectiveness of operations by modifying division funding statutes and improving the documentation and monitoring of enforcement cases (inspections and investigations). Modifying funding statutes will ensure greater transparency, eliminate potential conflict of interest with the division administrator (administrator), and provide a more effective way to budget costs. Improving the documentation and monitoring of inspections and investigations may help reduce the time to complete enforcement cases. These recommendations will enhance the Office of the Secretary of State's (office) accountability and responsiveness to the public.

Modify Securities Division Funding Statutes

The division should modify funding statutes for enforcement operations. This will help ensure greater transparency, eliminate potential conflict of interest with the administrator and provide a more effective way to budget costs. The division funding statutes include:

- NRS 90.710 specifies all money received by the division must be deposited in the general fund.
- NRS 90.851 specifies all money received by the administrator as the result of an action (penalties and fines) from enforcement be deposited in the general fund and may be used to pay the division's expenses.

Statute Does Not Provide Funding to Cover Enforcement Costs

Current statute does not specifically provide sufficient funding to defray enforcement operating costs. The division provides licensing and registration services, compliance inspection and investigation, securities enforcement and investigation, and investor education. Division revenue includes securities registration fees, penalties, and fines, which could cover division's expenses. However, statute only designates funding from penalties and fines to be used for the division's operating costs.

The division receives general fund appropriations for enforcement personnel costs but relies on penalties and fines for the remaining operating costs. However, if revenue from penalties and fines are insufficient, the general fund subsidizes the division for enforcement operating costs.

Current Trends Show Declining Penalties and Fines

The division allocates funds received as a result of enforcement action (penalties and fines) for operating costs; however, penalties and fines are not covering operating costs. Moreover, the division represents they are not able to budget for funds available for operating costs on a consistent basis due to the fluctuations and decline in penalties and fines. We noted penalties and fines have declined over the past five years and operating costs have surpassed penalties and fines leading to a deficit in recent years. See Exhibit I.

Exhibit I

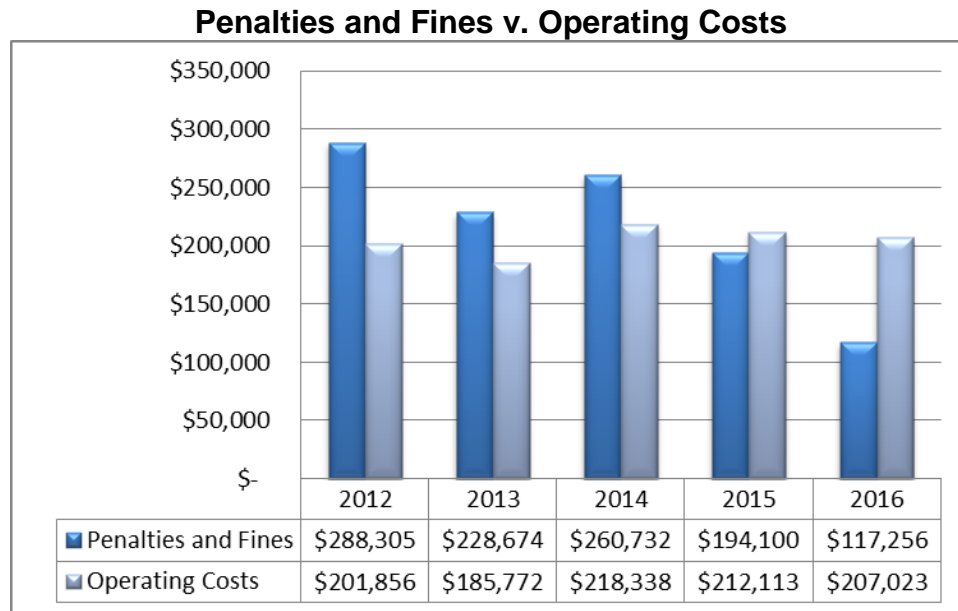


Table Note: Operating Costs do not include personnel costs

Current Funding Statute Allows for a Potential Conflict of Interest

NRS allows the division to pay for enforcement operating costs of the office from penalties and fines imposed by the administrator as the result of an enforcement action. The administrator is given recommendations from investigative staff for penalties and fines. However, the administrator has final determination of penalties and fines for enforcement cases and has knowledge of the division’s operating costs. Consequently, this may present a conflict of interest as the administrator has the authority to impose penalties and fines to cover enforcement operating costs.

The administrator has mitigated risk of conflict of interest by following penalties and fines prescribed in NRS 90.650. However, the current funding structure still provides a potential for a conflict of interest. Excluding penalties and fines from funding enforcement operating costs will eliminate the potential for conflict of interest for the administrator.

Other State Regulatory Agencies Cover Operating Costs

NRS requires other state regulatory agencies to cover their operating costs through fees and other revenues received from industries they regulate. Examples of agencies are the Division of Insurance, Taxicab Authority, and other Business and Industry agencies. Currently, the state general fund subsidizes enforcement activities for the securities industry in the state.

Other States Use Registration Fees to Cover Costs

Other states' statutes allow for securities enforcement operating costs to be funded by a portion of registration fees.¹ Using a portion of registration fees will serve as a consistent source of funding to cover enforcement operating costs.

Division Registration Fees Could Cover Costs

If NRS was to allow for a portion of registration fees to fund the division's enforcement operating costs, we estimate it would take approximately 6.1 percent of fees annually. See Exhibit II.

Exhibit II

Fee/Operating Cost Comparison Fiscal Year 2016

Registration Fees	\$27,978,707
Less Operating Costs	1,698,866
Total	\$26,279,841
Percent of Registration Fees to Cover Costs (1,698,866 / 27,978,707 = 6.07%)	6.1%

¹ Alabama, Colorado, Montana

Conclusion

Modifying statute to designate a portion of registration fees to fund enforcement operations will provide a more effective way to budget costs. Modifying statute to exclude penalties and fines from funding enforcement operations will ensure greater transparency and eliminate potential conflicts of interest. This will enhance the office's accountability and responsiveness to the public.

Recommendations

1. Modify statute to designate a portion of registration fees to fund enforcement operations.
2. Modify statute to exclude penalties and fines from funding enforcement operations.

Improve Documentation and Monitoring of Enforcement Cases

The division should improve documentation and monitoring of compliance inspection and investigation cases. Improving documentation and monitoring may help reduce the time to complete enforcement cases.

Division Working to Improve Completion Time for Enforcement Cases

The division is working to improve completion time for inspections and investigation cases. As part of that improvement effort, the division is researching and beginning to formalize the development of a comprehensive case management system to help managers track the progress of enforcement cases. Improved tracking will allow division managers to engage more effectively with individual investigators and better affect the progress of cases. An effective case management system will also allow managers to collect and assess the progress of cases, including cost information, and help determine an appropriate standard for completing different kinds of inspections and investigations.

Case Completion Taking 17-26 Months

We reviewed a total of 48 randomly selected enforcement cases during the fiscal years 2014-2015: 30 were closed cases, of which 9 were compliance inspections and 21 were investigations.²

We reviewed nine closed compliance inspections. Based on our sample, it takes the division an average of 17 months to complete compliance inspections:

- One compliance inspection was opened on February 22, 2007, and resulted in summary orders filed on November 19, 2009, revoking the licenses of certain representatives of a broker dealer. The broker dealer firm went out of business and filed notice of withdrawal of its registration on December 22, 2009. The Financial Industry Regulatory Authority (FINRA) expelled the firm on June 1, 2010. The matter did not proceed to a hearing because the representatives involved were not in the securities industry any longer and a final order after a hearing was never issued. One of the representatives approached the division in 2015 to resolve the matter so he could apply for a license as an investment adviser representative. As a result, the division and this individual entered into two administrative consent orders finally resolving this case. The individual agreed to pay a civil penalty and be placed under special

² "Investigations" include both compliance investigations and criminal investigations

supervision with his new investment advisory firm. The case was formally closed on February 29, 2016.³

- One inspection took 42 months to complete. The inspection was opened on March 23, 2011. The compliance investigator assigned to this case left the employ of the division on November 11, 2011, before she completed the inspection and summary report. The division represents at that time, other than the chief compliance investigator, the division only had one compliance investigator in the Las Vegas office that was hired in August 2011 and was not fully trained. Due to the fact that the inspection was not completed, the division initiated a new inspection of the firm on November 14, 2013. Both cases were closed on September 19, 2014 after entry of an administrative consent order.
- One inspection took 25 months. The case was opened on July 31, 2014. Requested documents were received on December 17, 2014. The summary report was completed in August of 2016, with no deficiencies noted. The case was closed on August 8, 2016.
- One inspection took 21 months. The case was opened on August 7, 2014. The summary report was completed on April 5, 2016 noting deficiencies. A deficiency letter was mailed to the firm on April 19, 2016. The division then negotiated and entered into an administrative consent order on May 9, 2016, and the case was closed on May 17, 2016.
- The remaining 5 inspections took 10 months or less to complete.

Untimely Investigations May Result in Loss of Penalties and Fines

The division does not have a standard for completing enforcement cases. We contacted the Northern American Securities Administrators Association to advise on an appropriate case completion standard. The association had no guidance or opinion on an appropriate standard for completing enforcement cases. There is, however, a three year statute of limitations for criminal licensing/registration violations and a four year statute of limitations for criminal securities fraud.

Based on our sample of 21 closed investigations, seven criminal investigations took an average of 26 months to complete and 14 compliance investigations took an average of 23 months to complete. However, we noted four cases took longer than four years to complete. The division may have lost its right to pursue criminal action on any of these investigations assuming investigative findings warrant such action.

³ Our calculation of the average time to complete inspections only included the 33 months this case took the division to complete (February 2007 – November 2009). Our calculation did not include the additional months adding to the total 108 months the case remained open.

Staffing Shortages May Have Affected Case Completion Rate

The division reports it recently filled two long-term investigator vacancies and reorganized some enforcement assignments to increase the rate at which cases are being completed. The new hires bring the division enforcement investigator staff to six. This represents an increase of just over 33 percent in enforcement investigators.⁴

If the division were to improve its overall case completion rate by 33 percent over time with a full staff, inspections should take about a year to complete and investigations should take about a year and a half. In the absence of a comprehensive case management system that will provide more precise information and help determine an appropriate standard for completing different kinds of inspections and investigations, these may be reasonable timeframes to help evaluate progress on completing some types of enforcement cases based on the result of our analysis of division records.

Improving Case Completion Rate Requires Better Documentation for Improved Reporting and Management Monitoring

The division established an internal goal for investigators providing a draft report of their cases for management review within six months. The division notes all cases are not the same; some may take longer because they are more complex or involve larger industry entities. Consequently, the six month goal guides expectations of investigators in general and is not a hard standard by which they are evaluated. However, helping investigators meet case completion expectations requires documentation be complete and up to date for management to effectively monitor the status and progress of enforcement cases.

Incomplete Reporting Hinders Management Monitoring

In the absence of a comprehensive case management system, division management uses various reports to monitor how an inspection or investigation is progressing. However, the division reports investigators and supervisors do not consistently document their timelines and actions on the reports used by management to monitor cases. Moreover, specific information about timelines and actions may be available in the individual case file or personal note. Not having complete information on monitoring reports makes it more difficult and time consuming for senior managers to monitor enforcement cases.

Lack of complete monitoring reports hinders management's ability to quickly access and assess the status of an enforcement case. Until the division acquires

⁴ New Hires (2) / Enforcement Investigators (6) = 33.33 percent

a comprehensive case management system or improves documentation with current monitoring reports, management may continue to be hindered in effectively monitoring the progress of enforcement cases.

Conclusion

Improving documentation and monitoring of division reports on inspections and investigations will help ensure reporting on enforcement cases is complete and cases are processed in a timely manner. The division's effort to field a comprehensive case management system will provide a centralized system that will also allow managers to collect and assess the progress of cases, including cost information, and help determine an appropriate standard for completing different kinds of inspections and investigations.

Recommendation

3. Improve documentation and monitoring of enforcement cases.

Appendix A

Scope and Methodology, Background, Acknowledgements

Scope and Methodology

We began the audit in July 2016. In the course of our work, we interviewed office staff and discussed processes inherent to the division's responsibilities. We reviewed division records for fiscal years 2014 through 2016, applicable Nevada Revised Statutes and other state guidelines. We also surveyed other states, comparing state fee structures. We concluded field work and testing in December 2016.

We conducted our audit in conformance with the *International Standards for the Professional Practice of Internal Auditing*.

Background

The Secretary of State, elected to a four-year term, is responsible for maintaining the official records of the acts of the Nevada Legislature and of the executive branch of state government, as prescribed by law. The office is organized into eight divisions: Commercial Recordings, Document Preparation Services/Domestic Partnerships/Registry for Advanced Directives for Healthcare (Living Will Lock Box), Elections, Executive Administration, Nevada Business Portal, Notary, Operations and Securities.

- **Commercial Recordings** – is one of the largest general fund revenue generators in the state and is responsible for processing and filing the organizational and amendatory documents of entities organized under the laws of the State of Nevada. These entities include for-profit and non-profit corporations, limited liability companies, limited partnerships, limited liability partnerships, limited liability limited partnerships, business trusts, and professional corporations and associations. The division is also charged with reviewing, filing and processing: (1) trademarks, trade names, service marks, and rights of publicity; (2) Uniform Commercial Code financing statements, changes, lien searches, federal tax liens and utility filings; (3) video service provider certificates of authority; and (4) statements of partnership authority. The Division is also responsible for issuing the annual State Business License to all Title 7 entities as well as sole proprietors and partnerships.

- **Document Preparation Services Program/Domestic Partnership Registry/Registry for Advance Directives (Living Will Lockbox) –**
 - NRS 240A requires that persons who wish to engage in the business of a documentation preparation service must be registered by the Secretary of State and sets forth requirements for persons providing such services. This program provides for the annual registration of document preparation service providers and for investigation of alleged violations of NRS 240A.
 - The office files and maintains all domestic partnership registrations and terminations.
 - The Living Will Lockbox program is a secure, virtual lockbox in which Nevadans can file certain advance health care directives such as living wills, durable powers of attorney for health care decisions, Physician Order for Life Sustaining Treatment (POLST) and "do not resuscitate" (DNR) orders. These documents can be accessed online by registrants, authorized health care professionals and family when medical treatment decisions must be made
- **Elections** – is responsible for the execution, interpretation, and enforcement of federal election and state election and campaign finance laws; administering the requirements of the Help America Vote Act (HAVA); serving as the filing office for statewide elective positions, initiative petitions, and referendums; maintaining the statewide voter registration database; and conducting voter outreach programs. This division also administers the Advisory Committee on Participatory Democracy (ACPD) which is comprised of ten members selected by the Secretary of State's Office and whose purpose is to assist the Secretary of State in: identifying and proposing programs that promote citizen participation in governance; establishing a Jean Ford Democracy Award; and working with partner organizations at the local, state, and national level to increase voter participation in Nevada.
- **Executive Administration** - provides leadership, strategic direction and administrative support to the office as a whole. The division includes all of the office's deputies, the Securities Administrator, the Public Information Officer as well as the Executive Assistant to the Secretary of State
- **Nevada Business Portal** - SilverFlume is Nevada's first-stop business portal launched in 2012 that consolidates the registrations needed to start and run a Nevada business. SilverFlume eliminates about 80% of redundant steps by collecting and streamlining business information

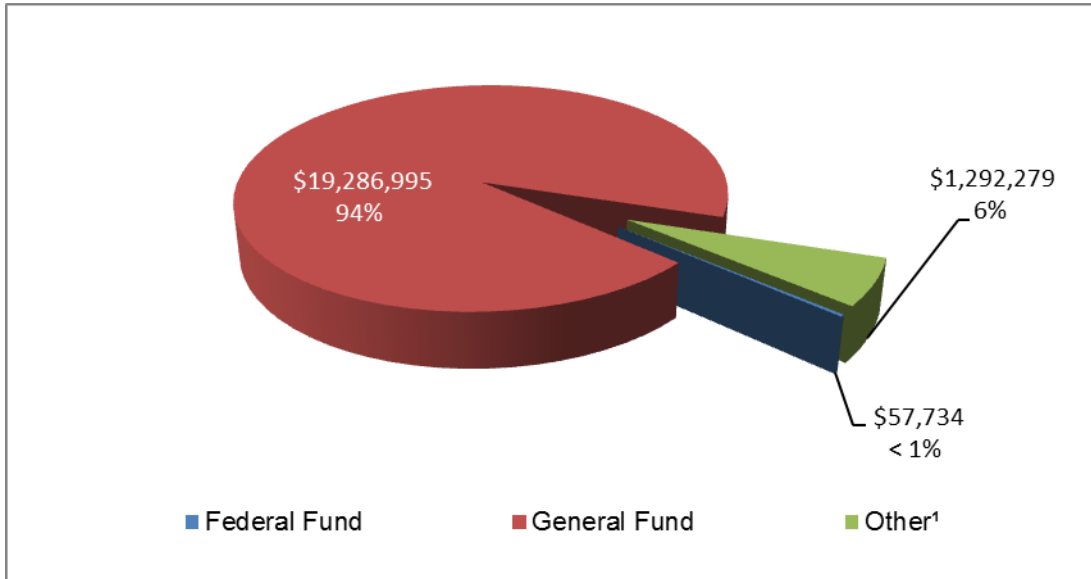
across governmental agencies. An important component of economic development, SilverFlume offers a New Business Checklist to guide customers through the business startup steps, including estimated licensing costs and time to complete each step. SilverFlume also offers a no-cost Digital Operating Agreement to support startup businesses with necessary corporate governance.

- **Notary** – responsible for the appointment and enforcement of qualified individuals as Notaries Public and conducting notary education training courses, which the office has recently begun offering through an online training module. The division also issues authentication of documents (known as Apostilles) to be submitted to foreign countries in accordance with the Hague Convention of 1961 and maintains a list of qualified licensed Ministers in the State of Nevada who have been permanently or temporarily licensed by the state's county clerks.
- **Operations** – supports the internal functions of the office, including Personnel, Information Technology (SoSTek), Facilities, Accounting and preparation and management of the office's budget.
- **Securities** – is the regulatory, compliance and enforcement agency for state securities laws. The division registers securities which are offered and sold in Nevada; registers and licenses qualified individuals and firms to conduct securities related business; provides assistance and guidance for raising capital through securities offerings for the formation and/or expansion of a business; conducts periodic field inspections of broker-dealers and investment advisers registered in Nevada to ensure that both the firm and its employees are in compliance with Nevada Securities Laws; investigates alleged securities violations brought to the division's attention through the proactive anti-fraud activities of division investigators, written complaints from investors, or information received from other agencies or persons; and administers investor protection/education activities. This division also licenses Nevada based transfer agents and registers athlete's agents.

The office's budget for fiscal year 2016 was approximately \$20.6 million. Exhibit III summarizes the office's budget.

Exhibit III

**Office of the Secretary of State Funding Sources
Fiscal Year 2016**



Source: 2016 Legislatively Approved Budget

Table Note:

¹Other includes balance forward from prior year

Acknowledgments

We express appreciation to the Secretary of State, Deputy Secretaries of State, Division Administrator, and staff for their cooperation and assistance throughout the audit.

Contributors to this report included:

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Executive Branch Audit Manager

Ashwini Prasad, CPA, CIA, CGMA
Executive Branch Auditor

Appendix B

Office of the Secretary of State Response and Implementation Plan

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Secretary of State

GAIL J. ANDERSON
Deputy Secretary for Southern Nevada

CADENCE MATIJEVICH
Deputy Secretary for Operations

STATE OF NEVADA



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RECEIVED

JAN 18 2017

DIVISION OF INTERNAL AUDITS

January 18, 2017

Mr. Steve Weinberger
Administrator, Division of Internal Audits
209 East Musser Street, Suite 300
Carson City, NV 89701

RE: Response to Securities Division Audit Report

Dear Mr. Weinberger:

Thank you for the work your team has completed in reviewing the operational effectiveness of the Securities Division of the Office of the Secretary of State. We have reviewed the draft report from your audit and generally accept your recommendations, though as you will see in our comments below we do believe it will take longer than you have indicated to fully address Recommendation Number 3. I am pleased to let you know that we had previously identified each of your areas of recommendation as opportunities for improvement and had already taken action to begin addressing these items.

Recommendation Number 1 – Modify statute to designate a portion of registration fees to fund enforcement operations, and:

Recommendation Number – 2: Modify statute to exclude penalties and fines from funding enforcement operations.

We accept and agree with both of these recommendations. We have prepared and submitted our budget request for the upcoming biennium with provisions that would accomplish both of these recommendations. While these requests are included in the Governor's recommended budget, they still require legislative approval. Our budget request includes a BDR that seeks to change the funding source for the operations of the Division from Miscellaneous Program Fees (penalties and fines) to the General Fund, which is where the registration fees you recommend as the funding source are currently deposited. We appreciate your recognition of the mitigation efforts our Securities Administrator has taken to address conflict of interest concerns and have full confidence that she and her staff act with the utmost integrity, but agree that any potential for conflict or the perception of conflict should be eliminated so that the public may have full faith in the actions of this Office. We agree with your July 2017 timeline for implementation of these

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recommendations, but would note that action by the Legislature and the Governor are necessary for these changes to be made.

Recommendation Number 3 – Improve documentation and monitoring of enforcement cases.

We accept and agree with this recommendation. Prior to initiation of your audit, this Office had identified modernization of the case management system utilized by the Securities Division as an opportunity for improvement of operational efficiency and had initiated an Information Technology project to replace the current system. We are currently in the process of developing business requirements for the new system so that we can be sure we are procuring a system that will meet all of the Division's needs. We are grateful to have had your input on areas that we may focus on in pursuit of operational efficiencies. While we do not yet know what the cost of such a system will be, there is a possibility that the total cost to procure and implement the system would exceed the threshold under which our Office could initiate the purchase without first obtaining Legislative approval of a Technology Investment Request (TIR). If in fact the system requires approval of a TIR, the earliest that approval could be granted would be during the 2019 Legislative Session. Because of this uncertainty, we are unable to commit to complete implementation of a new system by December 2017 as you recommend.

While complete implementation of a new documentation and monitoring system may still be a way off, we will continue to look for opportunities to better utilize the systems currently in place and to provide our staff with tools to help them manage their individual caseloads. We have a Compliance tracking file where all Compliance Inspections will be logged and will allow for monitoring against a three-month internal goal for drafting of initial inspection reports and a six-month internal goal for completion of inspections. We are discussing ways to improve this tracking file, other tools, and how we might monitor cases more efficiently. Additionally, prior to the audit, and once we had our two new compliance investigator positions filled, we decided to revise the method by which cases are assigned, with one Compliance/Audit Investigator focusing primarily on investigations and the remainder of the Compliance/Audit Investigators focusing on inspections. The investigator who is primarily working on investigations has been in the process of closing all of his compliance cases to complete this transition. We are hopeful that this process will result in more efficient closings of both compliance inspections and investigations given the differing nature of the work activities and techniques needed for these two assignment types. Finally, we are moving the responsibility of the drafting of certain Administrative Consent Orders in Compliance Inspections to the new legal secretary, under the guidance of the Chief of Enforcement. It should also be noted that a new case management system will not serve as the primary tool by which individual inspector/investigator performance will be documented. Because case files may become subject to discovery in legal or other proceedings, documentation within individual case files of efforts of management to assist inspectors/investigators in closing files may not be appropriate for placement in the case file itself. The office currently utilizes and will continue to utilize face to face meetings between

supervisors and their subordinates to discuss meeting standards with respect to completion of their job duties, including timely closing of cases.

Your report's acknowledgement that the Division's staffing shortages may have affected case completion rate is appreciated. We do anticipate seeing an increase in the number of cases we are able to complete now that we have been successful in recruiting for nearly all of our vacant positions and those new employees have completed necessary orientations and are completing their training and probation periods. However, as your report correctly notes, the nature of investigative casework makes it difficult to set finite standards for each and every case.

Finally, we would like to address your report's notation regarding the potential loss of right to pursue criminal action on compliance cases that take an extended period of time to complete. It should be noted that if sufficient evidence is available at the time a case is opened that leads us to believe that it should be investigated as a criminal matter, a separate criminal case number and file may be opened simultaneously. The deficiencies in our current case management system may not have allowed for visibility within the scope of your audit to connect some of the open compliance cases with parallel criminal cases. We are acutely aware of and regularly monitor statutes of limitation for criminal cases and make every effort to keep cases in such a status as to allow appropriate actions to be taken.

Again, I sincerely appreciate the efforts you and your staff have taken to share with us opportunities for improvement within our operations. Please feel free to contact Chief Deputy Scott Anderson at 775-684-5711 or Securities Administrator Diana Foley at 702-486-2440 should you need any additional information.

Respectfully,



BARBARA K. CEGAVSKE

Secretary of State

Appendix C

Timetable for Implementing Audit Recommendations

In consultation with the Office of the Secretary of State, the Division of Internal Audits categorized the three recommendations contained within this report into one of two separate implementation time frames (i.e., *Category 1* – less than six months; *Category 2* – more than six months). The office should begin taking steps to implement all recommendations as soon as possible. The office's target completion dates are incorporated from Appendix B.

Category 2: Recommendations with an anticipated implementation period of more than six months.

<u>Recommendations</u>	<u>Time Frame</u>
1. Modify statute to designate a portion of securities registration fee revenues to fund enforcement operations. (page 5)	Jul 2017
2. Modify statute to exclude penalties and fines from funding enforcement operations. (page 5)	Jul 2017
3. Improve monitoring and documentation of enforcement cases. (page 9)	Jul 2019

The Division of Internal Audits shall evaluate the action taken by the office concerning report recommendations within six months from the issuance of this report. The Division of Internal Audits must report the results of its evaluation to the committee and office.