

# OFFICE OF INSPECTOR GENERAL

U.S. SECURITIES AND EXCHANGE COMMISSION

*The mission of the Office of Inspector General (OIG) is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the U.S. Securities and Exchange Commission (SEC or Commission). This mission is best achieved by having an effective, vigorous and independent office of seasoned and talented professionals who perform the following functions: Conducting independent and objective audits, evaluations, investigations, and other reviews of Commission programs and operations; Preventing and detecting fraud, waste, abuse, and mismanagement in Commission programs and operations; Identifying vulnerabilities in Commission systems and operations and recommending constructive solutions; Offering expert assistance to improve Commission programs and operations; Communicating timely and useful information that facilitates management of measurable gains; and Keeping the Commission and the Congress fully and currently informed of significant issues and developments.*



REGISTERED SEC COMMISSIONER (WASHINGTON, DC)

AUTHORIZED OFFICER.

AUTHORIZED OFFICER. U.S. Securities and Exchange Commission (Washington, DC)



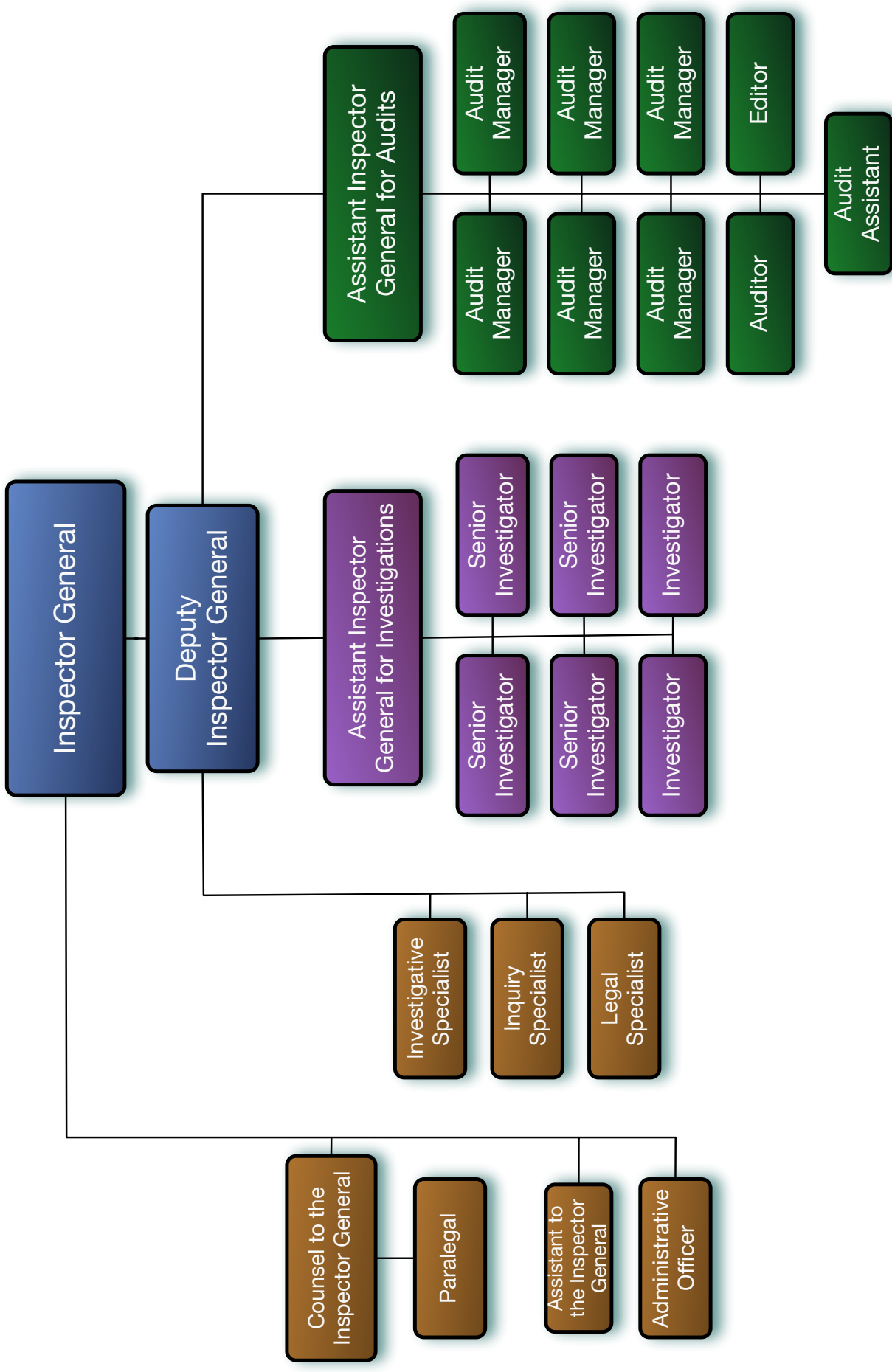
## U.S. SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

SEMIANNUAL REPORT TO CONGRESS  
APRIL 1, 2011 - SEPTEMBER 30, 2011



# ORGANIZATIONAL CHART

Office of Inspector General



April 1, 2011 - September 30, 2011



U.S. Securities  
and Exchange  
Commission

# OFFICE OF INSPECTOR GENERAL SEMIANNUAL REPORT TO CONGRESS

## MISSION

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- Conducting independent and objective audits, evaluations, investigations, and other reviews of SEC programs and operations;
- Preventing and detecting fraud, waste, abuse, and mismanagement in SEC programs and operations;
- Identifying vulnerabilities in SEC systems and operations and recommending constructive solutions;
- Offering expert assistance to improve SEC programs and operations;
- Communicating timely and useful information that facilitates management decision making and the achievement of measurable gains; and
- Keeping the Commission and the Congress fully and currently informed of significant issues and developments.







# SEMIANNUAL REPORT TO CONGRESS

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Message from the  
**Inspector General**

I am pleased to present this Semiannual Report to Congress on the activities and accomplishments of the Securities and Exchange Commission (SEC) Office of Inspector General (OIG) for the period of April 1, 2011 through September 30, 2011. This report is required by the Inspector General Act of 1978, as amended, and covers the work performed by the OIG during the period indicated.

The audits, reviews, and investigations described in this report illustrate the commitment of the SEC OIG to promote efficiency and effectiveness in the SEC, as well as the tremendous effect and impact that the SEC OIG has had upon SEC operations.

During this reporting period, we issued several significant audit reports on matters critical to the SEC's programs and operations. We conducted a review of the SEC's cost-benefit analyses in connection with Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) rulemakings pursuant to a request from several members of the United States (U.S.) Senate Committee on Banking, Housing, and Urban Affairs. The review concluded that a systematic cost-benefit analysis was conducted for each of the six rules we reviewed. Overall, we found that the SEC formed teams with sufficient expertise to conduct comprehensive and thoughtful economic analyses of the six proposed releases we reviewed. In several instances, we found that staff from the Division of Risk, Strategy, and Financial Innovation were involved in the early stages of the rulemaking process and contributed extensively to the scope and breadth of the cost-benefit analyses. In these instances particularly, we found the analyses to be thorough and to have incorporated all aspects of the principles of the applicable Executive Orders and the SEC's internal compliance handbook for rulemakings.

We also conducted a review of the SEC's oversight of and compliance with conditions and representations related to exemptive orders and no-action letters that are granted to regulated entities. The SEC has statutory authority to issue an exemptive order, in response to an entity's request, which allows the entity to engage in transactions that would otherwise be prohibited by the securities laws, rules, or regulations. In some instances, instead of exemptive relief, a company may request a "no-action" letter from Commission staff. A no-action letter states that the staff will not recommend enforcement action in response to the entity's proposed activity. We found that the Commission could improve its processes for monitoring compliance with the conditions and representations related to exemptive orders and no-action letters in a variety of ways. Significantly, our review found that the SEC divisions that issue exemptive orders and no-action letters to regulated entities do not have a coordinated process for reviewing these entities' compliance with the conditions and representations related to the orders and letters, and instead rely on the Office of Compliance Inspections and Examinations to review compliance as part of its examinations. Because exemptive orders and no-action letters allow industry participants to conduct activities that, without the relief, could violate the securities laws and regulations, our review determined that monitoring is important to ensure that regulated entities fully comply with all conditions and representations related to exemptive orders and no-action letters.

During the reporting period, we also conducted an assessment of the functions of the SEC's Office of Investor Education and Advocacy (OIEA), which receives investor inquiries and complaints from the

general public, and is responsible for gathering, processing, and responding to these inquiries and complaints. Our assessment resulted in several recommendations designed to improve the operations of OIEA. We also conducted a review of alternative work arrangements, overtime compensation, and continuity of operations (COOP)-related activities at the SEC, an audit of the SEC's employee recognition program and recruitment, relocation, and retention incentives, and reviews of information technology (IT) areas of concern we identified as part of our annual assessment conducted pursuant to the Federal Information Security Management Act.

We also had a very productive semiannual report period for investigations. At the request of the Chairman, we investigated any conflicts of interest arising from the former SEC General Counsel's participation in matters relating to the Bernard L. Madoff Ponzi scheme, most notably, the liquidation proceeding under the Securities Investor Protection Act. During the course of our investigation, we obtained and reviewed over 5.1 million e-mails for a total of 45 current and former SEC employees and took the sworn testimony or interviewed 40 witnesses, including the former SEC General Counsel, the former SEC Ethics Counsel who provided pertinent ethics advice, the Chairman, the Commissioners, Securities Investor Protection Corporation officials, the trustee administering the Madoff liquidation, and various current and former SEC employees. After completing the fact-finding phase of our investigation, we provided to the Acting Director of the Office of Government Ethics (OGE) a summary of the salient facts uncovered in the investigation and requested that OGE review those facts and provide its opinion regarding the former General Counsel's participation in matters that could have given rise to a conflict of interest. After reviewing that factual summary, the Acting Director of OGE informed us that based upon the facts provided, the former General Counsel's work on the policy determination of the calculation of net equity in connection with clawback actions stemming from the Madoff matter, and the former General Counsel's work on proposed legislation affecting clawbacks should be referred to the U.S. Department of Justice (DOJ) for possible violations of Section 208 of Title 18 of the United States Code (U.S.C.). In late October 2011, the DOJ decided not to pursue prosecution of the former General Counsel.

We also conducted an investigation of the SEC's decision to lease 900,000 square feet of space at a facility in Washington, D.C., known as Constitution Center. Our investigation concluded that the analysis the SEC conducted to justify the lease was deeply flawed and unsound, and that the SEC's Office of Administrative Services (OAS) grossly overestimated the amount of space needed at SEC headquarters for the SEC's projected expansion and used unsupportable figures to justify the SEC committing to an expenditure of \$556,811,589 over ten years. We also found that OAS prepared a faulty Justification and Approval to support entering into the Constitution Center lease without competition. Moreover, this Justification and Approval was prepared after the SEC had already signed the contract to lease space at the Constitution Center facility. Further, OAS backdated the Justification and Approval, thereby creating the false impression that it had been prepared only a few days after the SEC entered into the lease. Our report recommended that the newly-appointed Chief Operating Officer/Executive Director carefully review the report's findings and conduct a thorough and comprehensive assessment of all matters currently under the purview of OAS, and that disciplinary action be taken against several of the senior OAS officials involved in the leasing process. We also recommended that the Office of Financial Management, in consultation with the Office of the General Counsel, request a formal opinion from the Comptroller General as to whether the Commission violated the Antideficiency Act by failing to obligate appropriate funds for the Constitution Center lease. On June 15, 2011, the SEC's Chief Financial Officer submitted a request for a formal opinion to the Comptroller General on this issue, and that request was pending at the end of the semiannual reporting period. On October 3, 2011, the Comptroller General



issued a decision that the “SEC had no authority to record an obligation for an amount less than its full liability under [its Constitution Center] contract,” and that the SEC failed to fully record its obligation when it entered into the contract.

We also completed several additional complex investigations during the semiannual reporting period and issued comprehensive reports that did not substantiate allegations of misconduct by Division of Enforcement (Enforcement) staff in an insider trading investigation, improper preferential treatment and special access in connection with an Enforcement investigation, and the failure to investigate possible violations of the federal securities laws. We also completed investigations that found evidence of the excessive payment of living expenses in contravention of OPM guidance for a headquarters senior official and inappropriate communications between an SEC manager and an outside party.

This semiannual reporting period has also been a particularly busy one for consultations and briefings with Congressional offices. I testified before Congressional Subcommittees on five separate occasions during the reporting period. Three of these testimonies pertained to our investigation of the SEC’s leasing of space at Constitution Center, one related to our investigation of conflicts of interest arising from the former SEC General Counsel’s participation in Madoff-related matters, and one related to an investigation we completed during a previous semiannual reporting period regarding the SEC’s response to concerns regarding Robert Allen Stanford’s alleged Ponzi scheme. During the reporting period, I also conducted numerous briefings of, and had discussions with, Members of Congress and Congressional staff concerning a wide variety of issues impacting the SEC.

This semiannual report also includes, for the first time (at Appendix B), the annual report of our efforts conducted pursuant to the newly-established OIG SEC Employee Suggestion Program. We implemented this program pursuant to section 966 of the Dodd-Frank Act, and it has been an unqualified success. During the past year, we received and reviewed a total of 74 suggestions and allegations, with a significant number of the suggestions leading to tangible improvements in the SEC’s programs and operations and, in some instances, cost savings.

The accomplishments of my Office have been enhanced by the support of the SEC Chairman and Commissioners, as well as that of the SEC’s management team and employees. I wish to particularly note Chairman Mary Schapiro’s leadership and support of the OIG, which has been instrumental to the many significant improvements in the SEC over the past several years. I look forward to continuing this productive and professional working relationship as we continue to help the SEC meet its important challenges.



H. David Kotz  
Inspector General







Office of  
Inspector  
General

# SEMIANNUAL REPORT TO CONGRESS

## MANAGEMENT AND ADMINISTRATION

### AGENCY OVERVIEW

The U.S. SEC's mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust and characterized by transparency and integrity. The SEC's core values consist of integrity, accountability, effectiveness, teamwork, fairness, and commitment to excellence. The SEC's goals are to foster and enforce compliance with the federal securities laws; establish an effective regulatory environment; facilitate access to the information investors need to make informed investment decisions; and enhance the Commission's performance through effective alignment and management of human resources, information, and financial capital.

SEC staff monitor and regulate a securities industry comprising more than 35,000 registrants, including approximately 10,000 public companies, 11,000 investment advisers, about 7,500 mutual funds, and about 5,000 broker-dealers, as well as national securities exchanges and self-regulatory organizations, 500 transfer agents, 15 national securities exchanges, nine clearing agencies, and ten credit rating agencies. Additionally, the agency has oversight responsi-

bility for the Public Company Accounting Oversight Board (PCAOB), the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC). While about 3,200 smaller investment advisers will transition to state regulation under the Dodd-Frank Act, the SEC is gaining responsibility for directly overseeing approximately 700 larger private fund advisers, including hedge funds.

In order to accomplish its mission most effectively and efficiently, the SEC is organized into five main divisions (Corporation Finance; Enforcement; Investment Management; Trading and Markets; and Risk, Strategy, and Financial Innovation) and 16 functional offices. The Commission's headquarters is located in Washington, D.C., and there are 11 regional offices located throughout the country. As of September 30, 2011, the SEC employed 3,844 full-time equivalents (FTEs), consisting of 3,806 permanent and 38 temporary FTEs.

### OIG STAFFING

During the reporting period, the OIG added an investigator and an auditor to the

staff, thereby further increasing its capacity to conduct its oversight responsibilities.

In May 2011, Elizabeth Leise joined the OIG as a Senior Investigator. Ms. Leise comes to us from the law firm of Arnold & Porter LLP, where she was a litigation associate for over eight years. Her law practice at Arnold & Porter focused on securities litigation and enforcement matters. This practice encompassed various types of matters under the federal securities laws and general corporate law, including the defense of corporations, as well as their officers and directors, at all stages of securities fraud actions brought by private plaintiffs and in investigations by the SEC's Division of Enforcement; internal investigations; and the representation of special litigation committees. Ms. Leise received a Juris Doctor degree from the George Washington University School of Law in 2002 and Bachelor of Arts degrees in Foreign Affairs and French from the University of Virginia in 1999.

In June 2011, Russell Moore joined the OIG as an auditor. Mr. Moore comes to us from the Environmental Protection Agency (EPA) OIG, where he served as a project manager in the Office of Program Evaluation.

During his time at the EPA, Mr. Moore supervised reviews of the agency's position management program, Freedom of Information Act (FOIA) program, and EPA's management of classified national security information. Prior to joining EPA, Mr. Moore was a supervisory auditor at the Naval Audit Service, where he conducted reviews of classified programs that focused on acquisitions management, contract management, financial management, organizational structure, and internal controls. Mr. Moore retired from the U.S. Marine Corps in 2007, after more than 20 years of military service. He graduated from the U.S. Naval Academy in 1987, subsequently completing a master's degree in military studies and a certificate in accounting. Mr. Moore will also complete an MBA in accounting in May 2012. Mr. Moore is a member of the Institute of Internal Auditors and the American Society of Military Comptrollers.

During the semiannual reporting period, one of our senior auditors, Jim Etheridge, retired after over 30 years of federal service. A second senior auditor, Laura Benton, left the OIG for an opportunity outside the Commission.



# SEMIANNUAL REPORT TO CONGRESS

## CONGRESSIONAL TESTIMONY, REQUESTS, AND BRIEFINGS

During this semiannual reporting period, the OIG continued to keep the Congress fully and currently informed of the OIG's investigations, audits, and other activities through testimony and written reports, as well as numerous meetings and telephonic communications. The Inspector General (IG) testified before Congressional Subcommittees on five separate occasions during the reporting period. As discussed in detail below, three of these testimonies pertained to the OIG's investigation of *Improper Actions Relating to the Leasing of Office Space* (Report No. OIG-553, issued May 16, 2011); one related to the OIG's *Investigation of Conflict of Interest Arising from Former General Counsel's Participation in Madoff-Related Matters* (Report No. OIG-560, issued September 16, 2011); and one related to an OIG investigation completed during a previous semiannual reporting period, *Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme* (Report No. OIG-526, issued March 31, 2010).

### INSPECTOR GENERAL TESTIMONIES ON THE OIG'S LEASING INVESTIGATION

On June 16, 2011, the IG testified before the Economic Development, Public Buildings,

and Emergency Management Subcommittee (Economic Development Subcommittee) of the U.S. House of Representatives Committee on Transportation and Infrastructure regarding the OIG's investigation into numerous complaints received about the SEC's decisions and actions relating to the leasing of office space at a newly-renovated building known as Constitution Center. The IG described in detail the investigative work conducted and the results of the OIG's investigation, as reflected in the OIG's report of investigation containing over 90 pages of analysis and more than 150 exhibits.

The IG informed the Subcommittee that the OIG investigation found that the SEC's entering into a lease for 900,000 square feet of space at Constitution Center in July 2010 was part of a long history of missteps and misguided leasing decisions made by the SEC since it was granted independent leasing authority by Congress in 1990. The IG also summarized the report's recommendations, including that (1) the SEC's Chief Operating Officer/Executive Director (COO) carefully review the report's findings and conduct a thorough and comprehensive review and assessment of all matters currently under the purview of the SEC's Office of Administrative Services (OAS); (2) the

COO, upon conclusion of this review and assessment, determine the appropriate disciplinary action and/or performance-based action to be taken for matters relating to the OIG's report; and (3) the SEC request a formal opinion from the Comptroller General as to whether the SEC violated the Antideficiency Act by failing to obligate appropriate funds for the Constitution Center lease. The full text of the IG's written testimony is contained in Appendix C to this Report and can also be found at [http://www.sec-oig.gov/Testimony/KotzTestimonyBeforeHouseEconomicDevelopmentSubcommittee\\_6.16.11.pdf](http://www.sec-oig.gov/Testimony/KotzTestimonyBeforeHouseEconomicDevelopmentSubcommittee_6.16.11.pdf).

The IG testified a second time before the Economic Development Subcommittee regarding the OIG's leasing investigation on July 6, 2011. In his testimony, the IG summarized the results of the OIG's investigation and focused in particular on the report's recommendations that were designed to ensure that the requisite improvements to policies and procedures were made and appropriate disciplinary action was taken. The IG noted that the OIG was committed to following up on all the recommendations made in the report and described the actions taken by the OIG to date to ensure that appropriate steps were being taken to implement the OIG's recommendations. The full text of the IG's written testimony is contained in Appendix C to this Report and can also be found at [http://www.sec-oig.gov/Testimony/KotzTestimony\\_7\\_6\\_11.pdf](http://www.sec-oig.gov/Testimony/KotzTestimony_7_6_11.pdf).

On August 4, 2011, the IG testified before the Federal Financial Management, Government Information, Federal Services, and International Security Subcommittee of the U.S. Senate Committee on Homeland Security and Government Affairs regarding the OIG's leasing investigation. During that testimony, the IG discussed in detail the investigative work conducted, the results of the investigation, and the recommendations contained in the OIG's report. The OIG also described the follow-up efforts the OIG had undertaken subsequent to the issuance of its report to ensure that the

necessary improvements were made and appropriate disciplinary action was taken. The full text of the IG's written testimony is contained in Appendix C to this Report and can also be found at [http://www.sec-oig.gov/Testimony/KotzWrittenTestimonyBeforeSenateSubcommitteeonFederalFinMangtGovInfoFedServcsandIntnlSecurity8\\_4\\_11.pdf](http://www.sec-oig.gov/Testimony/KotzWrittenTestimonyBeforeSenateSubcommitteeonFederalFinMangtGovInfoFedServcsandIntnlSecurity8_4_11.pdf).

## **INSPECTOR GENERAL TESTIMONY ON THE OIG'S CONFLICT-OF- INTEREST INVESTIGATION**

On September 22, 2001, the IG testified before a joint hearing of the Subcommittee on Oversight and Investigations of the U.S. House of Representatives Committee on Financial Services, and the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs of the U.S. House of Representatives Committee on Oversight and Government Reform, concerning the conflict-of-interest matter investigated by the OIG. Specifically, the IG described SEC Chairman Mary Schapiro's request that the OIG investigate any conflicts of interest arising from the former General Counsel's participation in determining the SEC's position in the liquidation proceeding brought by the Securities Investor Protection Corporation of Bernard L. Madoff Investment Securities, LLC. The IG discussed in detail the investigative work conducted by the OIG and the results of the investigation, as reflected in the OIG's report of investigation containing nearly 120 pages of analysis and 200 exhibits.

The IG informed the Subcommittees that the OIG's investigation found overall that the former General Counsel participated personally and substantially in particular matters in which he had a personal financial interest by virtue of his inheritance of the proceeds of his mother's estate's Madoff account and that the matters on which he advised could have directly impacted his financial position.



The IG further testified that after conducting the fact-finding phase of the investigation, the OIG provided a summary of the salient facts uncovered in the investigation to the Acting Director of the Office of Government Ethics (OGE), and requested that OGE review those facts and provide the OIG with its opinion regarding the former General Counsel's participation in matters that could have given rise to a conflict of interest. The IG reported in his testimony that the Acting Director of OGE advised the OIG that, in his opinion, as well as that of senior attorneys on his staff, the former General Counsel's work on two matters relating to Madoff should be referred to the U.S. Department of Justice (DOJ) for consideration of whether he had violated 18 U.S.C. § 208, and that, based upon this guidance, the OIG had referred the result of its investigation to the Public Integrity Section of DOJ's Criminal Division. The IG also described the recommendations made in the OIG's report, including recommendations for enhancement of the SEC's Ethics Office. The IG noted that he was confident that under Chairman Schapiro's leadership, the SEC will review the report and take appropriate steps to implement the OIG's recommendations to ensure the concerns identified in the investigation are appropriately addressed. The full text of the IG's written testimony is contained in Appendix C to this Report and can also be found at [http://www.sec-oig.gov/Testimony/Kotzwrittentestimony\\_92211.pdf](http://www.sec-oig.gov/Testimony/Kotzwrittentestimony_92211.pdf).

## **INSPECTOR GENERAL TESTIMONY ON THE OIG'S STANFORD INVESTIGATION**

On May 13, 2011, the IG testified before the Oversight and Investigations Subcommittee of the U.S. House of Representatives Committee on Financial Services concerning the OIG's investigation of the handling of the SEC's investigations into Robert Allen Stanford and his various companies. The IG described the work completed during the investigation, as reflected in the OIG's report of investigation containing

over 150 pages of analysis and 200 exhibits. The IG reported in detail the results of the OIG's investigation, which reviewed the SEC's examinations and investigations of Stanford from 1997 through 2009, and the agency's response to all complaints it received regarding the activities of Stanford's companies. The IG further described the recommendations contained in the OIG's report of investigation, as well as the steps the OIG had taken to follow up with Enforcement and the Office of Compliance Inspections and Examinations (OCIE) concerning the implementation of those recommendations. The IG noted that all of the report's recommendations had been implemented and closed to the OIG's satisfaction.

In his testimony, the IG also reported on a recently-completed audit of the process by which OCIE refers examination results to Enforcement in the SEC's regional offices that was conducted in response to the request of the former Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee), the Honorable Christopher Dodd (D-Connecticut). The IG testified that the audit found that examiners across the SEC regional offices were generally satisfied with their Enforcement attorney counterparts, but that certain aspects of the referral process could be improved. The IG provided information concerning the numerous recommendations made by the OIG to address the areas of improvement identified and noted that the OIG was following up to ensure these recommendations are implemented.

Finally, in his testimony, the IG discussed another investigation involving the SEC's Fort Worth Regional Office that was completed in September 2009. The IG noted that this investigation concluded that complaints voiced by two members of the Fort Worth examination staff about programmatic issues at a planning meeting improperly led to actions being taken against them. The IG reported that based upon the OIG's investigative findings, the OIG recommended the consideration of performance-based or disciplinary action

against two Fort Worth senior management officials. The full text of the IG's written testimony is contained in Appendix C to this Report and can also be found at [http://www.sec-oig.gov/Testimony/House%20Oversight%20and%20Investigations%20written%20testimony%205%2013%2011%20\(FINAL\).pdf](http://www.sec-oig.gov/Testimony/House%20Oversight%20and%20Investigations%20written%20testimony%205%2013%2011%20(FINAL).pdf).

## REPORTS PREPARED IN RESPONSE TO CONGRESSIONAL REQUESTS

During the reporting period, the OIG prepared two reports in response to Congressional requests. On May 4, 2011, the OIG received a letter from several members of the Senate Banking Committee requesting that the IG review the economic analyses performed by the SEC in connection with rulemaking initiatives undertaken pursuant to the Dodd-Frank Act. The letter specifically requested that the OIG's review focus on six particular Dodd-Frank Act regulatory initiatives. As is more fully described in the Audit and Evaluations Conducted Section of this Report, the OIG completed a report containing the OIG's initial assessment of the economic analyses related to the six specific rulemakings identified. On June 13, 2011, the OIG provided this initial report to the Senate Banking Committee members who had requested the review. The OIG's report stated that, overall, the OIG found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful economic analysis of the six proposed releases. However, we also identified two areas of potential deficiencies in the SEC's cost-benefit analyses. As noted in the report, the OIG will issue a subsequent report on the results of our further review of the SEC's cost-benefit analyses. This report is available on the OIG website at [http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report\\_6\\_13\\_11.pdf](http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf).

At a hearing of the Subcommittee on Financial Services and General Government of the U.S. House of Representatives Committee on Appropriations at which the IG testified in a

prior reporting period, the Honorable Barbara Lee (D-California) questioned the IG regarding the status of the SEC's Office of Minority and Women Inclusion. In response to Congresswoman Lee's question, the OIG reviewed the SEC's implementation of the requirement for an Office of Minority and Women Inclusion contained in Section 342(a)(1)(A) of the Dodd-Frank Act. As is more fully discussed in the Audits and Evaluations Conducted Section of this Report, the OIG found that the SEC had not established the required office within the statutory timeframe of six months from the date of enactment of the Dodd-Frank Act. SEC management informed the OIG that it had not met this deadline because Congress had not yet approved the SEC's request to create the office, but that in the meantime the SEC has been planning for the implementation of the new office and other SEC offices have been conducting activities intended to promote diversity and inclusion. The OIG provided its report to Congresswoman Lee on June 15, 2011; it can also be found at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/496.pdf>.

## OTHER REQUESTS AND BRIEFINGS

During the reporting period, the IG also conducted numerous briefings of, and had discussions with, Members of Congress and Congressional staff concerning a wide variety of issues impacting the SEC. For example, on April 21, 2011, the IG met with staff of the Subcommittee on Oversight and Investigations of the U.S. House of Representatives Committee on Financial Services regarding the OIG's Stanford report and the status of the OIG's conflict of interest investigation. On May 2, 2011, and again on June 22, 2011, the IG briefed various staff of the Senate Banking Committee on the OIG's review of the cost-benefit analyses performed by the SEC in connection with Dodd-Frank Act rulemaking initiatives. On that same day, the IG discussed issues pertaining to the SEC's budget and Dodd-Frank Act implementation efforts with

staff of the Subcommittee on Financial Services and General Government of the U.S. Senate Committee on Appropriations.

In addition, on May 31, 2011, the IG met with staff of the Subcommittee on Economic Development, Public Buildings, and Emergency Management of the U.S. House of Representatives Committee on Transportation and Infrastructure, concerning the SEC's leasing investigation. On June 16, 2011, the IG and Deputy IG met with staff of the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security of the U.S. Senate Committee on Homeland Security and Government Affairs on that same topic. The IG also had numerous meetings and telephone calls with Congressional majority and minority staff concerning the OIG's conflict-of-interest investigation, and on September 14, 2011, the IG met with the Honorable Randy Neugebauer (R-Texas), Chairman of the Subcommittee on Oversight and Investigations of the U.S. House of Representatives Committee on Financial Services, regarding the findings of the OIG's investigation.

The OIG also received a Congressional request for investigative work during the reporting period. On May 2, 2011, the Honorable Roger F. Wicker (R-Mississippi) sent a letter to the IG expressing concerns regarding allegations pertaining to the SEC's treatment of whistleblowers in connection with the alleged Stanford Ponzi scheme. Congressman Wicker requested that the IG review correspondence pertinent to the matter and, if appropriate, investigate the matter. On May 4, 2011, the

OIG commenced an inquiry to review the matter.

Finally, the OIG responded during the period to Congressional requests for information regarding closed investigations, evaluations and audits, as well as open and unimplemented recommendations. On May 31, 2011, the IG provided the Honorable Charles Grassley (R-Iowa), Ranking Member, U.S. Senate Committee on the Judiciary, and the Honorable Tom Coburn (R-Oklahoma), Ranking Member, Permanent Subcommittee on Investigations of the U.S. Senate Committee on Homeland Security and Governmental Affairs, with a previously-requested biannual report on all closed investigations, evaluations, and audits conducted by the OIG. On April 27, 2011, the IG responded to a letter dated April 7, 2011, from the Honorable Darrell Issa (R-California), Chairman, U.S. House of Representatives Committee on Oversight and Government Reform, requesting information on open and unimplemented recommendations. In that letter, the IG identified, among other things, all pending OIG recommendations with estimated cost savings as of April 1, 2011. The IG also described what the OIG considered to be the three most important open and unimplemented recommendations, which were that (1) OAS determine the universe of active and open contracts and the corresponding contract values; (2) OAS ensure that the Leasing Branch's policies and procedures provide comprehensive guidance for SEC leasing officials; and (3) OAS management institute a strong and effective anti-retaliation policy and communicate this policy in writing.







# SEMIANNUAL REPORT TO CONGRESS

## THE INSPECTOR GENERAL'S STATEMENT ON THE SEC'S MANAGEMENT AND PERFORMANCE CHALLENGES

As required by the Reports Consolidation Act of 2000 and Office of Management and Budget guidance, I am pleased to submit the following statement summarizing what I consider to be the most serious management challenges facing the Securities and Exchange Commission. This statement has been compiled based on Office of Inspector General audits, investigations, evaluations, and the Office's general knowledge of the agency's operations.

### **CHALLENGE: PROCUREMENT AND CONTRACTING**

The OIG first identified the SEC's procurement and contracting function as a management challenge in Fiscal Year (FY) 2008. While management has reported that improvements were made in the procurement and contracting area during FYs 2010 and 2011, the SEC's efforts in this area have not been completed, and the SEC's procurement and contracting function continues to be a management challenge.

Moreover, work performed by the OIG's investigative unit during FY 2011 demonstrated that there are particular deficiencies in the SEC's processes relating to the use of Justifications for Other than Full and Open Competition. Specifically, on May 16, 2011, the OIG completed an investigation regarding the circumstances surrounding the SEC's entering into a lease for 900,000 square feet of space at a facility located in Washington, D.C., known as Constitution Center. The OIG's Report of Investigation found that after the SEC committed itself to a ten-year lease term at a cost of \$556,811,589 based upon flawed projections of its space needs, the SEC's Office of Administrative Services prepared a Justification and Approval for Other than Full and Open Competition, which the Federal Acquisition Regulation (FAR) requires when an agency decides not to allow for full and open competition on a procurement or lease.

The OIG investigation found that the Justification and Approval to lease space at Constitution Center without competition was inadequate, not properly reviewed, and backdated.

Although the SEC's Competition Advocate signed the Justification and Approval, the OIG investigation found that she did not take sufficient steps to verify that the information in the Justification and Approval was accurate. In addition, the Justification and Approval was not posted publicly within 30 days after contract award as required by the FAR.

The OIG investigation also found that after the SEC's Competition Advocate executed the signature page of the Justification and Approval, she initially backdated her signature to reflect an earlier date and then whited-out a portion of the date of her signature to make it appear that she signed the document nearly a month before she actually did. This action gave the public a false impression about when the SEC finalized the Justification and Approval.

In addition, an OIG Report of Investigation issued earlier in FY 2011 found that the Justification and Approval for Other than Full and Open Competition used to support the sole source acquisition of approximately \$1 million of information technology (IT) equipment relied on an inapplicable provision of the FAR. Similarly, OIG audit reports issued in previous FYs have questioned the propriety of the SEC's use of Justification and Approvals for Other than Full and Open Competition in various circumstances.

Therefore, while the SEC continues to make improvements in the procurement and contracting area, further progress is needed to ensure that the SEC complies fully with all pertinent provisions of the FAR and provides for maximum competition consistent with the requirements of federal laws and regulations.

## **CHALLENGE: INFORMATION TECHNOLOGY MANAGEMENT/ INFORMATION SYSTEMS SECURITY**

IT management continues to be a management challenge for the SEC, although

significant improvements have been made in FY 2011. The OIG's *2010 Annual FISMA Executive Summary Report*, Report No. 489, issued March 3, 2011, confirmed that additional improvements are needed in several IT-related areas, specifically relating to Federal Information Security Management Act (FISMA) requirements (*e.g.*, deviations from Federal Desktop Core Configurations), access controls, privacy requirements, and the SEC's continuous monitoring program. During FY 2011, in addition to the Annual FISMA Summary Report, we conducted reviews of two additional areas of IT management and issued the following reports: (1) *Assessment of SEC's Continuous Monitoring Program*, Report No. 497 (issued August 11, 2011), and (2) *Review of SEC Contracts for Inclusion of Language Addressing Privacy Act Requirements*, Report No. 496 (issued July 18, 2011).

In its *2010 Annual FISMA Executive Summary Report*, Report No. 489, the OIG identified concerns with the agency's identification, documentation, and reporting of Federal Desktop Core Configuration requirements to the National Institute of Standards and Technology. Further, this report identified multiple concerns in key areas relating to logical access controls, including the disabling of accounts and oversight of user accounts with elevated privileges.

The OIG's *Assessment of SEC's Continuous Monitoring Program*, Report No. 497, also identified several key areas of concern, including access control, audit and accountability, configuration management, contingency planning, identity and authentication, system and services acquisition, system and communications protection, and system and information integrity.

The OIG's *Review of SEC Contracts for Inclusion of Language Addressing Privacy Act Requirements*, Report No. 496, found that although the sampled SEC's contracts contained language requiring that vendors and their employees comply with the Privacy Act, strengthening the language in SEC contracts pertaining to privacy

and information would help to ensure vendors' compliance with those privacy-related provisions and could further reduce the risk that personally identifiable information (PII) will be mishandled.

Additionally, as noted in SEC's FY 2010 Performance and Accountability Report, attention is still needed in specific critical IT areas, such as oversight of IT capital investment, oversight of IT contracts and IT human capital. These key initiatives remain challenges because measures have not been completed to mitigate deficiencies that were identified in the past.

The Office of Information Technology (OIT) and the Office of the Chief Operating Officer concurred with the recommendations identified in the aforementioned OIG reports and have already begun taking steps to remediate the deficiencies.

## **CHALLENGE: HUMAN RESOURCE MANAGEMENT**

The OIG has identified the SEC's human resource management as a management challenge.

During FY 2011, the OIG conducted audits related to human resource management that identified a number of concerns and the need for increased management controls. Specifically, the OIG issued *Audit of SEC's Employee Recognition Program and Recruitment, Relocation, and Retention Incentives*, Report No. 492, in August 2011, and *Review of Alternative Work Arrangements, Overtime Compensation, and COOP-Related Activities*, Report No. 491, in September 2011.

In OIG Report No. 492, we identified numerous areas in which the Office of Human Resources (OHR) needed to improve its processes related to awards and recruitment, relocation, and retention incentives. Significantly, our audit found that OHR had not fully implemented recommendations pertaining to the SEC's award activities that resulted from a 2007 Office of Personnel Management (OPM) human

resources operations audit and, therefore, deficiencies identified in OPM's audit continued to exist.

The OIG's audit also found that there were insufficient resources dedicated to developing and overseeing the SEC's Employee Recognition Program (ERP), and that a large number of sampled awards and recruitment, relocation, and retention incentives lacked documentary support. The audit also found that OHR lacked updated comprehensive policies and procedures and formal training for awards and incentives. Further, we found that the SEC's budgeting processes for awards and incentives for SEC SK (staff-level) employees were flawed which made it difficult for supervisors to reward employees for outstanding performance in the course of their normal job duties.

In OIG Report No. 491, we determined that several improvements were needed to the SEC's alternative work schedule (AWS), overtime, and telework programs. The OIG audit found that although only three types of AWSs were authorized for SEC employees—Flexitour, 5-4/9 compressed, and 10-4 compressed, SEC employees actually used eight types of AWSs in FYs 2008 through 2010. We also determined that, due to the benefits that AWS options provide to employees (*i.e.*, flexibility with respect to their arrival and departure times and the length of workdays within the workweek or pay period), the SEC might benefit from making additional flexible work schedule options officially available to its employees. Our review also found that the SEC did not have a comprehensive manual that addressed the AWS options available to employees. We further determined that the SEC had no official form for employees to use when requesting to participate in AWS programs, and little training on AWS was available to SEC employees.

The OIG audit also found that there was significant confusion with respect to SEC procedures regarding overtime compensation, as well as a lack of formal policies on key issues such as the earning of credit hours by SEC Senior Offi-

cers. The audit also identified areas for improvement with respect to the tracking of telework data and ensuring that SEC Continuity of Operations (COOP) personnel have telework agreements in place.

The OIG audits made numerous specific recommendations designed to improve the SEC's operations in the areas reviewed. Agency management concurred with all of the OIG audits' recommendations and indicated that they intend to take steps to remedy the deficiencies.

### **CHALLENGE: FINANCIAL MANAGEMENT**

The Government Accountability Office's (GAO) FY 2010 audit of the Commission's financial statements found that they were fairly presented in all material respects, and the GAO found no reportable noncompliance with the laws and regulations tested. However, because of two material weaknesses in internal control it identified, the GAO found that the SEC did not maintain, in all material respects, effective internal control over financial reporting, and thus did not provide reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements would be prevented or detected and corrected on a timely basis.

The GAO defines a material weakness as a deficiency or combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by management. The material weaknesses identified by the GAO included (1) information systems controls, and (2) controls over financial reporting and accounting processes.

The GAO has identified pervasive deficiencies in the design and operation of the SEC's information security and other system controls that span across its general support system and all key applications that support financial reporting. Many of these deficiencies have existed since SEC began preparing financial statements in FY 2004. The identified deficiencies jeopardize the confidentiality, availability, and integrity of information processed by SEC's key financial reporting systems and pose a risk of material misstatement in financial reporting. The continuing and newly-identified general and application control deficiencies are in the areas of (1) security management, (2) access controls, (3) configuration management, (4) segregation of duties, and (5) contingency planning. The significant deficiencies that collectively comprise a material weakness over financial reporting and accounting processes concern internal control over (1) the financial reporting process, (2) budgetary resources, (3) registrant deposits, (4) disgorgement and penalties, and (5) required supplementary information.

In addition, the GAO identified other deficiencies in internal controls that although not considered material weaknesses or significant deficiencies, could adversely affect the Commission's ability to meet financial reporting and other internal control objectives. These deficiencies concerned the Commission's (1) proper and timely approvals of disbursements, (2) review of service providers' auditor reports, and (3) controls over travel transactions.

The GAO also reported that it continued to find ineffective automated controls for the SEC's general ledger system and supporting applications, and ineffective security controls over the databases and supporting processes used to generate and maintain the SEC's financial reports. Many of the SEC's key financial reporting applications occurred manually outside the general ledger system through the use of spreadsheets and databases because many of the SEC's key financial system applications did not automatically interface with the general



ledger system. Further, the SEC's general ledger system and certain software applications and configurations lacked the capacity to timely and accurately generate and report information needed to prepare financial statements and manage operations on an ongoing basis. Until these system deficiencies, limitations, and vulnerabilities are addressed, the SEC cannot rely on the internal controls contained in its automated accounting system and supporting financial applications systems to provide reasonable assurance that, in the absence of effective compensating procedures, (1) its financial statements, taken as a whole, are fairly stated; (2) the information the SEC relies on to make decisions on a daily basis is accurate, complete, and timely; and (3) sensitive data and financial information are appropriately safeguarded.

The OIG also conducted work in the financial management area in FY 2011. Specifically, in March 2011, the OIG issued *Audit of the SEC Budget Execution Cycle*, Report No. 488, which identified numerous concerns in the SEC's budgeting process. The audit's findings included: (1) by alternating between two separate appropriations, the SEC may have violated federal law pertaining to the purpose of appropriations and, as a consequence, the Antideficiency Act; (2) the SEC inactivated budgetary controls in the Momentum financial system to facilitate processing payroll transactions, which could lead to a violation of the Antideficiency Act; (3) the SEC's Budget and Program Performance Analysis System (BPPAS) was not configured to accept more than one appropriation; (4) the Office of Financial Management (OFM) did not have a formal budgetary training program; (5) OFM did not require written authorization of reprogramming and realignment actions between budget object classes; and (6) OFM did not sufficiently track the reprogramming and realignment of funds. The OIG made nine specific and concrete recommendations to correct the deficiencies found in the audit. OFM agreed to all of the recommendations and has taken significant steps to address them.

## **CHALLENGE: ETHICS**

The OIG has identified the SEC's Ethics program as a management challenge.

In January 2011, the OIG issued a report of investigation in response to a Congressional request regarding whether a senior employee had violated conflict-of-interest restrictions in connection with employment at a trading firm. While the OIG's investigation found no evidence that the former employee violated conflict-of-interest provisions or acted inappropriately in connection with employment at the trading firm, the OIG investigation did find deficiencies in the agency's ethics procedures, including a lack of proper record keeping. The OIG's report made several recommendations for improvement to the SEC Ethics Office, including that it document the advice provided to SEC employees.

In September 2011, the OIG completed an investigation of potential conflicts of interest arising from the participation of the SEC's former General Counsel in determining the SEC's position in the liquidation proceeding brought by the Securities Investor Protection Corporation (SIPC) of Bernard L. Madoff Investment Securities, LLC (BMIS). After the SEC charged BMIS and Bernard L. Madoff with securities fraud, SIPC determined that BMIS customers were in need of certain protections against losses that are provided through a reserve fund that is used to restore money to investors who have assets with bankrupt or financially troubled brokerage firms.

The OIG investigation found that the former General Counsel participated personally and substantially in particular matters in which he had a personal financial interest by virtue of his inheritance of the proceeds of his mother's estate's Madoff account and that the matters on which he advised could have directly impacted his financial position.

The OIG investigation further found that the SEC's former General Counsel had sought ethics

advice from the former SEC Ethics Counsel who advised him that he did not have a financial conflict of interest. We found that the former SEC Ethics Counsel's advice was based upon several incorrect assumptions and that he did not document the consideration of whether the former SEC General Counsel's actions constituted an appearance of impropriety. We also found that the former Ethics Counsel reported directly to the former General Counsel, who had given the former Ethics Counsel a performance evaluation just seven months after the ethics advice was provided.

The OIG investigation also found that the Ethics Office considered the former General Counsel's participation differently when matters other than the Madoff liquidation proceedings were involved. In addition, the OIG investigation found that the Ethics Office considered recusals in Madoff-related matters differently in situations that did not involve the former General Counsel, and took a more conservative approach for recusal from Madoff-related matters with respect to other employees in the Office of the General Counsel. These findings raised concerns about the consistency of the advice being provided by the SEC Ethics Office.

The OIG Report of Investigation made the following three recommendations with respect to the Ethics Office:

- (1) The SEC Ethics Counsel should report directly to the Chairman, rather than to the General Counsel.
- (2) The SEC Ethics Office should take all necessary steps, including the implementation of appropriate policies and procedures, to ensure that all advice provided by the Ethics Office is well-reasoned, complete, objective, and consistent, and that Ethics officials ensure that they have all the necessary information in order to properly determine if an employee's proposed actions may violate rules or statutes or create an appearance of impropriety.
- (3) The SEC Ethics Office should take all necessary actions to ensure that all ethics advice provided in significant matters, such as those involving financial conflict of interest, are documented in an appropriate and consistent manner.

The SEC Ethics Office has indicated that it intends to implement all three recommendations and take the necessary steps to improve the SEC ethics program.



# SEMIANNUAL REPORT TO CONGRESS

## ADVICE AND ASSISTANCE PROVIDED TO THE AGENCY

During this semiannual reporting period, the OIG provided advice and assistance to SEC management on various issues that were brought to the OIG's attention during the course of audits and investigations conducted by the Office and otherwise. This advice was conveyed through written communications, as well as in meetings and conversations with agency officials. The advice provided included comments on draft policies and procedures and suggestions for improvements in existing policies and procedures.

Specifically, during the reporting period, the IG met with the SEC's Chief Operating Officer (COO), who had recently taken over the functions of the agency's Executive Director, to discuss this new role and future coordination between the OIG and the COO. The IG discussed the challenges facing the COO and offered suggestions and recommendations with respect to the offices under the COO's purview. The IG also met with outside consultants who were advising the agency on the Voice of the Customer portion of the Mission Advancement Program, the goal of which is to design and deliver an effective shared services organization for the SEC. During that meeting, the IG provided his insights on various topics including

an overview of support services, enterprise planning, financial services, human capital administration and facilities, IT data management, enterprise risk management, records management, and internal legal and conflict management.

In addition, the IG and Deputy IG met with the newly-appointed Acting Director of the Office of Administrative Services (OAS) to discuss issues identified in the OIG's Report of Investigation No. OIG-553, *Improper Actions Relating to the Leasing of Office Space*, issued on May 16, 2011, as well as other OIG reports. The IG and OIG staff members met with the SEC's Chief Information Officer and Chief Information Security Officer, as well as other OIT staff, to review new technology OIT plans to deploy to improve the effectiveness of the SEC, including technology pertaining to business automation, workflow, knowledge management, and electronic discovery. Further, on a monthly basis, the IG and the Counsel to the IG met with the Office of Human Resources (OHR) Assistant Director for Work Life Engagement and her staff to review the status of disciplinary and other actions taken or to be taken in response to recommendations contained in OIG investigative reports.

In connection with an inquiry performed into the misuse of government resources by an SEC attorney, we determined that certain guidance on the SEC's intranet site concerning the use of SEC resources for *pro bono* matters was vague and potentially confusing. We recommended that the SEC Ethics Office review the guidance documents on the intranet pertaining to *pro bono* work and the use of government resources, and ensure that all the intranet guidance on these matters was accurate and clear. The Ethics Office promptly took the necessary steps to implement the OIG's recommendation.

Further, the OIG provided advice and assistance to management in connection with several suggestions received by the OIG through the OIG SEC Employee Suggestion Program, established in accordance with Section 966 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For example, the OIG received and reviewed employee suggestions that cost savings could be achieved by eliminating the mailing of hard copy leave and earnings statements to employees' home addresses and limiting the distribution of paper copies of the Code of Federal Regulations (CFR). Based upon our analysis of these suggestions, we concluded that both suggestions could result in cost savings. In particular, we noted that the SEC spent over \$21,000 for paper copies of the CFR during 2011, even though the CFR was available online at no cost. The OIG recommended that management consider both suggestions and further recommended that OAS take steps to ensure that additional information regarding the availability of the CFR online is communicated to SEC staff and that paper copies of the CFR are not ordered unnecessarily. Management concurred with and agreed to implement both suggestions. In particular, OAS agreed to implement new procedures to be used the next time the Government Printing Office offered paper copies of the CFR for sale.

The OIG also reviewed an employee suggestion for revisions to the current SEC Rules of Practice pertaining to service of subpoenas

to allow the service of subpoenas by e-mail in order to expedite the investigative process and decrease costs incurred by sending subpoenas by overnight mail. We determined that revisions to the current rule permitting service of subpoenas by personal service, U.S. mail, commercial carrier, or facsimile may be warranted to reflect advancements in technology. We recommended that Enforcement review the merits of the suggestion and determine if recommended revisions to the Rules of Practice would be beneficial. Enforcement concurred with the suggestion and indicated that it was working with the Office of the General Counsel (OGC) to prepare a recommendation to the Commission to amend the Rules of Practice and/or the Rules Relating to Investigations to permit the service of investigative subpoenas by e-mail.

The OIG also reviewed an employee suggestion that OHR had received under its previous Employee Suggestion Program that was discontinued in April 2011. This suggestion noted the need for additional electronic public records search capabilities and that certain services available to staff in the past had provided better information than the services that were currently available. During our review of this suggestion, we learned that it was possible that *Lexis/Nexis* offered additional features that might be added to the Commission's existing subscription. We forwarded the suggestion to the Office of the Secretary for consideration, noting that employees could benefit from having additional information available when conducting public records searches. We recommended that the Office of the Secretary review current and available data subscriptions to determine if additional data sources could or should be procured, and ensure that all employees receive notice if and when such new services were procured or additional information was made available. In response, the Office of the Secretary indicated that the SEC Library had gained access to an additional feature available through *Lexis/Nexis*, consistent with the employee's suggestion, and that the library would work to strengthen its efforts to

ensure that employees were fully aware of the available information resources.

The OIG reviewed another suggestion that had been received through the previous OHR Employee Suggestion Program, which stated that the SEC should contact state unclaimed property offices to determine whether funds belonging to the SEC were being held by state governments and could be recouped. Research performed by the employee who submitted the suggestion and the OIG revealed numerous instances in which the SEC appeared to be entitled to unclaimed property and/or funds. The OIG learned during its review of the suggestion that the SEC currently had no policies or procedures in place for searching for or potentially retrieving unclaimed property. The OIG referred the suggestion to the Office of Financial Management (OFM) for consideration of establishing procedures to search for potential unclaimed property that could potentially result in cash and/or property being returned to the SEC. In response, OFM established new written procedures to implement a process for searching for and reclaiming SEC property and, pursuant to those policies and procedures, had begun to reclaim funds belonging to the SEC.

In addition, during the reporting period, the OIG reviewed and submitted comments on several draft OIT policies and procedures. For

example, the OIG provided numerous comments on a draft System Development Life Cycle Management Waiver Request Form, which was designed to reflect the decision to allow a project or product to proceed to the next life cycle phase or to deny the waiver request. Overall, the OIG suggested, among other things, that guidance be provided as to what constitutes sufficient justification for a waiver; the form specify whether and what type of documentation should be submitted to support the waiver request; and the form more clearly explain what requirements are being waived and what specific signatures are required. The OIG noted that it might be helpful if an instruction sheet was prepared to accompany the form.

The OIG also reviewed and provided substantial comments on a draft Information Technology Contingency Planning Handbook, which detailed the agency's various IT contingency planning activities, including the development of Information Technology Contingency Plans and Disaster Recovery Plans. The OIG's comments pertained to, among other things, clarification and consistency of various terms or acronyms used in the handbook, clarification as to who must approve certain draft documents, and adding an explanation as to the differences between the SEC's Continuity of Operations (COOP) plan and the contingency plans covered by the handbook.







# SEMIANNUAL REPORT TO CONGRESS

## COORDINATION WITH OTHER OFFICES OF INSPECTOR GENERAL

During this semiannual reporting period, the SEC OIG coordinated its activities with those of other OIGs, as required by Section 4(a)(4) of the Inspector General Act of 1978, as amended. Specifically, the SEC IG, or a senior OIG staff member, attended the monthly meetings of the Council of the Inspectors General on Integrity and Efficiency (CIGIE). The SEC IG also participated in the CIGIE-GAO Annual Coordination Meeting, which took place on April 11, 2011. The topics covered during this joint meeting included, among other things, the elimination of duplicative and wasteful spending, improper payments, and emerging and other issues.

The SEC IG is a member of the CIGIE's Professional Development Committee, the purpose of which is to provide educational opportunities for members of the CIGIE community and to assist in ensuring the development of competent personnel. The IG or a senior SEC OIG staff member attended the Professional Development Committee's monthly meetings. The Counsel to the SEC IG participated in the activities of the Council of Counsels to the Inspector General, an informal organization of IG attorneys through-

out the federal government who meet monthly and coordinate and share information. The SEC OIG also participated in various surveys being conducted by the CIGIE, including surveys pertaining to new media tools and technology that might be useful to the OIG mission and performance measurement for audit products.

Further, one of the SEC OIG's auditors served as a member of the CIGIE Cybersecurity Working Group, which was charged with undertaking a two-part review consisting of (1) identifying recommended practices for maintaining the integrity of OIG IT systems and protecting them from internal threats and vulnerabilities, and (2) examining the role of the IG community in current federal cybersecurity initiatives. During the reporting period, the Cybersecurity Working Group completed the first part of its review and issued its "Management Advisory Report on Cybersecurity" to CIGIE leadership on September 30, 2011. The SEC OIG's auditor provided valuable information to the working group and contributed significantly to the identity management section of the report.

In addition, the SEC IG participated in the activities of the Council of Inspectors General on Financial Oversight (CIGFO), which was created by Section 989E of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CIGFO is chaired by the IG of the Department of Treasury and also includes the IGs of the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Commodity Futures Trading Commission, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration, and the SEC and the Special Inspector General for the Troubled Asset Relief Program. Under the Dodd-Frank Act, the CIGFO is required to meet at least quarterly to facilitate the sharing of information with a focus on the concerns that may apply to the broader financial sector and ways to improve financial oversight. The CIGFO is also required to submit an annual report to the newly-established Financial Stability Oversight Council (FSOC) and the Congress, which must include a section that highlights the concerns and recommendations of each IG who is a member of the CIGFO and a summary of the general observations of the CIGFO.

During this reporting period, the SEC IG attended CIGFO meetings that were held on May 26, 2011, and July 20, 2011, and the SEC Deputy IG participated in the CIGFO's conference calls. The CIGFO's 2011 Annual Report was issued in July 2011. The report included a section primarily drafted by the SEC Deputy IG that provided an overview of the SEC, discussed the mission of the SEC OIG, and set forth recent examples of oversight work performed by the SEC OIG. These examples included audits and investigations related to the SEC's failure to uncover Bernard Madoff's Ponzi scheme, a review of the SEC's role regarding and oversight of Nationally Recognized Statistical Rating Organizations, an assessment of the SEC's bounty program, and a review of the SEC's Section 13(f) reporting requirements. The report also

described the SEC OIG's planned oversight work, including an assessment of the SEC's economic analyses for Dodd-Frank Act rule-making initiatives, a study of the whistleblower protections established under the Dodd-Frank Act, a review of the SEC's Office of Minority and Women Inclusion, and a review of the SEC's internal organizational structure to ensure efficiencies and lack of duplication of efforts. The CIGFO Annual Report is available on the SEC OIG website at [http://www.sec-oig.gov/Reports/Other/CIGFO %20Annual Report July 2011.pdf](http://www.sec-oig.gov/Reports/Other/CIGFO%20Annual%20Report%20July%202011.pdf).

Also during this reporting period, the SEC IG significantly contributed to a letter sent on July 21, 2011, from the CIGFO Chair to the Chair of the FSOC, in accordance with the CIGFO's responsibilities for monitoring the activities of the FSOC. The letter addressed a proposed rule issued by the FSOC, after obtaining public comment, on the development of specific criteria and an analytical framework for designating systemically important financial institutions (SIFIs) for heightened prudential supervision by the Federal Reserve Board. The letter noted that the FSOC was currently revising the proposed regulation to provide further detail and planned to seek additional public comment. In the letter, the CIGFO encouraged the FSOC, as it moved forward with its rulemaking and guidance-related activities, to use to the extent possible (1) objective criteria; (2) transparency; and (3) established timeframes. The CIGFO letter also stated that the FSOC should ensure continuing and appropriate transparency in the process for finalizing the SIFI designation rule and the manner in which the criteria for SIFI designation were implemented. The CIGFO suggested that the FSOC's transparency efforts include periodic reporting on the status of its implementation of the final rule and clear disclosure of the parameters of the SIFI designations and the basis for those designations. The CIGFO further stated that it would be beneficial for the FSOC, in coordination with the Federal Reserve Board, to develop timeframes for completing its review of public comments, revising the pro-

posed regulation, and issuing a final regulation, while balancing the need to ensure the proper process is in place. Finally, the letter noted that the CIGFO will continue to monitor the

FSOC's finalization and implementation of the SIFI designation rule and associated guidance, consistent with the CIGFO's Dodd-Frank Act responsibilities.







# SEMIANNUAL REPORT TO CONGRESS

## AUDITS AND EVALUATIONS

### OVERVIEW

The OIG is required by the Inspector General Act of 1978, as amended, to conduct audits and evaluations of agency programs, operations, and activities. The OIG's Office of Audits focuses its efforts on conducting and supervising independent audits and evaluations of the programs and operations of the various SEC divisions and offices. The Office of Audits also hires independent contractors and subject matter experts to conduct work on its behalf. Specifically, the Office of Audits conducts audits and evaluations to determine whether:

- There is compliance with governing laws, regulations, and policies.
- Resources are safeguarded and appropriately managed.
- Funds are expended properly.
- Desired program results are achieved.
- Information provided by the agency to the public and others is reliable.

Each year, the Office of Audits prepares an annual audit plan. The plan includes work that is selected for audit or evaluation based on risk and materiality, known or perceived vulnerabilities and inefficiencies, resource availability, and complaints that are received from Congress,

internal SEC staff, the Government Accountability Office (GAO), and the public.

### Audits

Audits examine operations and financial transactions to ensure that proper management practices are being followed and resources are adequately protected in accordance with governing laws and regulations. Audits are systematic, independent, and documented processes for obtaining evidence. In general, audits are conducted when firm criteria or data exist, sample data are measurable, and testing internal controls is a major objective. Auditors collect and analyze data and verify agency records by obtaining supporting documentation, issuing questionnaires, and through physical inspection.

The OIG's audit activities include performance audits that are conducted of SEC programs and operations relating to areas such as the oversight and examination of regulated entities, the protection of investor interests, and the evaluation of administrative activities. The Office of Audits conducts its audits in accordance with the generally accepted government auditing standards (Yellow Book) issued by the U.S. Comptroller General, OIG policy, and guidance issued by the Council of the Inspec-

tors General on Integrity and Efficiency (CIGIE).

## Evaluations

The Office of Audits also conducts evaluations of the SEC's programs and activities. Evaluations consist of reviews that often cover broad areas and are typically designed to produce timely and useful information associated with current or anticipated problems. Evaluations are generally conducted when a project's objectives are based on specialty and highly technical areas, criteria or data are not firm, or needed information must be reported in a short period of time. The Office of Audits' evaluations are conducted in accordance with OIG policy, Yellow Book non-audit service standards, and guidance issued by the CIGIE.

## Audit Follow-Up and Resolution

During this semiannual reporting period, the SEC offices and divisions made significant efforts to reduce the backlog of open recommendations, while ensuring that the most recent recommendations were fully implemented. Based on the appropriate evidence and documentation management provided to the OIG to support its implementation of the OIG's recommendations, the OIG closed 76 recommendations related to 17 different Office of Audits reports during this semiannual reporting period.

## AUDITS AND EVALUATIONS CONDUCTED

### Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings

#### Background

The Dodd-Frank Consumer Protection and Wall Street Reform Act (Dodd-Frank Act) was signed into law on July 21, 2010. The law reformed the financial regulatory system, includ-

ing how financial regulatory agencies such as the SEC operate. Among other things, the Dodd-Frank Act:

- gave the SEC regulatory authority over advisers to hedge funds;
- authorized the SEC, together with the Commodity Futures Trading Commission, to regulate over-the-counter derivatives;
- provided the SEC with additional authority and responsibilities for oversight of credit rating agencies;
- imposed greater disclosure and risk retention requirements with respect to the issuance of asset-backed securities;
- strengthened the SEC's authority with respect to corporate governance; and
- required the SEC to study and adopt a uniform fiduciary duty for investment advisers and broker-dealers.

The Dodd-Frank Act required the SEC to undertake a significant number of studies and rulemakings, including regulatory initiatives addressing derivatives; asset securitization; credit rating agencies; hedge funds, private equity funds, and venture capital funds; municipal securities; clearing agencies; and corporate governance and executive compensation. Although the Dodd-Frank Act mandated specific rulemakings, the SEC may have discretion to determine the content of a particular rule.

On May 4, 2011, the SEC OIG received a letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Senate Banking Committee) requesting that the Inspector General review the economic analyses performed by the SEC in connection with rulemaking initiatives undertaken pursuant to the Dodd-Frank Act. The letter asked that the review focus specifically on the cost-benefit analyses prepared by the SEC for the following Dodd-Frank Act regulatory initiatives:

- Credit Risk Retention, 76 Fed. Reg. 24090 (April 29, 2011)

- Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (March 16, 2011)
- Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (February 28, 2011)
- Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (February 11, 2011)
- Registration of Municipal Advisors, 76 Fed. Reg. 824 (January 6, 2011)
- Conflict Minerals, 75 Fed. Reg. 80948 (December 23, 2010)

The OIG retained Professor Albert S. (Pete) Kyle, Ph.D., as a technical expert to assist with the OIG's review of the SEC's economic or cost-benefit analyses in connection with Dodd-Frank Act rulemakings. The technical expert has conducted significant research on such topics as informed speculative trading, market manipulation, price volatility, and the information content of market prices, market liquidity, and contagion.

In connection with this report, issued on June 13, 2011, the technical expert analyzed the cost-benefit and economic analyses conducted by the SEC's different rulemaking divisions and specifically reviewed the process and the collaboration between divisions and offices when determining possible costs and benefits of the proposed rules.

## Results

The review concluded that a systematic cost-benefit analysis was conducted for each of the six rules reviewed. Overall, we found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful economic analysis of the six proposed releases. In several cases, we found that staff from the Division of Risk, Strategy, and Financial Innovation (RiskFin) were involved in the process in

the early stages and contributed extensively to the scope and breadth of the cost-benefit analyses. In these instances particularly, we found the analyses to be thorough and to have incorporated all aspects of the principles of the applicable Executive Orders and the SEC's internal compliance handbook.

However, we also found from discussions with RiskFin staff that the Division's level of communication and involvement in rulemaking initiatives varied considerably and that it had a stronger working relationship with some rule-making teams than with others. Our technical expert noted that because performing a cost-benefit analysis is fundamentally an exercise in economics, it is critically important for RiskFin staff, who have greater expertise in economics than other SEC staff, to be an integral part of the cost-benefit analysis process. He also noted that economists often have skills in econometrics and familiarity with economic data that are necessary for quantifying costs and benefits.

Moreover, the OIG's technical expert noted that the Dodd-Frank Act requires the adoption of many different required regulations. According to our technical expert, individual regulations often create costs and benefits which spill over into other regulations. It is critical, therefore, to have cost-benefit analyses coordinated by one group of economists, who can ensure that the costs and benefits of proposed rules are not ignored or double-counted. Furthermore, as one rule proposal changes, spillovers are created in the costs and benefits of other rules. Dealing with such spillovers requires effective lines of communication among personnel conducting the cost-benefit analyses. Communication works most efficiently when the personnel who need to communicate are in one place, such as in RiskFin.

We also identified two areas of potential deficiencies in the SEC's cost-benefit analyses. First, we particularly noted the lack of macro-level analysis in the proposed release enumerating standards for clearing agency operation and governance. The OIG's technical expert

stressed the importance of a robust macro analysis in connection with the clearing agency operation standards. Second, we noted the lack of an assessment of the quantitative impact of proposed rules, particularly in connection with the rulemaking requiring municipal advisors to register with the Commission. Our technical expert noted that measuring costs and benefits requires both qualitative and quantitative analysis. A specific advantage of quantitative analysis is that it can be used to set benchmarks that can then be used to measure costs and benefits when rules are revisited several years after their adoption. Because the Dodd-Frank Act requires many rules to be implemented in a short time frame, it is likely that there will be many proposals to change the rules in the future. The OIG intends to conduct a more in-depth review of specific cost-benefit analyses performed by the agency and will issue a subsequent report on the results of that review.

This report is available on the OIG website at [http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report\\_6\\_13\\_11.pdf](http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf).

## **Oversight of and Compliance with Conditions and Representations Related to Exemptive Orders and No-Action Letters (Report No. 482)**

### **Background**

The SEC has statutory authority to issue exemptive orders, in response to an entity's request, that allow the entity to engage in transactions that would otherwise be prohibited by the securities laws, rules, or regulations. In some instances, instead of exemptive relief, a company may request a "no-action" letter from Commission staff. A no-action letter states that the staff will not recommend enforcement action in response to the entity's proposed activity. Exemptive orders and no-action letters allow the Commission to provide flexibility and accommodate situations not originally contemplated by the securities laws.

The Commission's general statutory authority to provide exemptive relief is located in Section 28 of the Securities Act of 1933, Sections 12(h) and 36 of the Securities Exchange Act of 1934, Section 6(c) of the Investment Company Act of 1940, and Section 206A of the Investment Advisers Act of 1940. The Commission has delegated authority to its program divisions to issue exemptive orders. The Division of Investment Management (IM) provides exemptive relief under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The Division of Trading and Markets (TM) provides exemptive relief pursuant to the Securities Exchange Act of 1934 to entities, including regulated entities such as broker-dealers and exchanges, and for certain market activities. The Division of Corporation Finance (CorpFin) provides exemptive relief under the securities registration and reporting sections of the Securities Exchange Act of 1934. These divisions may coordinate on exemptive relief regarding cross-cutting securities laws issues—for example, auction rate securities.

Exemptive relief was not intended to provide unrestricted or unlimited relief from the securities laws and rules, however. For example, the Commission has noted the following regarding the general exemptive authority under the Investment Company Act of 1940: "[T]he exceptional power under Section 6(c) to free any person from any or all provisions of the [Investment Company] Act is one which must be exercised with circumspection and with full regard to the public interest and the purposes of the [Investment Company] Act. ..." In order to provide exemptive relief under Section 36 of the Exchange Act, "the Commission must determine that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors." While the Commission may provide unconditional exemptive relief, it generally requires that the recipient of the relief comply with specified conditions. If the SEC grants an exemption that contains conditions, the request-

tor must adhere to the conditions of the exemptive relief issued by the Commission or a division acting pursuant to delegated authority in order for the exemption to have any effect.

In some instances, instead of exemptive relief from the provisions of the securities laws, a company will request assurances, known as “no-action” letters, from Commission staff that the staff will not recommend enforcement action in response to the company’s proposed activity. No-action letters expressly represent only a position by the staff based on the facts and circumstances described in the request, and the letters expressly do not represent legal conclusions or opinions. No-action letters are intended to help industry comply with the securities laws by providing the divisions’ staff positions on contemplated transactions. The division staff clearly state in the no-action letters that the relief granted is based solely on the facts and representations presented, and that any different facts or conditions might require another conclusion.

Compliance by registered entities with the conditions and representations in exemptive orders and no-action letters is reviewed primarily by the Office of Compliance Inspections and Examinations (OCIE) as part of its inspections and examinations program. OCIE conducts examinations of firms that are registered with the Commission, including registered broker-dealers, transfer agents, clearing agencies, investment advisers, and investment companies (collectively, “regulated entities”). According to OCIE, it has been a longstanding practice for examiners to review, as part of pre-examination work, exemptive orders and no-action letters that have been issued to the registrant being examined. OCIE indicated that an examination report or deficiency letter will include the results of OCIE’s review of compliance with exemptive orders or no-action letters if potential violations of the law are found. TM’s Office of Market Operations has on occasion reviewed compliance with IT-related conditions of certain temporary exemptive

orders, but does not engage in any systematic monitoring of such orders.

The objective of our review was to assess the Commission’s processes for ensuring adherence to the conditions under which exemptive orders and no-action letters are granted to regulated entities.

## Results

We found that the Commission can improve its processes for monitoring compliance with conditions and representations related to exemptive orders and no-action letters in a variety of ways. Significantly, our review found that SEC divisions that issue exemptive orders and no-action letters to regulated entities do not have a coordinated process for reviewing these entities’ compliance with the conditions and representations contained in the orders and letters, and instead rely on OCIE to review compliance as part of its examinations. Because exemptive orders and no-action letters allow industry participants to conduct activities that, without the relief, could violate the securities laws and regulations, the review determined that monitoring is important to ensure that regulated entities comply with the conditions and representations in exemptive orders and no-actions letters.

We further determined that the divisions separately track data regarding processed exemptive orders and no-action letters in various ad hoc spreadsheets and databases and that the collected data do not include information on compliance with the conditions and representations in exemptive orders and no-action letters. In addition, while OCIE’s examination tracking system tracks violations of the federal securities laws identified through inspections and examinations, OCIE’s system does not identify the exemptive order or no-action letter that may be related to the violation. Our review also found that while the divisions and OCIE occasionally share information pertinent to exemptive orders and no-action letters, the



process is informal and not systematic. Because the divisions do not systematically capture and analyze data on compliance with the conditions and representations in exemptive orders and no-action letters issued to regulated entities, we determined that the Commission is less effective than it could be in monitoring compliance with such conditions and representations.

Similarly, our review found that the SEC's current organizational structure separates the agency's rulemaking and examinations functions and that there is no formalized coordination between these functions. As noted above, there is also no formalized process for monitoring or ensuring compliance with the conditions and representations in exemptive orders and no-action letters. We noted that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires IM and TM to include examiners on their staffs to provide these divisions with expertise in inspections and regulations of those divisions.

During the review, we learned that although noncompliance with the conditions and representations in exemptive orders and no-action letters could result in significant violations of the securities laws, OCIE and the divisions do not view the granting of exemptive and no-action relief, *per se*, as a substantial non-compliance risk because of the self-executing nature of the relief granted. A sample of examination reports that we reviewed, however, revealed numerous instances in which OCIE examinations found deficiencies in compliance with conditions and representations in exemptive orders and no-action letters. The review found that, despite the noncompliance noted, OCIE's present risk-rating system does not incorporate the issuance of exemptive orders or no-action letters as *per se* risk factors.

## Recommendations

On June 29, 2011, the OIG issued a final report containing the following five recommendations that are intended to enhance the

Commission's oversight of compliance with conditions and representations in exemptive orders and no-action letters:

- (1) IM, TM, and CorpFin should develop processes for coordinating with OCIE regarding reviewing for compliance with conditions and representations in exemptive orders and no-action letters issued to regulated entities on a risk basis.
- (2) IM, TM, and CorpFin, in coordination with OIT and OCIE, should develop and implement processes to consolidate, track, and analyze information regarding exemptive orders and no-action letters.
- (3) IM and TM should, in their plans for implementing the Dodd-Frank Act requirement that they establish their own examination staffs, develop procedures to coordinate their examinations with OCIE and include provisions to review for compliance with conditions and representations in exemptive orders and no-action letters on a risk basis.
- (4) IM and TM should include compliance with the conditions and representations in significant exemptive orders and/or no-action letters issued to regulated entities as risk considerations in connection with their monitoring efforts.
- (5) OCIE should include compliance with conditions and representations in significant exemptive orders and no-action letters issued to regulated entities as risk considerations in connection with its compliance efforts.

Management concurred with all of the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/482.pdf>.

## **Assessment of the Office of Investor Education and Advocacy's Functions (Report No. 498)**

### **Background**

The SEC receives investor inquiries and complaints from the general public, and the SEC's Office of Investor Education and Advocacy (OIEA) is responsible for gathering, processing, and responding to these inquiries and complaints. OIEA consists of four offices: the Office of Investor Assistance, the Office of Investor Education, the Office of Chief Counsel, and the Office of Policy.

The Office of Investor Assistance processes and responds to inquiries and complaints from investors. It utilizes the Investor Response Information System (IRIS) to track and maintain inquiries and complaints received from the investing public. As noted in the Commission's 2010 *Performance and Accountability Report*, tens of thousands of investors each year contact the SEC with investment-related complaints and questions, and OIEA staff "aims to close out as many new investor assistance matters within seven and 30 business days." Staff in the Office of Investor Assistance consist of investor specialists and attorneys who focus on inquiries and complaints involving legal matters. The Office of Investor Assistance routinely works with other Commission divisions and offices, broker-dealers, investment advisers, and companies to provide answers to investors.

The Office of Investor Education produces educational material about investing activities and holds events to educate the investing public. The Office of Chief Counsel provides legal guidance to OIEA and is primarily responsible for preparing investor alerts and bulletins. The Office of Policy participates in the rulemaking process and, in an effort to promote the investor's perspective, reviews the Commission's rules, concept releases, and studies that might affect investors.

The objectives of our audit were to determine whether OIEA addresses investor inquiries accurately and timely processes complaints from investors or refers them to other parties in a timely manner, properly utilizes information from previously received complaints, has a tracking system and standard operating procedures for investor inquiries and complaints that enable it to address inquiries and complaints in accordance with its goals, and provides useful and relevant educational material and events to the investing public.

### **Results**

We found that, based on the samples we reviewed, OIEA's review procedures have lengthened response time for priority inquiries. OIEA's goal is to close out investor inquiries and complaints within seven and 30 business days. Its specific performance targets, as stated in the SEC's FY 2010 performance and accountability report, are to close 80 percent of complaints and inquiries within seven days and 90 percent within 30 days. In the sample we tested, which covered the period from November 14, 2009, to March 31, 2011, 53 percent of Congressional correspondence, 33 percent of Chairman's correspondence, and 22 percent of White House correspondence, excluding repeat complaints, were not closed out within 30 days. Some staff members indicated that review by multiple layers of management has caused response time for priority correspondence to be prolonged. According to OIEA management, the multiple review process for priority correspondence is consistent with OIEA's focus on the quality of responses rather than on simply closing inquiries. Additionally, OIEA management stated that certain inquiries require extensive research and that it was important for OIEA to do its best to assist investors.

During the audit, we also identified several errors in the processing and categorizing of investor inquiries and complaints. In addition, a number of OIEA staff indicated that they needed training on OIEA's tracking system and on the securities industry and new securities

products to better serve investors. OIEA management indicated that they believe staff have been offered many training sessions on OIEA's tracking system and the securities industry.

Additionally, we found that the automated bridge for transferring allegations of wrongdoing from the OIEA tracking system to the Tips, Complaints, and Referrals (TCR) system, which the Commission uses for enforcement and examination purposes, has experienced problems with transmitting complete information and transferring document attachments. We found two cases in which the information in the field describing the investor's allegation(s) in the TCR system was incomplete because of a limit on the amount of text that could be entered in that field. In addition, due to problems related to the automated bridge, the Office of Market Intelligence (OMI), which is responsible for collecting, analyzing, and monitoring complaints that the SEC receives, has expressed concern that it may not receive complete information from OIEA. OIEA employees also expressed concerns about the time it takes to manually transfer information to OMI if there is a problem with the automated bridge.

During our audit, we also found that investor specialists in regional offices do not follow the same procedures used by OIEA investor specialists and that they provide inconsistent responses to inquiries. OIEA stated that because investor specialists in regional offices report to regional directors, it does not have the authority to monitor their investor assistance and education activities.

Further, we found that while OIEA staff are required to ask investors who call OIEA with an inquiry or complaint to take a survey at the end of the call, they are not consistently doing so. Investors who submit an inquiry or complaint using the SEC web form are supposed to receive a follow-up survey from OIEA, but only a low percentage of these surveys have been completed and returned to OIEA. We

also found that the survey sent to investors who use the web form contained questions specifically geared to telephone inquiries.

We also found that information on the SEC website about how investors may contact OIEA by telephone to make inquiries or complaints is not displayed prominently or presented clearly. When we examined the SEC website, [www.sec.gov](http://www.sec.gov), we found that the home page contains no specific information about how to contact OIEA by telephone to make inquiries or complaints. Further, the SEC has two telephone numbers that lead callers to the same recorded greeting and menu options. Additionally, [www.investor.gov](http://www.investor.gov), which was established to support OIEA's mission to educate investors, separate from the SEC's main website, does not show the SEC Toll-Free Investor Information telephone number on the home page.

Finally, we found that there is a lack of communication between Office of Investor Assistance staff members and OIEA management. Many employees expressed concerns about management's lack of interest in addressing their suggestions on OIEA's procedures and requiring them to follow certain procedures that they believe are rigid or inappropriate. OIEA management stated that it seeks feedback from employees but that staff members are unwilling to communicate with management. We also found that Office of Investor Assistance staff thought it would be beneficial to have officewide meetings on a periodic basis so that they would be informed about what other offices in OIEA do.

## Recommendations

On September 30, 2011, the OIG issued a final report containing the following 16 recommendations that are intended to enhance OIEA's operations to assist the investing public:

- (1) OIEA should evaluate its review process for responses to priority and other inquiries to determine whether

bottlenecks or inefficiencies are present and whether opportunities to streamline the process and improve the timeliness of responses exist.

Based on the results of the evaluation, OIEA should make any appropriate changes to management review responsibilities and revise its operating procedures accordingly.

- (2) OIEA should enhance the training available to OIEA staff on IRIS and on processing investor inquiries and complaints. In particular, these enhancements should address areas where confusion or errors are common or persistent.
- (3) OIEA should make additional training available to OIEA staff, including training provided by other divisions or offices within the SEC, on new and emerging topics in the securities industry to help ensure that information provided to investors is accurate and current. OIEA management should regularly solicit ideas for training topics from OIEA staff.
- (4) OIEA should take measures to ensure that all staff, including staff with telephone duty responsibilities, have sufficient time to attend periodic training.
- (5) OIEA, in coordination with OMI and RiskFin, should continue to enhance the bridge between OIEA's IRIS and the TCR system, particularly the functions for transferring attachments and for ensuring the complete transfer of information.
- (6) OIEA should provide regional office investor specialists with ongoing training on investor assistance, including information on resources available on the SEC website and on IRIS.
- (7) OIEA should coordinate with regional offices to establish a system for communicating regularly to help ensure that investor specialists throughout the Commission are providing consistent assistance to investors and that OIEA is aware of significant issues in the regional offices.
- (8) OIEA should continue to consult with regional offices to determine ways it could facilitate participation by the SEC in local events held to educate investors and ways to assist regional offices with other efforts related to educating investors.
- (9) OIEA should issue periodic reminders to OIEA staff members that they are required to provide investors with the option to complete a survey after every call.
- (10) OIEA should revise the questions in its survey sent to investors who use the SEC's web form for inquiries and complaints by deleting questions applicable only to telephone inquiries and complaints and adding questions specifically relevant to inquiries and complaints submitted through the web form.
- (11) OIEA, in coordination with the Office of the Secretary, should move the SEC's Toll-Free Investor Information Service telephone number to a more prominent location on the SEC website, such as the home page.
- (12) OIEA should determine, in coordination with the Office of the Secretary, whether there should be one SEC information service telephone number instead of two on the "Useful SEC Contact Information" list on the SEC website.
- (13) OIEA should display the SEC Toll-Free Investor Information Service telephone number on the home page of Investor.gov for investors to make inquiries or complaints.
- (14) OIEA should communicate matters related to OIEA operations, such as personnel changes and initiatives by

offices within OIEA, to staff members at least once a month through office-wide e-mails or an officewide meeting and ensure appropriate and necessary communication between the different offices within OIEA.

- (15) OIEA should continue to seek feedback from staff members on new and revised policies and procedures and other matters that would affect the office and should provide adequate time for staff to review and respond to feedback requests.
- (16) OIEA should participate in team-building exercises that are available at the Commission to improve communications and relations between management and staff.

Management concurred with all of the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/498.pdf>.

## **Review of Alternative Work Arrangements, Overtime Compensation, and COOP-Related Activities at the SEC (Report No. 491)**

### **Background**

Federal agencies have in recent years been directed to provide employees with greater flexibilities in their work and expanded opportunities to telework. In addition, agencies are now required to have continuity of operations (COOP) plans and to incorporate telework into these plans.

Within the SEC, OHR is responsible for developing, implementing, and evaluating the Commission's work/life programs, including its alternative work schedule programs and its telework program. Although the existing SEC Personnel Operating Policies and Procedures (POPPS) Manual describes alternative work schedules and telework, as well as overtime compensation for employees, the material is

outdated. OHR is developing a new handbook, the Human Capital Directive, to replace the POPPS Manual. The 2007 collective bargaining agreement (CBA) between the SEC and the National Treasury Employees Union (NTEU) addresses alternative work schedules, telework, and overtime compensation in detail and is applicable to all SEC bargaining unit employees. According to OHR, the alternative work schedule programs described in the CBA are also available to nonbargaining unit employees.

The objectives of our review were to (1) examine how well the SEC has implemented and oversees its alternative work schedule and telework programs; (2) determine whether the SEC complies with applicable federal laws and regulations and SEC policies and procedures pertaining to alternative work schedules, telework, and overtime; and (3) assess the pertinent SEC IT capabilities and support for the SEC's telework and COOP programs. As part of our review, we issued a survey to all SEC personnel concerning alternative work schedules, telework, overtime compensation, and COOP. The survey consisted of numerous yes/no and multiple-choice questions and also included an opportunity for respondents to provide written comments.

### **Results**

We found that six alternative work schedule programs in which SEC employees participated—3-day workweek, flexible workweek, Maxiflex, 10-hour days biweekly, first 40-hour tours of duty, and rotating shifts—were not among the alternative work schedules included in the CBA or the POPPS Manual. In addition, we determined that some federal agencies are allowing their employees more flexibility with respect to their arrival and departure times and the length of workdays within the workweek or pay period by implementing work schedule options such as a gliding schedule, variable day schedule, or variable week schedule. We determined that, due to the benefits that alternative work schedule options provide



to employees, the SEC might benefit from making additional flexible work schedule options available to its employees.

Our review also found that the SEC does not have a comprehensive manual that addresses alternative work schedule options that are available to all employees. The CBA references only three types of alternative work schedules: Flexitour with credit hours, compressed 5-4/9, and compressed 4-10. The POPPS Manual addresses only two alternative work schedule options, Flexitour and 5-4/9 compressed, and the pertinent material has not been updated since January 20, 1995. Moreover, the POPPS Manual provision addressing Flexitour schedules and credit hours is inconsistent with the Flexitour provisions of the CBA. Additionally, the POPPS Manual provision addressing compressed work schedules is not only outdated, but contains significant inconsistencies with the CBA. We further determined that the SEC has no official form for employees to use when requesting to participate in an alternative work schedule. We also found that little training on alternative work schedules is available to SEC employees and that this lack of training may have contributed to the use of unauthorized alternative work schedules by SEC employees.

We found that the current CBA language allows employees who work a conforming schedule (*i.e.*, one that aligns with the office's official business hours) to earn and use credit hours and is, therefore, inconsistent with federal law providing that credit hours are available only to employees who work flexible schedules. We also found that while members of the Senior Executive Service (SES) are prohibited by federal regulation from earning credit hours, Senior Officers at the SEC (who are essentially equivalent to SES members) are permitted to earn and do earn credit hours, although the SEC has no official policy addressing this issue. Our review also found that while Senior Officers are prohibited from earning compensatory time off except for religious purposes, one Senior Officer did earn compensatory time off for

other than religious purposes during FYs 2008 through 2010.

In addition, we found that while many SEC employees are compensated for overtime work in some manner, other employees are not. A 1992 provision of the POPPS Manual stated that employees in professional or supervisory positions are expected to have sufficient interest in completing their assignments on a timely basis and keeping their workload reasonably current by performing voluntary work outside of regular work hours on their own initiative whenever necessary. We noted, however, that with respect to bargaining unit employees, this provision appeared to be superseded by the 2007 CBA, which provided that the SEC will not expect or require employees to donate time in lieu of proper overtime compensation. Further, we found no SEC policy that superseded the 1992 POPPS Manual provision for nonbargaining unit employees, and we found inconsistent views among OHR senior staff with respect to the appropriateness or legality of management's expectation that employees who are exempt from the overtime pay requirements of the Fair Labor Standards Act work some amount of uncompensated overtime.

We found the SEC's promotional and training activities related to telework to be inadequate. New SEC employees receive little information about telework during orientation, and 57 percent of the respondents to our work/life survey believed that the SEC's advertisement of its work/life programs could or should be improved, with some comments specifically mentioning the lack of information regarding telework. The work/life survey also identified improvements to the SEC's current guidance concerning telework. Our analysis of the training materials currently being used for SEC telework courses revealed some gaps in their content, particularly with respect to the teleworking provisions of the CBA.

In addition, we found that as of December 31, 2010, 125 SEC employees engaged in telework three or more days per week, with 68 of

these employees being located in the SEC headquarters facility. We learned, however, that the majority of these frequent teleworkers, including some who telework five days a week, still have private offices at SEC headquarters, notwithstanding that a stated purpose of federal telework programs is to reduce real estate and energy costs and promote management efficiencies.

In reviewing the use of telework at the SEC, we analyzed the telework data that the SEC reported to OPM for calendar years 2008 and 2009 and compared the reported data to other telework data maintained by OHR. We found inconsistencies between the two sets of data. We also found that the reports produced by the SEC for OPM do not track the number of employees whose telework agreements have been denied or terminated. We also noted that the Telework Enhancement Act of 2010 establishes additional requirements for OPM reports based on agency-provided data and that the SEC will be unable to provide the necessary data to OPM without a system for gathering timely and accurate information on telework. While we found that the SEC's Telework Coordinator has established a telework program work plan for FY 2011 that includes addressing OPM reporting requirements, the Telework Coordinator has not developed explicit goals and objectives to ensure that the elements of the plan are achieved or any goals and objectives for increasing telework participation.

With regard to telework as it relates to COOP, we found that nearly half—49 percent—of SEC COOP mission-essential personnel do not have telework agreements in place. We also determined that the telework agreements of mission-essential personnel do not include work expectations related to emergency telework and that the SEC does not require its mission-essential personnel to enter into telework agreements. In addition, we found that some SEC mission-essential personnel participating in COOP exercises are not required to remotely access the SEC's network during such exercises. We concluded that a significant number of SEC mission-essential

personnel are not likely routinely practicing their remote access capabilities, which could impair their ability to perform mission-essential functions during emergency situations.

We further determined that although telework is mentioned in the SEC's headquarters and regional office COOP plans, the telework provisions in the COOP Plan were not as specific and detailed as those contained in the SEC's April 2009 Pandemic Influenza Preparedness Plan. We found that the current SEC COOP Plan emphasizes the use of relocation facilities rather than telework.

Our examination of the regional office COOP plans revealed that none of those plans contained all the elements of a viable continuity plan and that some of the plans were outdated. We also determined that the SEC's regional office COOP plans, like the Commission-wide COOP Plan, do not fully address the role of telework.

Finally, we determined that although the SEC has a variety of remote access tools for teleworkers to use, the OIT has not tested the maximum user limits of the SEC's remote access technology.

## Recommendations

The OIG issued a report on the results of our review on September 28, 2011. The report included the following 27 recommendations to improve the SEC's alternative work schedule, overtime, telework, and COOP programs:

- (1) OHR should take necessary actions to ensure that employees do not work unauthorized alternative work schedules, including required revisions to the CBA, and steps to ensure that all Commission managers and staff are fully informed about which alternative work schedules are authorized.
- (2) OHR should ensure that the (a) new Human Capital Directive addresses all alternative work schedules avail-

- able to SEC employees, and (b) contents of the Human Capital Directive are and remain consistent with the alternative work schedule components of the CBA.
- (3) OHR should ensure that the new Human Capital Directive addresses all SEC employees—supervisory, managerial, professional, nonprofessional, bargaining unit, and nonbargaining unit employees—and contains up-to-date information on all alternative work schedule programs authorized by the Commission.
  - (4) OHR should (a) provide comprehensive training to all employees and managers on all available alternative work schedule programs and (b) make up-to-date information on alternative work schedules and policy available electronically to all employees on the SEC intranet site and periodically notify employees of its availability and location.
  - (5) OHR should develop an alternative work schedule request form that contains sections for the requesting employee's information and certification; the type of alternative work schedule requested, including specific work hours and, if applicable, workdays; the immediate supervisor's approval; and, if applicable, the approving official's decision.
  - (6) OHR, in developing the new Human Capital Directive, should work with NTEU to determine whether additional alternative work schedules, such as the gliding, variable day, variable week, three-day workweek, and Maxiflex options described in OPM's Handbook on Alternative Work Schedules, should be adopted as options for SEC employees.
  - (7) OHR should include in the new Human Capital Directive clear, up-to-date information on the laws, policies, guidelines, and procedures related to credit hours, compensatory time off, payment for overtime worked, and voluntary and uncompensated services.
  - (8) OHR should negotiate revisions to the language in the CBA between the Commission and the NTEU with respect to the use of credit hours by employees working conforming schedules, ensuring that the revised language conforms with applicable law.
  - (9) OHR should institute appropriate controls to ensure that Senior Officers do not receive compensatory time off.
  - (10) OHR should consult with OGC and OPM to determine whether the SEC should adopt an official policy that addresses whether Senior Officers are permitted to earn credit hours.
  - (11) OHR should ensure that the recommendations made by the Telework Advisory Group in its assessment of the SEC's telework policy are considered, including the recommendation that OHR use the Telework Advisory Group's telework policy evaluation checklist as a resource to further develop the Commission's telework policy.
  - (12) OHR should revise the one-page overview of telework provided to new employees to include website references for telework resources; the name, telephone number, and e-mail address of the SEC Telework Coordinator; and page references to article 11, Telework Program, of the 2007 CBA.
  - (13) OHR should provide comprehensive telework training sessions to SEC employees that address, among other things, telework tools; policies and procedures for discontinuing telework; what happens when an employee is promoted, reassigned, or

- detailed; duty station policy; employee availability during telework; employee personal computer usage; mandatory telework-related forms; office supplies and equipment; and protection of government records.
- (14) OHR should provide comprehensive telework training sessions to SEC managers that address, among other things, telework tools, policies, and procedures related to managers' approval and denial of employee telework, managers' right to direct employees to report to work on their telework day, and managers' ability to suspend or terminate telework.
  - (15) OHR should require training and recertification for current teleworkers and their managers at least every two years.
  - (16) OHR should send administrative notice e-mails to all SEC employees twice each year reminding them of the Commission's telework options and the benefits of participating in the program.
  - (17) The Office of Administrative Services should establish and enforce procedures to ensure that employees who telework three or more days a week do not maintain private offices, but rather share office space.
  - (18) OHR should develop an improved telework database that will track the processing of telework agreements and store telework agreements to ensure that the data it reports to OPM are reliable and valid.
  - (19) OHR should require that SEC managers provide the Telework Coordinator with copies of denied or terminated telework agreements to facilitate tracking of such agreements.
  - (20) OHR should develop goals and objectives for accomplishing the work listed in the telework program work plan for FY 2011 and for increasing telework participation by SEC employees.
  - (21) OHR should establish a process to monitor progress in meeting the Commission's telework-related goals and objectives and, if the goals and objectives are not being met, OHR should take action to identify and eliminate barriers to meeting the goals and objectives.
  - (22) Consistent with governing Federal Emergency Management Agency (FEMA) and OPM directives and the SEC CBA, OHR, in conjunction with the Office of FOIA, Records Management, and Security, should require all mission-essential personnel to enter into telework agreements that specifically allow them to conduct their continuity of operations responsibilities and the mission-essential functions they will perform during emergencies or agency closures.
  - (23) Consistent with governing FEMA and OPM directives and the SEC CBA, OHR, in conjunction with the Office of FOIA, Records Management, and Security, should require mission-essential personnel who have telework agreements to telework periodically to practice their assigned mission-essential and primary mission-essential functions.
  - (24) The Office of FOIA, Records Management, and Security should update the continuity communications section of the SEC's COOP Plan and expand it to expressly address conducting essential functions by telework consistent with governing FEMA and OPM directives and the SEC CBA, and include subsections addressing telework capability, training staff to telework effectively, and exercising agency telework competence as detailed in the SEC's Pandemic Influenza Preparedness Plan.

- (25) The Office of FOIA, Records Management, and Security should instruct regional office directors to revise their regional office COOP plan to address all the essential elements of viable continuity capability specified by FEMA and, to ensure that the plans are reviewed and modified timely and presented in a standard format, the Office of Security Services should establish timelines and submission criteria for the revised plans.
- (26) The Office of FOIA, Records Management, and Security should instruct the directors of the appropriate regional offices to include in their COOP plans strategies for supporting headquarters essential functions during devolution of control.
- (27) OIT should coordinate with other SEC offices and divisions to perform server stress tests, which should incorporate a variety of applications used with remote access.

Management concurred with all of the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/491.pdf>.

**Audit of SEC's Employee Recognition Program and Recruitment, Relocation, and Retention Incentives (Report No. 492)**

**Background**

The SEC's Employee Recognition Program (ERP) is designed to motivate employees and recognize contributions above and beyond normal job requirements with monetary and nonmonetary awards and to improve the efficiency of operations through an employee suggestion program. The Commission determines how much of its budget will be allocated to the ERP and how the budgeted amounts will be

allocated among the various divisions and offices. The Office of Human Resources (OHR) has authority for managing the Commission's awards budget and granting final approval of awards. OHR is also responsible for training supervisors to use the ERP effectively, providing guidelines for initiating appropriately selected performance-related awards, encouraging employees to submit suggestions to the suggestion program, and evaluating and processing awards and suggestions. Further, OHR is responsible for monitoring and evaluating the adequacy of documentation for award recommendations and the use of approval authority that is delegated to divisions and offices.

Recruitment, relocation, and retention (3R) incentives are among the human capital flexibilities intended to help federal agencies address human capital challenges and to build and maintain a high-performing workforce with essential skills and competencies. According to the Office of Personnel Management (OPM), the intent of 3R incentives is to provide agencies with discretionary authority to use nonbase compensation to help recruit, relocate, and retain employees in difficult staffing situations.

The overall objective of our audit was to assess whether monetary awards under the SEC's ERP and 3R incentives were awarded consistent with applicable governing policies and procedures. We also examined whether awards and incentives were linked to the Commission's human capital plan, as applicable.

**Results**

Our audit identified numerous areas where OHR needed to improve its process related to awards and 3R incentives. We found that OHR had not fully implemented recommendations resulting from a 2007 OPM human resources operations audit pertaining to the SEC's award activities and that the deficiencies the recommendations were intended to address continue to exist.



We found that insufficient resources were dedicated to developing and overseeing the ERP and that documentary support for a large number of sampled awards and 3R incentives was lacking. As a result, there was insufficient documentation to show the basis for the awards and incentives and that required approvals had been properly obtained. Our audit also found that OHR lacked updated comprehensive policies and procedures and formal training for awards and 3R incentives.

Further, we found that the SEC's budgeting processes for awards and incentives for SK employees were flawed and that supervisors currently can use their award budgets only for special act awards, virtually eliminating their ability to reward employees for outstanding performance in the course of their normal job duties and contrary to one of the primary purposes of the ERP. We also found that some offices and divisions exceeded their award budgets or provided awards in advance of receiving their award budgets. In addition, we identified significant time lags between award dates and special act dates that occurred because award budget allocations were made late in the fiscal year.

We also found that an SEC employee received an award for work that was the subject of an OIG investigative report and that the SEC made a cash award to an SEC Schedule C employee in FY 2010 in violation of OPM guidance restricting awards, bonuses, and similar payments for political appointees.

Our audit also found that although OHR had an Employee Suggestion Program from 2008 to 2011 that included a monetary incentive component, OHR did not make any cash awards under the program. Additionally, the program was given little priority and was not effectively managed. Lastly, we found that the SEC does not currently have in place a human capital plan. Accordingly, activities associated with the ERP and 3R incentives were not being assessed to determine whether they effectively

align with the SEC's overall human capital goals and objectives.

## Recommendations

The OIG issued a report on the results of the audit on August 2, 2011. The report included the following 14 recommendations to OHR to help enhance management controls over the ERP and 3Rs:

- (1) Implement an internal review process to review a select number or percentage of awards annually to ensure that appropriate documentation exists for the awards and needed information is readily available to support the awards.
- (2) Annually provide information to SEC supervisors on relevant parts of the SEC award program, including (1) types of awards available and procedures for nominating employees for awards, (2) appropriate types of division- and office-level awards for peer recognition, and (3) successful award practices.
- (3) Dedicate specific resources to develop and oversee the ERP.
- (4) Finalize its policies and procedures for the ERP within three months and publish them on the SEC's Insider. The policies and procedures should include information on current practices for determining bonuses for Senior Officers (SO), policies for determining performance-based awards for SK employees, and acceptable methods of providing informal non-monetary awards in addition to traditional nonmonetary awards.
- (5) Review and update its existing policies and procedures on 3R incentives. The update should ensure that the new policies and procedures reflect appropriate references to SK and SO employees and include expanded authority for retention bonuses.

- (6) Provide formal training on its revised policies and procedures and issue information notices to supervisors and employees as needed to reflect changes in practices and policies.
- (7) In conjunction with the Office of Financial Management (OFM), take the following actions:
  - (a) Develop alternatives for reviewing the SEC award budget so that it is competitive with other federal agencies' award budgets.
  - (b) Develop and implement a mechanism to reward employees for superior or meritorious performance within their job responsibilities through lump-sum performance awards.
  - (c) Determine ways to reduce the time required for formulation of budget allocations, including, for example, moving responsibility for formulating award budget allocations to OFM and having the OIT walk-in development center develop an electronic program to pull payroll data directly from the Department of the Interior to facilitate more timely completion of budget allocations.
  - (d) Implement a process to make initial award allocations in the first quarter of each fiscal year, thereby giving offices the ability to make awards throughout the year, as appropriate in light of continuing resolutions. Base initial allocations on historical data and then refine the allocations, as needed, when the SEC's annual budget has been approved.
  - (e) Allocate award funds directly to SEC divisions and offices instead of placing the initial award funds in OHR's budget, and hold office and division heads responsible for monitoring use of the funds.
- (f) Re-examine budgeted amounts for 3R incentives to ensure that sufficient funds are available, and make supervisors aware of available funding so that they can effectively use incentives to recruit and retain needed talent.
- (8) Develop and train human resources specialists on a centralized filing system (manual, electronic, or both) for all awards that contains appropriate documentation to support the awards, including SF 50 and SEC Form 48 with narrative justification and appropriate approvals.
- (9) Implement management controls to ensure that employees who are subject to disciplinary action are restricted from receiving awards related to the performance that resulted in the disciplinary action.
- (10) Review the August 12, 2010, cash award to a Schedule C employee to determine whether it was in violation of the OPM guidance and, if so, seek recovery of the improper award.
- (11) Consider ways that, as part of the ERP, it may be able to provide awards to employees for adopted suggestions submitted to the OIG's suggestion program.
- (12) Revise the service agreement format in SEC Form 2299, Securities and Exchange Commission Recruitment Bonus Service Agreement, to incorporate specific reasons that the SEC "may" and "must" terminate service agreements for recruitment and relocation bonuses.

- (13) Develop and train applicable human resources specialists on the use of a centralized filing system for all relocation, recruitment, and retention incentives. The centralized filing system should contain all appropriate documentation to support the incentives, including the SF 50 and the applicable SEC form with the narrative justification for the bonus and the appropriate approvals.
- (14) Identify resources and establish a timeline to complete the required human capital plan. Ensure that ERP activities are evaluated at least annually to ensure that they align with human capital plan objectives and strategies.

Management concurred with all of the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/492.pdf>.

### **Assessment of SEC's Continuous Monitoring Program (Report No. 497)**

In August 2010, the SEC OIG contracted with C5i Federal, Inc. (C5i) to assist with the completion and coordination of the OIG's input to Office of Management and Budget (OMB) Memorandum M-10-15, FY 2010 Reporting Instructions for the Federal Information Security Management Act (FISMA) and Agency Privacy Management, and to perform two separate reviews—one on the SEC's continuous monitoring program and the other on the inclusion of language addressing Privacy Act requirements in SEC contracts. This review was conducted to assess the Commission's continuous monitoring program.

Continuous monitoring is the process of tracking the security state of an information system on an ongoing basis and maintaining the security authorization for the system over time. Understanding the security state of information systems is essential in highly dynamic

operating environments with changing threats, vulnerabilities, technologies, and missions/business processes. Continuous monitoring includes, but is not limited to, the following components, which are specified in National Institute of Standards and Technology (NIST) Special Publication 800-53, *Recommended Security Controls for Federal Information Systems and Organizations* (NIST 800-53):

- Access Control
- Awareness and Training
- Audit and Accountability
- Security Assessment and Authorization
- Configuration Management
- Contingency Planning
- Identity and Authentication
- Incident Response
- Maintenance
- Media Protection
- Physical and Environmental Protection
- Planning
- Personnel Security
- Risk Assessment
- System and Services Acquisition
- System and Communications Protection
- System and Information Integrity

The overall objective was to assess the SEC's continuous monitoring program and further assess current policies and procedures and their compliance with NIST, FISMA, OMB guidance, and industry best practices. C5i reviewed the findings from previously issued OIG reports, conducted interviews with SEC OIT staff, and reviewed support documentation and the Commission's policies and procedures. C5i used the guidance and best practices to support their conclusions and recommendations.

### **Results**

As detailed in the report, C5i found that the following additional areas need improvement:

- Access Control
- Audit and Accountability
- Configuration Management

- Contingency Planning
- Identity and Authentication
- Planning
- System and Services Acquisition
- System and Communications Protection
- System and Information Integrity

Specifically, the assessment found that the OIT Server and Storage Group currently captures and retains logs for its networks and systems but has no documented policies and procedures pertaining to this function. Without fully defined and documented roles and responsibilities and procedures detailing the types of logs to be captured and retained, C5i could not fully determine whether the Commission was capturing system and network logs in a manner that would provide all the necessary information in the event of a security event investigation.

Also, during the assessment C5i found that not all the tests produced successful results. For example, some applications exceeded the maximum allowable time to come back online, and communication and coordination were not as strong as needed.

C5i did find there were improvements from the bi-annual April and November tests in 2010 to the retest performed in January 2011. However, issues encountered in the disaster recovery exercises raised concern about the SEC's ability to successfully failover and restore capabilities in the event of a major disaster.

The assessment also found that the Commission had made great strides in improving the deployment of patches to its systems and ensuring that the systems were up to date with current security remediation issued by vendors. However, C5i also found that the environment used to test patches before deployment was not identically configured to the Commission's production environment due to differences in hardware and software. Using a test environment that does not accurately reflect the current production environment can produce inaccurate results and can result in

failure of patches or other remediation to work correctly when deployed into production, which can lead to adverse effects on the production network and degradation of network performance.

The assessment further found that the SEC's password policy was not consistently applied to all network users. Specifically, C5i found five contractors who had never been prompted to change their passwords and had their then-current passwords in violation of the SEC's password policy. In addition, C5i found that the SEC password policy requirements for complexity, as documented in SEC Implementing Instruction, II 24-04.06.01 (01.1), Identification and Authentication, July 9, 2008, were inconsistent with the Group Policy requirements implemented in Active Directory on the SEC network. C5i also found many inconsistencies in the procedures used by the help desk technicians to verify callers' identity before resetting their network password.

Further, the assessment found that while OIT has a policy for contractors' entry and exit that specifies steps for issuing badges, setting up and terminating accounts, equipment issuance, and so on, the policy does not apply Commission-wide. Additionally, C5i found that the Office of Administrative Services (OAS) was developing a policy to be implemented throughout the Commission, but it had not been completed or approved. C5i assessed the OAS policy under development and found that the policy lacked some of the detail that was included in OIT's policy such as roles and responsibilities and checklists. C5i recommended that OAS and OIT work together on Commission-wide policy and finalize and implement this policy. Additionally, C5i recommended that training for all staff involved with contractors such as Contracting Officers, Contracting Officer's Technical Representatives, and Contractor Points of Contact be developed and rolled out to ensure the policy is effectively and thoroughly communicated.

The final report on the results of the assessment performed by C5i, issued on August 11, 2011, contained the following 13 recommendations for improving OIT's continuous monitoring program:

- (1) OIT should review the Commission's Microsoft Active Directory settings and make the necessary changes to ensure that OIT password policy requirements, as documented in the Implementing Instruction, are strictly enforced for both on-site and remote users and that the documented password structure set forth in OIT policy is strictly enforced.
- (2) OIT's help desk should begin using a random password generator to create temporary passwords for users.
- (3) OIT should implement training to ensure that technicians consistently verify users' information in accordance with OIT policy when they receive requests to change user accounts and passwords.
- (4) OIT should ensure that security controls configurations that are applied in the production environment are identical with those applied in the testing environment.
- (5) OIT should develop and implement written procedures to ensure configuration consistency in the Commission's production and testing environments. These procedures should detail the software and hardware components in both environments and specify the actions required to maintain consistent environments.
- (6) OIT should complete and finalize written server and storage log management policies and procedures that fully document roles and responsibilities for log capture, management, retention, and separation of duties.
- (7) OIT should require that facilities have consistent, appropriately installed application and system configuration files to ensure the ability to successfully failover and/or restore in the event of a disaster.
- (8) OIT should fully document and communicate the criteria used to determine the success or failure of an application during the disaster recovery tests to ensure consistent reporting of results and alleviate confusion.
- (9) OIT should analyze the level of criticality of the Commission's data and the needs and wants of its customers, and establish an appropriate backup retention period based on the results of that analysis and that meets the requirements of the Commission.
- (10) OIT should ensure that backup data are stored securely.
- (11) OAS should work with the OIT to develop and implement a comprehensive Commission-wide policy for the entry and exit of contractors.
- (12) After the OAS contractor entry and exit policy, "Contractor Personnel Employment Entrance and Exit Procedures," has been finalized and approved, OAS should provide training and communicate with responsible parties, such as Contracting Officers, Contracting Officer's Technical Representatives, and Inspection and Acceptance Officials, regarding their roles and responsibilities and proper procedures with respect to contractor entry into and exit from the Commission.
- (13) OHR, OIT, OAS, and the contracting office should take steps to ensure that OIT has received all account termination notices for separated/terminated employees and contractors and has deactivated the appropriate accounts in a timely manner.

Management fully concurred with all of the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/497.pdf>.

## **Review of SEC Contracts for Inclusion of Language Addressing Privacy Act Requirements (Report No. 496)**

### **Background**

The Privacy Act of 1974, 5 U.S.C. § 552a(m)(1), provides that when an agency contracts for the operation of a system of records to accomplish an agency function, the agency must include in the terms of the contract provisions making the contractor responsible for complying with the Privacy Act. It also makes these contractors liable under the criminal provisions of the Act. SEC Administrative Regulation 24-08 (SECR 24-08) establishes policy for the Commission's privacy program, including the protection of personally identifiable information (PII) that is collected by the SEC. SECR 24-08 applies not only to SEC employees, but also to contractors and others working on behalf of the SEC who handle, control, or have access to information, documents, or systems that contain PII.

In August 2010, the SEC OIG contracted with C5i to perform two separate reviews. One of the reviews, described above, examined the SEC's continuous monitoring program. This report, which was issued on July 18, 2011, presented the results of the second review, in which the objective was to determine whether SEC contracts contain appropriate language addressing Privacy Act requirements.

### **Results**

C5i reviewed a judgment sample consisting of 11 SEC contracts that included language requiring vendors to handle SEC PII. The sample contained employee recruitment, financial systems management, and IT contracts. The review found that each of the contracts in the sample contained the appropriate sections

addressing such requirements as nondisclosure agreements, system security, and PII protection.

C5i also reviewed the results of the SEC's FY 2010 Section (m) Contracts Compliance Review Memorandum, dated November 3, 2010, which detailed the results of the SEC Privacy Office's review of eight randomly selected SEC contracts for compliance with Privacy Act requirements. The review concluded that all sampled contracts included language binding vendors to the requirements of the Privacy Act. C5i examined six additional contracts to verify that they contained the appropriate provisions required by the Privacy Act for nondisclosure agreements, background investigations of personnel, PII handling, and security of systems. C5i found that the contracts did include such provisions and, therefore, concurred with the conclusions of the FY 2010 Section (m) Contracts Compliance Review Memorandum.

Although the review found that the SEC's contracts contained language requiring that vendors and their employees comply with the Privacy Act, the report contained the following two recommendations that were intended to strengthen the language in SEC contracts pertaining to privacy and to help ensure vendors' compliance with those provisions:

- (1) OAS should add language provided by OIT to new service contracts that require the handling of PII stating that the SEC requires the contractor to provide copies of the contractor's privacy policies and privacy impact assessments.
- (2) OAS should add OIT-defined security requirements to applicable contracts stating that contractors handling electronic PII may be required to meet defined security requirements when transmitting PII across public networks (*i.e.*, Internet) or stored on portable media. OIT should also add language to applicable interconnectivity agreements stating that partners



transmitting electronic PII across public networks (*i.e.*, Internet) are required to meet OIT-defined security requirements.

Management fully concurred with the report's recommendations. The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/496.pdf>.

## **Establishment of the Office of Minority and Women Inclusion**

### **Background**

On February 10, 2011, the SEC Inspector General testified before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives, concerning his oversight of the SEC by means of the OIG's audit and investigative functions. During that testimony, Congresswoman Barbara Lee (D-California) asked about the status of the SEC's efforts in creating the Office of Minority and Women Inclusion. In response to Congresswoman Lee's request, the OIG researched the SEC's implementation of the requirement for an Office of Minority and Women Inclusion and provided Congresswoman Lee with a copy of the OIG's report.

### **Results**

The OIG determined that the SEC did not establish an Office of Minority and Women Inclusion within six months after the date of enactment of the Dodd-Frank Act, as required by Section 342(a)(1)(A) of the Act. SEC management informed the OIG that it did not meet this deadline because Congress had not yet acted on the Commission's request that Congress approve creation of the office. SEC management further indicated that, in the meantime, the SEC organized a planning group to discuss and address issues related to the establishment of the office, and the SEC's OAS and Office of Equal Employment Opportunity were conducting activities intended to

promote minority and women inclusion in SEC contracts and hiring.

The report is available on the OIG website at <http://www.sec-oig.gov/Reports/AuditsInspections/2011/496.pdf>.

## **PENDING AUDITS AND EVALUATIONS**

### **Review of the SEC's Economic Analyses for Dodd-Frank Act Rulemaking Initiatives**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was passed on July 21, 2010. Among other things, the Dodd-Frank Act required the SEC to promulgate more than 100 new rules and to produce more than 20 new studies and reports.

During this semiannual reporting period, Congress requested that the OIG review select Dodd-Frank Act rulemakings to determine whether the SEC is performing the required cost-benefit analyses in a consistent manner and in compliance with applicable federal requirements. In its initial review conducted pursuant to this request, the OIG found, as described in the Audits and Evaluations Conducted Section of this Report, that the SEC generally took a systematic approach to preparing the cost-benefit analyses, but that the analyses for particular rulemakings were lacking in the areas of macro-level costs and quantitative analysis.

Upon completion of the OIG's initial review, the OIG informed Congress that it would conduct a second phase of work consisting of a more in-depth review of SEC cost-benefit analyses performed for five additional rulemakings mandated by the Dodd-Frank Act. In this second phase, the OIG is examining whether the SEC consistently and systematically prepared a cost-benefit analysis in compliance with applicable federal requirements for the following rulemakings:

- Shareholder Approval of Executive Compensation and Golden Parachute Compensation (76 Fed. Reg. 6010, February 2, 2011)
- Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Act (76 Fed. Reg. 4489, January 26, 2011)
- Issuer Review of Assets in Offerings of Asset-Backed Securities (76 Fed. Reg. 4231, January 25, 2011)
- Reporting of Security-Based Swap Transaction Data (interim final temporary rule, 75 Fed. Reg. 64643, October 20, 2010)
- Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information (proposed rule, 75 Fed. Reg. 75208, December 2, 2010)

This review will also determine where improvements are needed and identify best practices to enhance the overall methodology used by the SEC to perform cost-benefit analyses.

### **Review of the SEC’s System Certification and Accreditation Process**

Information systems are essential to accomplishing the SEC’s mission. Protecting the Commission’s systems from hostile attacks, both internal and external, has become a critical and very large component of the OIT’s responsibilities. The certification and accreditation (C&A) process required by federal law is designed to ensure that federal agencies’ information systems are secure before they begin operating and that they remain protected throughout their lifecycle. The C&A process involves determining whether system controls are in place and operating as intended, identifying weaknesses, mitigating weaknesses to the maximum extent possible, and officially recognizing and accepting residual risks. The C&A process must be performed on all SEC systems. A system’s C&A remains in effect for three years unless the system or its operating environment undergoes significant change.

Office of Management and Budget (OMB) Circular A-130, “Management of Federal Information Resources,” establishes policy for managing federal information resources and provides procedural and analytic guidelines for implementing specific aspects of this policy. In addition, OIT has policies and procedures for conducting the C&A process on SEC systems. However, both the OIG and the Government Accountability Office have found that the SEC has system security deficiencies that could significantly affect SEC operations.

The OIG contracted the services of C5i Federal, Inc., to perform an independent review of the SEC’s C&A process. The review will determine whether:

- OIT’s process for evaluating internal controls and gathering support adheres to governing federal guidance;
- OIT has properly established risk factors to ensure that system security controls have been designed to achieve results; and
- Internal controls have been established and are used to safeguard the integrity of the SEC’s programs, activities, and information.

Further, C5i Federal, Inc., will assess whether OIT certifies and accredits SEC systems in accordance with governing guidelines and industry best practices.

### **2011 Federal Information Security Management Act Assessment**

The Federal Information Security Management Act (FISMA) requires that each federal agency’s IT security programs and practices be independently evaluated each year to determine the effectiveness of those programs and practices. The evaluation is to be performed by the agency’s Inspector General or by an independent external auditor, as determined by the agency’s Inspector General. In addition, OMB guidance sets forth specific in-

structions and templates for meeting FISMA's reporting requirements.

The OIG has contracted the services of Networking Institute of Technology, Inc., to perform an independent review of OIT's implementation of IT security programs and practices and the extent to which OIT meets OMB, Department of Homeland Security, and National Institute of Standards and Technology requirements in the following areas:

- risk management,
- configuration management,
- incident response and reporting,
- security training,
- plans of actions and milestones,
- remote access,
- identity and access management,
- continuous monitoring management,
- contingency planning, and
- contractor systems.

The FY 2011 FISMA evaluation and accompanying OIG Executive Summary will also answer OMB's FY 2011 questions on the Commission's information security program.

### **Assessment of the SEC's Systems and Network Logs**

Events occurring within an organization's IT systems and networks are recorded in logs containing a series of entries. Each entry in a log contains information related to a specific event that has occurred within a system or network. Many logs within an organization contain information related to computer security. These computer security logs are generated by many sources, including (1) security software, such as antivirus software, firewalls, and intrusion detection and prevention systems; (2) operating systems on servers, workstations, and networking equipment; and (3) applications.

Log management is essential to ensure that computer security records are stored in sufficient detail for an appropriate period of time. In addition, routine log analysis is beneficial for identifying security incidents, policy violations, fraudulent activity, and operational problems. Logs are also useful in performing auditing and forensic analysis, supporting internal investigations, establishing baselines, and identifying trends and long-term problems.

The OIG has contracted with C5i Federal, Inc., to conduct an assessment of OIT's controls over SEC system and network logs and to assess OIT's ability to produce and maintain sufficient logs. Additionally, C5i Federal, Inc., will evaluate the roles and responsibilities of OIT staff who access the SEC's enterprise system and network logs; assess the adequacy of OIT's policies and procedures covering log management and analysis, data collection, and log storage; examine network logs located within OIT's enterprise to determine if adequate controls have been established to protect SEC data; and assess whether OIT maintains adequate data for forensic analysis.

### **Review of SEC's Continuity of Operations Plan**

A continuity of operations (COOP) plan is essential for maintaining critical agency operations during disruptions that affect normal operations. The SEC's Office of the Chief Operating Officer recently assumed overall responsibility for COOP planning for the agency. The SEC's Chief Information Officer has oversight responsibility for the disaster recovery component of the SEC's COOP plan.

The SEC has formal COOP policies and procedures and conducts periodic testing of its COOP plan. However, a recently issued OIG report found that OIT failover testing for certain internal IT applications had been unsuccessful. Another recently issued OIG report found that the SEC's regional offices lacked viable COOP plans and that the SEC

had not tested the maximum user limit for remote access to the SEC's network.

The OIG has contracted with TWM Associates, Inc., to conduct a review of the SEC's COOP plan. The objectives of the review are to determine whether the SEC has a viable COOP plan that is sufficient to support the SEC's operations at its headquarters, Operations Center, Alternate Data Center, and 11 regional offices. TWM Associates, Inc., will also determine whether the SEC is adequately prepared to perform essential functions during a business continuity or disaster recovery event, such as a human/natural disaster, national emergency, or technology failure that could affect the SEC's ability to continue mission-critical and essential functions.

#### **Audit of Management of SEC-Furnished and SEC-Funded Property Used by Contractors**

The SEC accomplishes much of its mission through the use of contractors. In some instances, the SEC provides its contractors with SEC property for use in their work and, in other instances, contractors use SEC funds to acquire property. In either case, the SEC often retains title or ownership of the property. SEC contractors are required to manage and account for property provided to them by the SEC or paid for with SEC funds in accordance with the Federal Acquisition Regulation, as well as other directives and specific contract provisions.

Within the SEC, the Property Management Officer (PMO), located within the Office of Administrative Services, has overall responsibility for developing, administering, and overseeing the SEC's property management program. In addition, OIT's Asset Management Branch is responsible for establishing property management policies for IT equipment; serving as the inventory control point for the acquisition, storage, and issuance of IT equipment; acting as the utilization coordinator for the reassignment and disposal of IT assets; and coordinating with the Assistant PMO regarding all IT property issues.

The OIG has contracted with Castro & Company, LLC, to perform an audit to assess whether (1) the SEC has established adequate internal controls over property used by contractors that has been furnished or funded by the SEC; (2) the SEC has reliable records to identify and track contractors who possess property furnished or funded by the SEC; (3) Contracting Officer's Technical Representatives or others responsible for administration of SEC property used by contractors have been properly trained and perform their duties in accordance with governing policy; (4) annual inventories are performed of SEC-furnished or SEC-funded property used by contractors; (5) adequate policies and procedures exist to cover managing and disposing of SEC-furnished or SEC-funded property used by contractors; and (6) SEC assets held by contractors are properly accounted for by the SEC and, if applicable, appropriately reported in the SEC's financial statements.





# SEMIANNUAL REPORT TO CONGRESS

## INVESTIGATIONS

### OVERVIEW

The OIG's Office of Investigations responds to allegations of violations of statutes, rules, and regulations, and other misconduct by SEC staff and contractors. The misconduct investigated ranges from criminal wrongdoing and fraud to violations of SEC rules and policies and the government-wide standards of conduct.

The Office of Investigations conducts thorough and independent investigations into allegations received in accordance with the Quality Standards for Investigations of the Counsel of the Inspectors General on Integrity and Efficiency (CIGIE) and the OIG's Investigations Manual. The Investigations Manual, which was issued during the previous semi-annual reporting period, contains the procedures by which the OIG conducts its investigations and preliminary inquiries and implements the CIGIE's Quality Standards. The Investigations Manual sets forth specific guidance on, among other things, OIG investigative authorities and policies, investigator qualifications, independence requirements, procedures for conducting investigations and preliminary inquiries, coordination with the U.S. Department of Justice, and issuing reports of investigation.

The OIG receives complaints through the OIG Complaint Hotline, an office electronic mailbox, mail, facsimile, and telephone. The OIG Complaint Hotline consists of both telephone and web-based complaint mechanisms. Complaints may be made anonymously by calling the Hotline, which is staffed and answered 24 hours a day, seven days a week. Complaints may also be made to the Hotline through an online complaint form, which is accessible through the OIG's website. In addition to a mechanism for the receipt of complaints, the OIG's website also provides the public with an overview of the work of the Office of Investigations, as well as links to some investigative memoranda and reports issued by the Office. The OIG also receives allegations from SEC employees of waste, abuse, misconduct, or mismanagement within the agency through the OIG SEC Employee Suggestion Program, which was established pursuant to Section 966 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and is described in the annual report on that program at Appendix B of this Report.

The OIG reviews and analyzes all complaints received to determine the appropriate course of action. In instances where it is determined that something less than a full investigation is appropriate, the OIG may conduct a preliminary inquiry into the allegation.



If the information obtained during the inquiry indicates that a full investigation is warranted, the Office of Investigations will commence an investigation of the allegation. Upon the opening of an investigation, the primary OIG investigator assigned to the case prepares a comprehensive plan of investigation that describes the focus and scope of the investigation, as well as the specific investigative steps to be performed during the investigation. The OIG investigator interviews the complainant whenever feasible and conducts significant interviews under oath and on-the-record. The OIG investigator may give assurances of confidentiality to potential witnesses who have expressed a reluctance to come forward.

Where allegations of criminal conduct are involved, the Office of Investigations notifies and works with DOJ and the Federal Bureau of Investigation (FBI), as appropriate. The OIG also obtains necessary investigative assistance from the SEC's Office of Information Technology, including the prompt retrieval of employee e-mails and forensic analysis of computer hard drives. During this semiannual reporting period, the OIG, in the course of conducting its investigations and inquiries, obtained and searched more than 8.7 million employee e-mails. The OIG investigative staff meets with the Inspector General frequently to review the progress of ongoing investigations. The OIG investigative staff also consults as necessary with the Commission's Ethics Counsel to coordinate activities.

Upon completion of an investigation, the OIG investigator prepares a comprehensive report of investigation that sets forth in detail the evidence obtained during the investigation. Investigative matters are referred to the DOJ and SEC management as appropriate. The OIG does not publicly release its reports of investigation because they contain nonpublic information. Decisions regarding whether an OIG investigative report should be publicly released, in response to a FOIA request or otherwise, are made by the agency.

In many investigative reports provided to SEC management, the OIG makes specific findings and recommendations, including whether the OIG believes disciplinary, or other action, should be taken. The OIG requests that management report back disciplinary or other actions taken in response to the OIG's recommendations within 45 days of the issuance of the report. The OIG follows up as appropriate with management to determine the status of disciplinary action taken in matters referred by the OIG. The OIG also often makes recommendations for improvements in policies and procedures and internal controls in its investigative reports, and these recommendations are tracked in a manner similar to how the OIG tracks its audit recommendations.

## **INVESTIGATIONS AND INQUIRIES CONDUCTED**

### **Improper Actions Relating to the Leasing of Office Space (Report No. OIG-553)**

#### **Background**

On July 28, 2010, the SEC's Office of Administrative Services (OAS) leased approximately 900,000 square feet of space for a ten-year period at a newly-renovated office building located at 400 Seventh Street, S.W., Washington, D.C., known as Constitution Center. The lease also included a right of first refusal for the remaining 500,000 square feet of space at Constitution Center. The SEC estimated the costs associated with leasing and occupying Constitution Center at \$556,811,589.

In early October 2010, the SEC informed the owner of Constitution Center that it did not need approximately 600,000 of the 900,000 square feet of space it had leased or the 500,000 square feet that had been subject to the right of first refusal. In January 2011, the Constitution Center owner signed leases with two other agencies for approximately 558,000 square feet of the space that the SEC previously had leased. In March 2011, the

SEC informed the Constitution Center owner that it was trying to sublease the remaining 342,000 square feet covered by its lease. The SEC and the Constitution Center owner subsequently had a dispute regarding the SEC's obligation to compensate the owner for damages allegedly caused by the SEC's actions. The owner asserted damages of \$93,979,493, while the SEC denied that any damages were owed.

In October and November 2010, the OIG received several written complaints about the SEC's actions related to the Constitution Center lease. These complaints alleged that the decision to lease space at Constitution Center was ill-conceived, resulted from poor management practices, and was made without Congressional funding for the significant projected growth necessary to support the leasing decision. On November 16, 2010, the OIG opened its investigation into these allegations.

### **Scope of the Investigation**

The OIG made numerous requests to the SEC's OIT for the e-mails of current and former SEC employees for various periods of time pertinent to the investigation. The requested e-mails were received, loaded onto computers with specialized search tools, and searched on a continuous basis throughout the course of the investigation. In all, OIT provided the OIG with e-mails for a total of 27 current or former SEC employees for the time periods pertinent to the investigation. The OIG estimates that it obtained and searched over 1.5 million e-mails during the course of its investigation.

The OIG also made several requests to OAS for documents relating to its leasing practices. We carefully reviewed and analyzed the information received as a result of our document production requests. These documents related to, among other things, planning information for the Constitution Center lease; the approval of funding for the Constitution Center lease by parties within or outside the

SEC; the leasing of office space in the Station Place Three facility (located adjacent to the SEC's Station Place One and Two headquarters building); the availability of space in Station Place Three; and analyses of current and future SEC staff size.

Finally, the OIG took the sworn testimony of 18 witnesses and interviewed 11 other individuals with knowledge of the facts or circumstances surrounding the SEC's leasing activities.

### **Results of the Investigation**

The OIG issued its report of investigation to management on May 16, 2011, which included over 90 pages of analysis and more than 150 exhibits. Overall, the OIG investigation found that the circumstances surrounding the SEC's entering into a lease for 900,000 square feet of space at Constitution Center in July 2010 represented another in a long history of missteps and misguided leasing decisions made by the SEC since Congress granted it independent leasing authority in 1990. We found that notwithstanding this significant authority, the SEC had not even established a Leasing Branch until April 2009 and did not put in place leasing policies and procedures until August 2010.

The OIG investigation further found that, based upon estimates of increased funding primarily to meet the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), between June and July of 2010, OAS conducted a deeply flawed and unsound analysis to justify the need for the SEC to lease 900,000 square feet of space at Constitution Center. We found that OAS grossly overestimated the amount of space needed at SEC headquarters for the SEC's projected expansion by more than 300 percent and used these groundless and unsupported figures to justify the SEC committing to an expenditure of \$556,811,589 over ten years.

The OIG investigation also found that OAS prepared a faulty Justification and Approval to support entering into the Constitution Center lease without competition. This Justification and Approval was prepared after the SEC had already signed the contract to lease the space in the Constitution Center facility. Further, OAS backdated the Justification and Approval, thereby creating the false impression that it had been prepared only a few days after the SEC entered into the lease. In actuality, the Justification and Approval was not finalized until a month later.

More specifically, the OIG investigation found that, in 1990, Congress provided the SEC with independent leasing authority, which exempted the SEC from General Services Administration (GSA) regulations and directives. The House Conference Report for this legislation expressed the clear intention that “the authority granted the Commission to lease its own office space directly will be exercised vigorously by the Commission to achieve actual cost savings and to increase the Commission’s productivity and efficiency.”

The OIG investigation found that notwithstanding this clear Congressional intent, since the SEC was granted independent leasing authority, there have been several expensive missteps related to the SEC’s leasing actions and space management. For example, in May 2005, the SEC disclosed to a House Subcommittee that it had identified unbudgeted costs of approximately \$48 million attributable to miscalculations and omissions of costs associated with the construction of its headquarters facilities near Union Station, known as Station Place One and Two. In 2007, merely a year after moving into its new headquarters, the SEC embarked on a major “restacking” project, in which various SEC employees were shuffled to different office spaces at a cost of over \$3 million. An OIG review of the project found that there was no record of any cost-benefit analysis having been conducted before this restacking project was implemented. Moreover, an OIG survey found that an overwhelming majority of

Commission staff affected by the restacking project had been satisfied with the location of their workspace before the project was initiated, and did not believe the project’s benefits were worth the cost and time of construction, packing, moving, and unpacking.

The OIG investigation further found that as a result of a belief that the SEC would receive significant increases to its appropriations in FYs 2011, 2012, and 2013, OAS made grandiose plans to lease space at the upscale Constitution Center facility. On May 14, 2010, the SEC submitted an authorization request to the Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, requesting \$1.507 billion for FY 2012 to fund an increase of 800 new staff positions. On May 20, 2010, the U.S. Senate passed a version of the financial regulatory reform bill that eventually became the Dodd-Frank Act (the U.S. House of Representatives had previously passed a version of the legislation on December 11, 2009). The SEC estimated that it would need to add another 800 positions in FYs 2011 and 2012 to implement the Dodd-Frank Act. After completion of the reconciliation process between the two versions of the financial regulatory reform bills, the Dodd-Frank Act became law on July 21, 2010. The Dodd-Frank Act authorized an increase in the SEC’s budget from the \$1.11 billion appropriated in FY 2010 to \$1.3 billion in FY 2011, \$1.5 billion in FY 2012, and \$2.25 billion by FY 2015.

The OIG investigation determined that authorization of funding for an executive agency like the SEC does not guarantee that the agency will be appropriated the funds. Rather, an authorization request is only the first step in the SEC’s lengthy budget process. An authorization request is submitted to Congress in May of the fiscal year two years prior to the fiscal year for which the authorization is requested (*e.g.*, the FY 2012 authorization request takes place in May 2010). The following September, several months after the authorization request is made, the SEC submits a proposed budget request to OMB. In November, OMB replies to

the SEC with a “pass-back,” and the SEC and OMB then usually negotiate the amount of the budget request. Several months later, the President formally submits a budget proposal to Congress, which then begins the decision-making process as to how much money to appropriate the SEC and other agencies. SEC employees interviewed in the OIG’s investigation acknowledged that an authorization may indicate an intention for Congress to provide funding, but that circumstances frequently change and, therefore, federal agencies understand that they cannot count on money coming to them until it has been appropriated.

Notwithstanding the uncertainty of actually being appropriated the amount requested through the budget process, in May 2010, OAS began planning for an expansion at SEC headquarters based on the SEC’s FY 2012 budget request. Initially, the SEC’s Associate Executive Director of OAS and the former Chief of the Leasing Branch decided that the SEC needed to lease approximately 300,000 square feet of space to accommodate its needs through FY 2012. In May 2010, the former Chief of the Leasing Branch’s plan was to solicit offers from three properties within walking distance of Station Place. However, on June 2, 2010, the former Chief of the Leasing Branch received an e-mail from the real estate broker for the Constitution Center facility, which was located approximately two miles from the SEC’s Station Place facility, regarding its availability and some of its features.

The 1.4 million square foot Constitution Center building had just been renovated in “one of the largest office redevelopment projects in Washington, DC,” according to building promotional literature. One of the more attractive features of the Constitution Center facility was its 5,000 square foot lobby, which included spacious accommodations for a guard desk(s), security screening room, shuttle elevator lobby, and display space, Jerusalem limestone floors and marble walls, wood and metal paneling, decorative light, and a floor-to-ceiling glass wall facing the landscaped courtyard. The

facility promised abundant daylighting, panoramic views of the city and surrounding region, and an open plaza area containing a one acre private garden.

Almost immediately after being contacted by the broker for Constitution Center, OAS decided to expand the delineated locality of consideration for new office space to add Constitution Center to the other three buildings that would be included in the solicitation for offers for approximately 300,000 square feet of space.

On June 17, 2010, OAS and the then-Executive Director briefed Chairman Mary Schapiro on OAS’s immediate expansion plans at SEC headquarters. At that briefing, the former Executive Director told the Chairman that the SEC needed to immediately lease 280,000 to 315,000 square feet of office space in Washington, D.C., and identified on a map specific locations for that expansion, including Constitution Center. Both Chairman Schapiro and her former Deputy Chief of Staff recalled the Chairman expressing a clear preference for the locations that were within walking distance of Station Place, as opposed to Constitution Center. Chairman Schapiro also questioned whether the SEC needed 300,000 additional square feet in light of her belief that the SEC should concentrate its growth in the regional offices.

However, the OIG investigation found that notwithstanding Chairman Schapiro’s expressions in mid-June of her preference for a facility closer to Station Place and her questioning of why the SEC needed as much as 300,000 square feet of space, by mid-July, the former Executive Director came back to the Chairman with an urgent recommendation that the SEC immediately lease 900,000 square feet of space with the only available option being Constitution Center. The OIG investigation found that the analysis OAS performed to justify the need for three times its original estimate of necessary square footage, and its determination that Constitution Center was the only available option,

was deeply flawed and based on unfounded and unsupported projections. We found that OAS grossly overestimated the amount of space needed at SEC headquarters for the SEC's projected expansion.

The OIG investigation found that OAS assumed that all of the new positions contained in the SEC's Office of Financial Management's (OFM) projections for FYs 2011 and 2012 would be allocated to SEC headquarters and none of those new positions would be allocated to the SEC's regional offices. This assumption was contrary to the Chairman's position communicated to OAS at the June 17, 2010 meeting that as much as possible of the SEC's future growth should occur in the regional offices, not at SEC headquarters. We found that although there were discussions about the need to calculate the number of positions being allocated to the regions, no such calculation was ever conducted. The OAS Associate Executive Director acknowledged that assuming all the new positions would be located in SEC headquarters would "inflate the number."

We also found that OAS factored in a standard of 400 square feet per person when calculating how much space would be needed for the additional positions it believed the SEC was gaining as a result of the Dodd-Frank Act and associated increases in the SEC's budget. A Realty Specialist in OAS explained that she and the former Leasing Branch Chief developed the standard by dividing the square footage of existing office space by the number of people the SEC had authority to hire for the offices in that space at headquarters and several of the SEC's regional offices. The Realty Specialist described the standard as a "back of the envelope" calculation, and she stated in her OIG testimony that "we didn't do this scientifically." OAS's 400 standard of square feet per person was an "all-inclusive number" that included common spaces and amenities. It included an additional ten percent for contractors, ten percent for interns and temporary staff, and five percent for future growth. Notwithstanding this "all-inclusive" number, we found that when OAS later did its

calculations to justify the Constitution Center lease, it added even more unnecessary space by double-counting for contractors, interns, and temporary staff, and by projecting future growth. We also found that each one of these estimates was wildly inflated and unsupported by the data OAS was using.

The OIG investigation found that OAS inflated its estimate of new positions that would need space by including an estimate of the number of contractors that would be hired in addition to the number of new SEC employees. This new contractor estimate was prepared by the OAS Assistant Director for Real Property Operations. In early June 2010, the OAS Associate Executive Director asked the OAS Branch Chief for Space Management and Mail Operations (Space Management) to obtain information about the number of SEC contractors. On June 12, 2010, the Branch Chief reported back, "Right now, based on the Contractor numbers I have at [Station Place], I can justify us using a 10%, Contractor to Position, factor." The Space Management Branch Chief later learned that OAS needed the numbers to be larger. He testified that he understood the former Leasing Branch Chief was trying to "make sure that whatever size lease she entered into was enough to meet our needs. And I think that in this case, if we were going to take the whole building, the numbers needed to be larger." Ultimately, OAS ignored the data that had been gathered during the first two weeks of June 2010, which indicated the correct contractor factor was ten percent, and inflated its calculation of needed space by adding contractors using a completely arbitrary 20 percent.

In addition, we found that OAS's estimate of new positions that would require space included an estimate of the number of interns and temporary staff who would be hired in addition to new employees. OAS's estimate of new interns and temporary staff assumed an increase of 16.5 percent (nine percent for interns and 7.5 percent for temporary staff). However, the OIG found that the estimate of interns and temporary staff positions used in OAS's calculation

was significantly higher than the estimate contained in the data it received. On July 16, 2010, a management program analyst in the SEC's Office of Human Resources provided OAS with "the [peak] numbers [for interns and temporary staff]," which ranged from approximately four to seven percent for the six fiscal years of data she analyzed.

Further, the OIG investigation found that OAS's calculations increased the amount of space required for every person to be hired in FY 2011 and FY 2012 by ten percent for "inventory," representing vacant offices for expansion and unanticipated growth. However, the calculation of the 400-square-foot standard itself already incorporated an inventory factor. Moreover, the ten percent inventory factor added was double the five percent factor that was previously determined to be appropriate.

We also found that OAS's estimate of new positions that would require space not only included assumptions about FYs 2011 and 2012, but also assumed that in FY 2013, the SEC's appropriation would increase by 50 percent of the agency's FY 2012 budget request. We found that the assumption of 50 percent growth in FY 2013 was arbitrary and unsupported. Based on the FY 2013 assumption, OAS projected that the SEC would add another 295 positions in that year and again assumed that all of those positions would be allocated to SEC headquarters. We found that this estimate was not based on any firm numbers or projections and was contrary to the SEC's planning and budget process, which does not project growth more than two years into the future.

The OIG investigation found that OAS used the above-described overinflated estimates to calculate a space need of 934,000 square feet. On Friday, July 23, 2010, the former Executive Director met with Chairman Schapiro, her Chief of Staff, and the SEC's then-Deputy Chief of Staff to recommend that the SEC lease 900,000 square feet of space at Constitution Center. The former Deputy Chief of Staff

recalled the July 23, 2010 meeting with the former Executive Director, noting that the former Executive Director had come to her "and said that he needed to see Mary [Schapiro] quickly because he needed to make a quick decision on Constitution Center. That the other possible space opportunities had evaporated, gone to others, were no longer available. And that this one was really all that was left and that we needed to act quickly."

Chairman Schapiro testified as follows regarding the July 23, 2010 meeting with the former Executive Director:

I remember explicitly being told there really wasn't any other space available that could fulfill our needs and that there was a time—a sense of we were about to lose this. We had lost other space that we had apparently indicated an interest in and that we were about to lose this. So there was a sense of urgency on their part.

The former Deputy Chief of Staff testified that the former Executive Director did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC headquarters needed an additional 900,000 square feet was predicated, in part, on the assumption that all the agency's new positions in FYs 2011 and 2012 would be allocated to SEC headquarters. The former Deputy Chief of Staff testified, "[I]n fact, that's inconsistent with what I had understood, because . . . [Chairman Schapiro] specifically said that, to the extent possible, she wanted new hires to go to the regions." The former Deputy Chief of Staff also testified that the former Executive Director did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC headquarters needed an additional 900,000 square feet was predicated, in part, on OAS's projection of significant growth in FY 2013.

On July 23, 2010, the former Executive Director sent an e-mail to the OAS Associate Executive Director, the OAS Assistant Director for



Real Property Operations and the former Leasing Branch Chief, stating, “Met with Chairman this morning, and we have her approval to move forward.” The OIG investigation found that the SEC negotiated the contract for 900,000 square feet at Constitution Center in three business days, signing the contract on July 28, 2010. On July 27, 2010, the SEC staff involved in the negotiations discussed the fact that they had “no bargaining power” because “[the OAS Associate Executive Director] want[ed] this signed tomorrow.” Internal e-mails showed that OAS feared losing the building to the National Aeronautics and Space Administration (NASA), which had also expressed an interest in the facility. However, the OIG found that OAS staff apparently understood that NASA could not have had signed a lease for space at Constitution Center before September 2010.

On July 28, 2010, the SEC executed a Letter Contract committing the SEC to lease approximately 900,000 square feet of space at Constitution Center. The Letter Contract set a multiphase delivery schedule, in which Phase 1, consisting of approximately 350,000 square feet, would be delivered no later than September 2011, and Phase 2, consisting of approximately 550,000 square feet, would be delivered no later than September 2012. The Letter Contract stated that “the SEC’s interests require that [the Constitution Center owner] be given a binding commitment so that the space required will be committed to the SEC and initial build out for the Phase 1 space can commence immediately....” The lease term in the Letter Contract was ten years. The former Leasing Branch Chief estimated the costs associated with leasing and occupying Constitution Center would be \$556,811,589.

The Letter Contract also granted the SEC the right of first refusal for the remaining approximately 500,000 square feet of space at Constitution Center until December 15, 2010. If the SEC had exercised this option, it would have leased the entire 1,400,000 square feet of space at Constitution Center. The former

Leasing Branch Chief testified that OAS wanted a right of first refusal on all of the remaining space at Constitution Center “because the Congress was throwing money at us,” and “[the Associate Executive Director of OAS] was always hoping that we wouldn’t have anybody else in the building. That we would be able to ultimately justify the need for the whole building or something.”

After the SEC committed itself to the ten-year lease term, it prepared a Justification and Approval for Other than Full and Open Competition, which is required by the Federal Acquisition Regulation (FAR) when an agency decides not to allow for full and open competition on a procurement or lease. Under Section 6.302-2 of the FAR, 48 C.F.R. § 6.302-2, other than full and open competition is permitted “when the agency’s need for the supplies or services is of such an unusual and compelling urgency that the Government would be **seriously injured** unless the agency is permitted to limit the number of sources from which it solicits bids or proposals.” (Emphasis added).

The OIG investigation found that the Justification and Approval to lease space at Constitution Center without competition was inadequate, not properly reviewed, and backdated. The Justification and Approval provided as follows:

To fulfill these new responsibilities it is necessary to significantly increase full-time staff and supporting contractors by approximately 2,335 personnel to be located at the SEC’s headquarters in Washington, DC. However, the SEC’s current headquarters is full. Accordingly the SEC has a requirement of an unusual and compelling urgency to obtain approximately 900,000 rentable square feet (r.s.f.) of additional headquarters space in the Washington, D.C. Central Business District, as this is the amount of space required to accommodate the approximately 2,335 new staff and contractors in headquarters.

The Justification and Approval asserted that the 900,000 square feet “must be in a single building or integrated facility to support the SEC’s functional requirements and operational efficiency.”

An OAS Management and Program Analyst signed the Justification and Approval as the SEC’s Competition Advocate. She testified that she did not take any steps to verify that the information in the Justification and Approval was accurate, “[o]ther than asking [the former Leasing Branch Chief], the contracting officer, you know, just general questions, ‘Is this indeed urgent and compelling[?].’” She further testified that when she signed the Justification and Approval, she was not aware that funding for the projected growth had not been appropriated. She also did not have an understanding of when the projected 2,335 personnel were expected to be hired. Further, she acknowledged in testimony that the SEC would, in fact, not be “seriously injured” if it lost the opportunity to rent one contiguous building and had to rent multiple buildings to fill its space needs.

The FAR also requires that a Justification and Approval for Other than Full and Open Competition be posted publicly “within 30 days after contract award.” The Letter Contract was signed on July 28, 2010. Accordingly, the deadline for publication of the Justification and Approval was August 27, 2010. On September 3, 2010, the SEC publicly posted the Justification and Approval on the Federal Business Opportunities website. The document was signed by four individuals with all four signatures dated August 2, 2010.

However, the OIG investigation found that the Justification and Approval was not finalized until September 2, 2010, and substantial revisions were being made up to that date. We found that three of the four signatories executed the signature page on August 2, 2010, before a draft even remotely close to the final version existed. The OIG found that the SEC’s Competition Advocate executed the signature page on August 31, 2010, and initially back-

dated her signature to August 27, 2010, but subsequently whited-out the “7” on the date to make it appear that she had also signed the document on August 2, 2010. The actions of the signatories to the Justification and Approval gave the public the false impression that the document was finalized a few days after the Letter Contract was signed and there was only a delay in its publication.

The OIG investigation also found that there was significant uncertainty among the SEC staff regarding important requirements of government leasing, as well as serious questions as to whether the SEC complied with several requirements in connection with its leasing of Constitution Center. Appendix B of the U.S. Office of Management and Budget (OMB) Circular No. A-11 states, “Agencies are required to submit to OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact: Any proposed lease of a capital asset where total Government payments over the full term of the lease would exceed \$50 million.” Although the evidence showed that the SEC initially contemplated providing OMB with the requisite written notification and senior SEC officials believed that OMB had been formally notified, no written notification was provided.

In addition, the OIG found that there was a possibility that the SEC violated the Antideficiency Act in connection with its lease of Constitution Center. The Antideficiency Act, 31 U.S.C. § 1341(a)(1)(B), prohibits officers or employees of the government from involving the government “in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.” The incurring of an obligation in excess or advance of appropriations violates the Antideficiency Act. Notwithstanding its July 28, 2010 commitment to a ten-year lease at Constitution Center, the SEC did not obligate the entire amount of rent payments due under the lease. Although the SEC has been granted independent leasing authority and is generally granted authority to enter into multiyear leases in its annual appro-

priations, the U.S. Government Accountability Office (GAO) has found that “[t]he existence of multiyear leasing authority by itself does not necessarily tell [an agency] how to record obligations under a lease.” GAO has distinguished agencies such as the GSA, which has “specific statutory direction” to obligate funds for multiyear leases one year at a time, from agencies such as the Federal Emergency Management Agency (FEMA), which does not have such explicit direction. Because the SEC, like FEMA, does not have specific statutory direction to obligate funds for multiyear leases on an annual basis, its lease obligations may have to be obligated in their entirety at the time they are incurred. As a consequence, the SEC may have violated the Antideficiency Act in connection with its commitment to lease space at Constitution Center.

In early October 2010, the SEC informed the Constitution Center owner that it could not use approximately 600,000 of the 900,000 square feet of space it had leased at Constitution Center and asked for the owner’s assistance in finding other tenants for that space. In November 2010, the Constitution Center owner began negotiations with the Federal Housing Finance Agency (FHFA) and the Office of the Comptroller of the Currency (OCC) to lease portions of Constitution Center. In January 2011, FHFA and OCC entered into contracts to lease space at Constitution Center, leaving approximately 350,000 square feet to which the SEC remained committed. The SEC expressed its intention to sublease the remaining 350,000 square feet. On January 18, 2011, the Constitution Center owner’s counsel sent a demand letter to the SEC, asserting that the SEC’s actions had caused the Constitution Center owner to incur \$93,979,493 in costs at Constitution Center.

The OIG investigation further found that a “closed” and “rigid” atmosphere within OAS may have contributed to the irresponsible decisions made with respect to the Constitution Center lease. In the course of the OIG’s investigation, several witnesses who sought to remain

anonymous came forward to provide information concerning the environment and decision-making processes within OAS. These witnesses described an environment in which inexperienced senior management made unwise decisions without any input from employees with significant knowledge and experience. We found that questioning of upper management decisions by the staff was “not allowed,” and that the OAS Associate Executive Director surrounded herself with “yes-men” and did “not want to hear what [experienced staff would] tell her.” These individuals testified that upon learning of the SEC’s decision to lease 900,000 square feet of space at Constitution Center, they “just couldn’t understand how they could justify that amount of space . . .” and were “flabbergasted” by the decisions. One experienced employee testified that OAS management had “grandiose plans” and was significantly influenced by the upscale nature of the facility.

### **Recommendations in the Report of Investigation**

The OIG recommended that the newly-appointed Chief Operating Officer/Executive Director carefully review the report’s findings and conduct a thorough and comprehensive review and assessment of all matters currently under the purview of OAS, including, but not limited to: (1) the adequacy of written policies and procedures currently in place for all aspects of the SEC’s leasing program, particularly written procedures for leasing approvals; (2) the methods and processes used to accurately project spacing needs based on concrete and supportable data; (3) the determination to employ a standard of 400 square feet per person for planning SEC space needs; (4) the necessity of retaining architects, furniture brokers, or other consultants to assist in the work generally performed by OAS officials; and (5) all pending decisions in which OAS is committing the SEC to expend funds, including decisions relating to regional office lease renewals. As of the end of the semiannual reporting period, action had not yet been taken by management to fully address the OIG’s recommendations.

The OIG further recommended that the Chief Operating Officer/Executive Director, upon conclusion of such review and assessment, determine the appropriate disciplinary and/or performance-based action to be taken for the matters discussed in the OIG's report of investigation, as well as other issues identified during the review and assessment. The OIG specifically recommended, at a minimum, consideration of disciplinary action, up to and including dismissal against the OAS Associate Executive Director and the OAS Assistant Director for Real Property Operations, and consideration of disciplinary action against the Competition Advocate, for their actions in connection with the gross overestimation of the amount of space needed at SEC headquarters for projected expansion, the failure to provide complete and accurate information to the Chairman's office, and the preparation of a faulty and back-dated Justification and Approval to support eliminating competition. As of the end of the semiannual reporting period, management had not yet proposed any disciplinary action against these individuals.

Finally, the OIG recommended that the OFM, in consultation with OGC, request a formal opinion from the Comptroller General as to whether the SEC violated the Antideficiency Act by failing to obligate appropriate funds for the Constitution Center lease. On June 15, 2011, the SEC's Chief Financial Officer submitted a request for a formal opinion to the Comptroller General on this issue, and a decision was pending as of the end of the reporting period. A public version of the OIG's report is available on the agency's website at <http://www.sec.gov/foia/docs/oig-553.pdf>.

### **Investigation of Conflict of Interest Arising from Former General Counsel's Participation in Madoff-Related Matters (Report No. OIG-560)**

#### **Background**

On March 4, 2011, the SEC Chairman requested that the OIG investigate any conflicts

of interest arising from the former SEC General Counsel's participation in matters relating to the Bernard L. Madoff Ponzi scheme, most notably, the liquidation proceeding under the Securities Investor Protection Act (SIPA). Her request came after she received inquiries from certain Congressional committees and subcommittees requesting information and documents related to, among other things, the former General Counsel's participation in the SEC's work on the Madoff liquidation. These inquiries came in response to recent press reports indicating that the former SEC General Counsel, along with his two brothers, had been named as defendants in a clawback suit brought by the trustee administering the Madoff liquidation to recover approximately \$1.5 million in fictitious profits received from the Ponzi scheme by a Madoff account held by his mother's estate. The OIG immediately commenced the requested investigation and met with the Honorable Darrell Issa (R-California), Chairman of the U.S. House of Representatives Committee on Oversight and Government Reform, and numerous Congressional staff concerning their requests for information pertaining to this matter.

#### **Scope of the Investigation**

During the course of its investigation, the OIG obtained and searched over 5.1 million e-mails for a total of 45 current and former SEC employees, including employees of the Office of the General Counsel (OGC), the Division of Trading and Markets (TM), and the Office of Intergovernmental and Legislative Affairs (OLA), the Commissioners, and the Chairman. The OIG also obtained and reviewed numerous documents from the Office of the Secretary, including minutes of certain Commission meetings and memoranda presented to the Commission regarding the Madoff liquidation. The OIG also issued a subpoena for certain documents to the trustee administering the Madoff liquidation, and upon production thereof, reviewed the documents produced by the trustee.

The OIG took the sworn testimony of 35 witnesses, including the former SEC General Counsel, the former SEC Ethics Counsel who had provided ethics advice to the former General Counsel, the Chairman, the Commissioners, and various current and former employees from OGC, TM, and OLA. The OIG also interviewed the trustee appointed in the Madoff liquidation, representatives of the Securities Investor Protection Corporation (SIPC), a former senior official in TM who was awaiting confirmation as a Commissioner, and a former Commissioner. The OIG also consulted with officials from the Office of Government Ethics (OGE), requesting OGE's opinion regarding the former General Counsel's participation in matters that could have given rise to a conflict of interest.

### **Results of the Investigation**

On September 16, 2011, the OIG issued its report of investigation in this matter, which included nearly 120 pages of analysis and 200 exhibits. The OIG investigation found that the former SEC General Counsel participated personally and substantially in particular matters in which he had a personal financial interest by virtue of his inheritance of the proceeds of his mother's estate's Madoff account and that the matters on which he advised could have directly impacted his financial position. We found that the former General Counsel played a significant and leading role in determining what recommendation the staff would make to the Commission regarding the appropriate position for the SEC to advocate as to the determination of a customer's net equity under SIPA in the Madoff liquidation. In a SIPA proceeding like the Madoff liquidation, net equity is the amount that a customer can claim to recover, and the method for determining net equity is, therefore, critical to determining the overall amount that the trustee would pay to customers in the Madoff liquidation. SIPC officials and numerous SEC witnesses, as well as documentary evidence, demonstrated that there was a direct connection between the method used to determine a customer's net

equity and the clawback actions brought by the trustee in the Madoff liquidation, including the overall amount of funds the trustee would seek to claw back and the calculation of amounts sought in individual clawback suits. In addition to the former General Counsel's work on the net equity issue, the OIG investigation also found that he provided comments on a proposed amendment to SIPA that would have severely curtailed the power of a SIPA trustee, including the trustee in the Madoff liquidation, to bring clawback suits against individuals like the former General Counsel.

More specifically, the OIG investigation found that the former SEC General Counsel, along with his two brothers, inherited an interest in a Madoff account owned by his mother's estate after she died in 2004. The former SEC General Counsel testified that he became aware of this account in or about February 2009, and that he knew the account had been opened by his father prior to his death in 2000, was transferred to his mother's estate after her death in 2004, and was liquidated for approximately \$2 million. We also found that, at the time that the former General Counsel participated on behalf of the SEC in the net equity issue in the Madoff liquidation, he understood that there was a possibility that the trustee would bring a clawback suit against him for the fictitious profits in his mother's estate's account, but asserted that he did not know the likelihood of such a suit. Notwithstanding this knowledge, the former General Counsel, who also served as the SEC's alternate Designated Agency Ethics Official (*i.e.*, the alternate official responsible for coordinating and managing the SEC's ethics program), worked on particular matters that could impact the likelihood, and even possibility, of a clawback suit against him, as well as the amount that could be recovered in such a clawback action.

The OIG found that after the former General Counsel rejoined the SEC as General Counsel in February 2009, the SEC's approach to the net equity determination changed. As of February 2009, SIPC had emphasized that it

was critical for SIPC and the SEC to reach a consensus as to the methodology for paying customer claims. TM officials concurred with SIPC and the trustee that the Money In/Money Out Method was the appropriate method for determining net equity, and SIPC understood that the Commission was likewise in agreement. Under the Money In/Money Out Method, a Madoff investor's net equity claim would only be for the amount of money initially invested with Madoff, less any amounts withdrawn over time.

However, after the former General Counsel rejoined the Commission, and the SEC received submissions from representatives of Madoff claimants who disagreed with the proposed Money In/Money Out method, the former General Counsel and OGC began to analyze whether another approach should be used. These submissions, including a May 1, 2009 letter from the law firm of a former SEC Commissioner and other law firms, advocated the Last Account Statement Method, under which a Madoff investor would receive the amount listed as being in the customer's account on the last Madoff account statement that the customer received (*i.e.*, including the fictitious profits reflected on that statement). The OIG investigation found that after receiving the May 1, 2009 letter, the former General Counsel and OGC initially gave serious consideration to this method. We also found that the prevailing opinion within the SEC and SIPC was that using the Last Account Statement Method would have eliminated the trustee's ability to bring clawback suits like the one brought against the former General Counsel. In fact, the former General Counsel acknowledged that one of the reasons the Madoff trustee opposed using the Last Account Statement Method was that if this method was adopted, the trustee "couldn't do any clawbacks."

The OIG also found that the former General Counsel initially advocated to SIPC that some version of the Last Account Statement Method be adopted. SIPC's General Counsel

stated that during a June 2009 meeting, the former General Counsel "was very persistent on the view that the last account statement should be the measure of what customers were owed, which meant that you would basically recognize and honor fictitious profits." Meanwhile, SIPC officials expressed frustration to the SEC Chairman that the Commission was still exploring other options for the net equity determination while the trustee was processing claims and wished to offer settlements to Madoff customers.

The former General Counsel and OGC eventually rejected the Last Account Statement Method, and certain variations on that approach that it also considered, and determined that such approaches could not be reconciled with the law. However, they continued to consider other methods that would allow Madoff customers to receive some amount more than their initial investments with Madoff. After consultation with officials from the Division of Risk, Strategy, and Financial Management, the former General Counsel ultimately decided to recommend to the Commission the Constant Dollar Approach. Under that approach, an inflation rate, based upon the Consumer Price Index, would be added to the amount of a Madoff customer's initial investment to determine the additional amount the customer would receive. Accordingly, in late October 2009, the former General Counsel signed an Advice Memorandum to the Commission, which proposed that the Commission adopt the Money in/Money Out Method, as modified by the Constant Dollar Approach to take into consideration the time value of money. TM concurred in that recommendation as to the Money In/Money Out Method, but did not necessarily concur that using a time-equivalent-dollar basis would be consistent with SIPA. At a Commission Executive Session during which this issue was considered, the former General Counsel made this recommendation and request in person, and the Commission voted not to object to the staff's recommendation of the Constant Dollar Approach.



The OIG investigation found that neither SIPC nor the trustee believed that the Constant Dollar Approach was appropriate or consistent with SIPA, and that the President and Chief Executive Officer of SIPC had specifically informed the General Counsel that there was no justification under SIPA for such an approach. Moreover, the SIPC President and CEO made clear that every proffered methodology other than the Money In/Money Out Method would have directly affected the former General Counsel's financial position or the financial position of his mother's estate's Madoff account. He explained that, by increasing the amount that a customer's account was owed, the amount that the trustee could have received in a clawback suit from the former General Counsel would decrease. The SIPC President and CEO also explained that, upon learning in late February 2011 of the former General Counsel's mother's estate's account, he performed "back of the envelope calculations" to determine the difference in bringing a clawback suit under the Constant Dollar Approach, as opposed to the Money In/Money Out Method, and determined that the amount sought in the clawback suit would decrease by approximately \$140,000. The OIG recreated this analysis and calculated that a benefit of approximately \$138,500 would result from applying the Constant Dollar Approach in the clawback suit.

The OIG investigation also found that the former General Counsel participated in another particular matter that could have impacted his financial position while serving as SEC General Counsel. In October 2009, OLA forwarded the former General Counsel a draft amendment to SIPA, as well as TM's analysis of that proposal, and asked him if there was any reason that the staff should weigh in on this amendment regarding the trustee's ability to bring clawback suits. The proposed amendment would have amended SIPA to preclude a SIPA trustee from bringing clawback actions against a customer "absent proof that the customer did not have a legitimate expectation that the assets in his account belonged to him." The effect of this amendment would be

to preclude the trustee from bringing clawback suits, like the one against the former General Counsel and the majority of the clawback suits brought, which did not rely on any knowledge of the alleged wrongdoing. The former General Counsel responded to OLA that the amendment was "incomprehensible" and did not "seem fair." In testimony before the OIG, the former General Counsel defended his actions, stating that he regarded the amendment as merely "political noise," rather than a serious proposal.

The OIG investigation further found that the former General Counsel consulted with the SEC's Ethics Office on two occasions regarding his interest in his mother's estate's Madoff account: first, upon his return to the SEC in February 2009, and, second, when he received the May 1, 2009 letter advocating the Last Account Statement Method. On both occasions, he was advised that there was no conflict. However, the OIG investigation identified concerns about the role and culture of the Ethics Office at the time it provided this advice. The former SEC Ethics Counsel with whom the former General Counsel consulted on both occasions reported directly to the former General Counsel. The former General Counsel prepared a performance evaluation of the former Ethics Counsel only seven months after the May 2009 ethics advice was provided and described the performance of the Ethics Office as "superb" and the quality of the ethics advice as "very high." The former Ethics Counsel also held the former General Counsel in extremely high regard, and testified he factored into his analysis of whether the former General Counsel should be recused from the Madoff liquidation the fact that "he was a reputed securities lawyer who was making a decision to come back and serve the public and protect investors...."

Additionally, the former Ethics Counsel explained his belief that as Ethics Counsel, the most important thing was that people trust him, and noted that people trusted him with "incredibly personal information." He viewed his job as "to create a culture where people would

seek advice, and to alert those employees—all employees—where the danger lines were, and to encourage them to come and seek ethics advice, because that provides a level of protection.” He stated, “The people who, in the ethics community, that I respect the least are the ones who always say no. If you are a constant naysayer, one, nobody comes to secure advice; two, you’re not actually doing your job.” He further noted, “The key, as I saw it in my job as [Designated Agency Ethics Official] and as ethics counsel, was to make decisions. That’s the reason I was promoted. I was willing to make decisions. That requires a certain amount of willingness to be second-guessed by other people. If you always say no, you’ll never be second-guessed. That was not what I saw my role to be.”

The OIG investigation found that at no time was the former General Counsel advised that he should not participate in any Madoff-related matters, but that this advice appeared to have been based on incorrect assumptions. The OIG investigation further found that the former General Counsel never advised the former SEC Ethics Counsel of the request for his opinion of the SIPA amendment, which would have precluded clawbacks against individuals such as the former General Counsel, and never sought advice on whether providing advice on that amendment was improper.

In the second discussion in early May 2009, the former General Counsel disclosed to the former Ethics Counsel the details of his mother’s account with Madoff, including when it was opened and closed, and approximately how much money was invested. He also explained that the Madoff trustee had been bringing clawback suits and that a clawback suit could “[i]n theory” be brought against him. He also acknowledged that it was possible that the extent to which SIPA coverage would be available could make it “less likely that the [t]rustee would bring claw back actions against persons at the margin” like him. The former Ethics Counsel responded, in part, “There is no direct and predictable effect between the reso-

lution of the meaning of ‘securities positions’ and the trustee’s claw back decision. For this reason, you do not have a financial conflict of interest and you may participate.”

When the OIG took the testimony of the former Ethics Counsel in this investigation, we learned that his opinion was based upon the incorrect understanding that the SEC’s participation in the Madoff liquidation was solely an advisory one, when, in fact, the SEC was a party to the liquidation proceeding and could request the court to compel SIPC to do as it wished. The former General Counsel himself acknowledged in his OIG testimony that consistent with its role as a party, the SEC’s participation in the net equity issue in the Madoff liquidation was not theoretical, and that if SIPC disagreed with the SEC’s position, the SEC should eventually recommend that the court adopt the SEC’s position, indicating that “[t]he Commission had done that in the past and may do it again.”

The OIG also found that the former Ethics Counsel’s advice was also based upon the incorrect assumption that the interpretation of SIPA for purposes of claim determination was a separate and distinct legal question from the trustee’s decision of from whom to institute a claw back suit, and completely ignored any impact on the calculation of the amount to be clawed back. We also found no evidence that the former Ethics Counsel took any further steps to better understand the extent and nature of the General Counsel’s involvement in the Madoff liquidation, and the former General Counsel testified that he did not recall the Ethics Counsel asking for additional facts or directing him to seek additional guidance if new facts arose.

The OIG investigation further found that notwithstanding the importance that the former Ethics Counsel had placed on appearance matters in his communications to SEC employees, he did not even reference appearance considerations in his May 2009 written advice to the former General Counsel. Nonetheless, the

former Ethics Counsel testified that he did consider appearance issues when providing advice in this matter and, in fact, concluded that the former General Counsel's participation in the Madoff liquidation matter passed the "appearance of impropriety test," which the Ethics Counsel had himself described in an ethics bulletin issued to all SEC employees as follows:

What are the optics of the situation; what is the context of the facts and circumstances? Would it pass what has often been referred to as the *New York Times* or *Washington Post* test? If what you propose doing becomes the subject of an article in the press, would you not care or would it look like you were doing something wrong? Even if you wouldn't care, what effect would the story have on the SEC and your fellow employees?

Even with the advantage of hindsight and given the intense press scrutiny and criticism of the former General Counsel's work on Madoff-related matters in the *Washington Post* and *New York Times*, the former Ethics Counsel indicated in his OIG testimony that he stood by his conclusion that the former General Counsel's involvement in the SEC determinations in the Madoff liquidation passed this appearance test.

The OIG investigation further found that the Ethics Office considered the former General Counsel's participation differently in other matters than it did in the Madoff liquidation. For example, in March 2009, shortly after the former General Counsel returned to the Commission, the former Ethics Counsel advised him to recuse himself from the Commission's consideration of an insider trading matter involving a company in which the former General Counsel held about \$90,000 in securities of issuers that were harmed by the trading at issue in the case. In that case, the basis for recusal was a "theoretical possibility" of some benefit to the former General Counsel, which seems significantly less likely than the situation presented by his participation in the

Madoff SIPC liquidation proceeding. Similarly, the former General Counsel himself took a more conservative stance on recusal in certain matters, and even declined to participate in one matter where the Ethics Office had advised he could do so. In connection with one matter from which he had been recused, the former General Counsel commented to the Ethics Office, "I recused myself because of a brief (under 30 minutes) involvement with the case. Ultra conservative, but wise."

The OIG investigation also determined that the Ethics Office considered recusals in Madoff-related matters differently in situations that did not involve the former General Counsel. Shortly after Madoff confessed, the former Ethics Counsel sent a memorandum to all Commission employees regarding mandatory recusal from *SEC v. Madoff* in a broad variety of circumstances. The memorandum stated, "[A]ny member of the SEC staff who has had more than insubstantial personal contacts with Bernard L. Madoff or Mr. Madoff's family shall be recused from any ongoing investigation of matters related to SEC v. Madoff." The memorandum further set forth certain contacts that required recusal, including being invited to or visiting any Madoff family members' homes or being an active member of the same social or charitable organizations.

In addition, the OIG investigation found that with respect to employees within OGC besides the former General Counsel, the Ethics Office took a more conservative approach toward recusal from Madoff-related matters, including the Madoff liquidation. For example, the Ethics Office advised a staff attorney in OGC's Appellate Litigation and Bankruptcy Group that she had a conflict from working on any aspect of the Madoff liquidation because she "spent a very small amount of time in private practice working on a question related to the Madoff bankruptcy."

The OIG investigation also found that the former Ethics Counsel was not the only individual within the SEC who was aware of the

former General Counsel's mother's estate having an account with Madoff prior to the time this issue appeared in the press. Both the former General Counsel and the Chairman recalled that, around the time of his return to the SEC in February 2009, the former General Counsel discussed his mother's estate's Madoff account with her. While their recollections of the substance of the conversation were not entirely consistent, the evidence clearly showed that the former General Counsel advised the Chairman that his mother had had an account with Madoff, she had died several years before, and the account had been liquidated. The Chairman did not recall asking any questions after he told her about his mother's account, or whether he said anything about seeking advice from the Ethics Counsel regarding the account, although he testified he must have mentioned to her that he would consult with the Ethics Counsel. At that time, the Chairman did not consider the former General Counsel's personal financial gain "in any way, shape, or form," or whether he would be subject to a clawback action. Indeed, the Chairman testified that she would have had the former General Counsel recused from the net equity determination if she had known he was potentially subject to a clawback suit or "understood that he had any financial interest in how this [was] resolved...."

In addition, the issue of the former General Counsel's mother's estate's Madoff account was discussed by several SEC senior officials in the fall of 2009, when the SEC learned that the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the U.S. House of Representatives Committee on Financial Services was scheduling a hearing on SIPC and the Madoff victims. Shortly after the SEC learned that the Congressional testimony would focus on legal aspects of the SIPC/Madoff issues, the Chairman suggested that the former General Counsel testify on behalf of the SEC at the hearing. The OLA Director then had a conversation with the former General Counsel, during which the former General Counsel informed him that his mother

had a Madoff account from which he "had gotten an inheritance." The former General Counsel also testified that he told the OLA Director that "if [he did] testify, [he] would put at the beginning, [he] would mention [his], the fact of [his] mother's account with Madoff." He further testified that after this conversation, the OLA Director contacted him later in the day and said, "You know, now that I think about it, I think it would be better if somebody else testified. My concern is—not that there's anything inappropriate, but my concern is [ ] that when you're in a political environment, people might want to make something of that, and it would be a distraction rather than focusing on what the Commission's position was and why."

The former General Counsel testified that either the evening of his conversation with the OLA Director or the following morning, he spoke with the Chairman about his mother's account. The Chairman recalled the conversation with the former General Counsel and stated, "I recall saying that if [he] did testify, we needed to make it absolutely clear to Congress that there was this connection, remote though I believed it to be, that his long-deceased mother had had an account at Madoff, so that nobody would be surprised by that, so that we were completely forthcoming with Congress." The former General Counsel testified that he was certain that it was he who said in the meeting with the Chairman that if he were to testify, he would disclose his mother's account with Madoff. The OIG investigation found that eventually, the OLA Director made the decision not to have the former General Counsel testify. The SEC Deputy Solicitor, who had been suggested by the former General Counsel as a possible replacement witness, testified in his stead at the subcommittee hearing which occurred on December 9, 2009, and involved discussions of clawbacks. In the end, the former General Counsel's Madoff interest was not disclosed to Congress.

Moreover, the OIG investigation found that although the decision was made that should the

former General Counsel testify before Congress, he would disclose his mother's interest with Madoff, during this November 2009 time-frame, the fact of the former General Counsel's interest in his mother's estate's Madoff account was not disclosed to the Commissioners or the bankruptcy court, notwithstanding the fact that the Commission was considering the recommendation on the net equity position to take in court at this very time. One SEC Commissioner testified that it was "incredibly surprising and incredibly disappointing that there was enough awareness to know that the conflict existed to prevent him from giving [this] testimony, yet the decision-makers at the Commission were not provided that information."

In all, the OIG investigation found that, prior to the public disclosure of the former General Counsel's mother's Madoff account, at least seven SEC officials were informed at one time or another about that account, including the Chairman, the then-Deputy General Counsel and current General Counsel, the Deputy Solicitor who testified at the hearing in the former General Counsel's stead, the OLA Director, a Special Counsel to the Chairman and the two Ethics officials, and yet none of these individuals recognized a conflict or took any action to suggest that the former General Counsel consider recusing himself from the Madoff liquidation. The rest of the relevant personnel who worked with the former General Counsel on the Madoff liquidation found out about his mother's account from the media. These included all the TM personnel who played a role in the Madoff liquidation, OGC lawyers who worked with the former General Counsel on the net equity determination, all the SEC Commissioners other than the Chairman, SIPC's President and CEO, SIPC's General Counsel, and the Madoff trustee. Virtually all these individuals expressed some level of surprise at the revelation, and many expressed concern about the potential conflict of interest.

## **Consultation with OGE and Recommendations in the Report of Investigation**

On August 31, 2011, after completing the fact-finding phase of the investigation, the OIG provided to the Acting Director of the Office of Government Ethics (OGE) a summary of the salient facts uncovered in the investigation. The OIG requested that OGE review those facts and provide the OIG with its opinion regarding the former General Counsel's participation in matters that could have given rise to a conflict of interest. After reviewing that factual summary, the Acting Director of OGE provided the following guidance to the OIG: "It is [the OGE Acting Director's] opinion, as well as that of senior attorneys on [his] staff, that certain matters [the OIG] discussed in the materials [the OIG] provided to OGE should be referred to the United States Department of Justice for its consideration." The OGE Acting Director further explained that this guidance related to, more specifically: "(a) [the former General Counsel]'s work as General Counsel on the policy determination of the calculation of net equity in connection with clawback actions stemming from the Madoff matter, and (b) [the former General Counsel]'s SEC work on the proposed legislation affecting clawbacks." He also stated that the OGE attorneys' view was as follows:

[T]he materials provided to OGE contain information relevant to two elements of 18 USC 208, to the extent they evidence [the former General Counsel]'s apparent personal and substantial participation in both of the particular matters above, and to the extent there is implicated a personal financial interest that could be impacted by [the former General Counsel]'s participation in those matters. Nonetheless, the actual knowledge element of 18 USC 208, which would be required to establish a violation of that statute, remains a question of fact that can only be resolved in a court of law.

Based upon this guidance, the OIG referred the results of its investigation to the Public Integrity Section of the Criminal Division of the U.S. Department of Justice. This referral was pending as of the end of the semiannual reporting period.

Additionally, based on its findings, the OIG recommended that, in light of the former General Counsel's role in signing the Advice Memorandum to the Commission and participating in the executive session at which the Commission considered the pertinent recommendation from OGC regarding the Commission's position on net equity under SIPA, the Commission should reconsider its position on this issue by conducting a re-vote in a process free from any possible bias or taint and advise the bankruptcy court of the results thereof. With respect to the SEC Ethics Office, the OIG recommended that: (1) the SEC Ethics Counsel should report directly to the Chairman, rather than to the General Counsel; (2) the Ethics Office should take all necessary steps, including the implementation of appropriate policies and procedures, to ensure that all advice provided by the Ethics Office is well-reasoned, complete, objective, and consistent, and that Ethics officials ensure that they have all the necessary information in order to properly determine if an employee's proposed actions may violate rules or statutes or create an appearance of impropriety; and (3) the Ethics Office should take all necessary actions to ensure that all ethics advice provided in significant matters, such as those involving financial conflicts of interest, is documented in an appropriate and consistent manner. As of the end of the semiannual reporting period, the Chairman and the Ethics Counsel had agreed to and begun to implement the report's recommendations.

A public version of the OIG's report is available on the agency's website at <http://www.sec.gov/foia/docs/oig-560.pdf>.

## **Allegations of Enforcement Staff Misconduct in Insider Trading Investigation (Report No. OIG-511)**

The OIG conducted an investigation into a complaint made by counsel for a defendant in an SEC enforcement action that alleged numerous instances of misconduct by Enforcement attorneys during the course of the investigation leading up to that enforcement action. The alleged misconduct included, among other things, that (1) Enforcement staff violated SEC policy when they notified the prospective defendant that they intended to recommend insider trading charges against him (known as a "Wells notice") before the staff's investigation was substantially complete; (2) Enforcement staff demonstrated a bias and predetermined agenda against the defendant, and the investigation appeared to have been motivated by political bias evidenced by a series of politically-charged e-mails an SEC regional office Enforcement attorney had sent to the defendant; (3) Enforcement staff used the closure of an earlier investigation to attempt to induce company executives to cooperate with the staff and perhaps depart from testimony previously provided to the defendant's counsel; and (4) a senior Enforcement official failed to properly report the misconduct of the regional office Enforcement attorney who was e-mailing the defendant from his SEC e-mail account during the ongoing Enforcement investigation of the defendant. Counsel for the defendant also subsequently alleged that an SEC Enforcement attorney violated state bar rules by engaging in the "tamp down" of a witness, *i.e.*, requesting that a witness not be made freely available to defense counsel.

During its investigation, the OIG obtained and searched the e-mails of eight current or former SEC employees for the time periods relevant to the investigation. In all, the OIG received and searched more than 400,000 e-mails. In addition, the OIG thoroughly examined the record in the court proceedings related to the SEC's enforcement action against the defendant and reviewed numerous pleadings filed in connection with that litigation.



The OIG also took sworn, on-the-record testimony of eight current or former SEC staff members, the defendant in the SEC enforcement action and two of his counsel, and interviewed an additional former SEC employee.

After conducting a thorough investigation into the defendant's claims, the OIG issued a comprehensive report of investigation on August 22, 2011. Overall, the OIG investigation concluded that there was insufficient evidence to substantiate the allegations that the SEC Enforcement staff engaged in misconduct in conducting their investigation into the defendant's alleged insider trading. First, the OIG investigation found that there was insufficient evidence to substantiate the claim that Enforcement staff improperly provided the prospective defendant's counsel with a "Wells notice" before the investigation was substantially complete. The OIG found that Enforcement staff had conducted significant investigative work before the Wells notice was provided. Specifically, SEC Enforcement staff had (1) conducted several interviews, (2) obtained profilers from other relevant persons, and (3) taken investigative testimony of two key witnesses. SEC Enforcement staff had also obtained important documents, including trading and telephone records, documents reflecting the timing of the announcement of a particular offering, and relevant e-mails about a key telephone call. While the OIG did find that Enforcement staff conducted some additional investigative work after the Wells notice was provided and responsive submissions were received, the OIG found that conducting additional investigative work, and even taking testimony, after the Wells notice is provided, is not *per se* prohibited by the Enforcement Manual that sets forth various general policies and procedures as guidance for the Enforcement staff or internal guidance and sometimes occurs in Enforcement cases.

The OIG investigation also did not find sufficient evidence to substantiate the claim that an earlier Enforcement investigation into the relevant company was closed as a *quid pro quo* for the investigation relating to the defendant.

The complaint received by the OIG alleged that a mere four days after the defendant's counsel sent a letter to a senior Enforcement official and "just around the time the staff was seeking testimony from the very same [company] executives in its investigation of [the defendant], the Commission abruptly closed its investigation of [the company], which at that time had been ongoing for over three years." The complaint further alleged:

[T]hat the staff would suddenly choose to close a long-standing investigation ... only a few days after receiving a Wells submission, and just when the staff was seeking testimony from the company's senior executives, [gave] rise to the reasonable suspicion that the staff, bent on obtaining testimony unfavorable to [the defendant], used the closure of the investigation to attempt to induce [company] executives to cooperate with the staff and perhaps even to depart from the testimony they previously had provided to [the complainants].

However, the OIG found evidence that the Enforcement staff intended to close the earlier investigation several weeks before a matter under inquiry (MUI) was opened into the defendant's trading. While a letter was not sent notifying the relevant company of the closure of the investigation of the company until a year later, when SEC Enforcement staff was conducting additional investigative work in the matter related to the defendant, the OIG did not find any evidence that closing the earlier investigation had any effect on the investigation into the defendant's trading or in any way induced the company executives to provide different testimony. The Enforcement staff obtained additional information from only one company executive in a second follow-up testimony of that individual. Moreover, the OIG found that the two investigations were separate and there was very little interaction between the investigative teams, except to request certain transcripts of testimony taken years earlier.

The OIG investigation further established that a former SEC regional office Enforcement attorney began e-mailing the defendant from his SEC computer during the time period when the Enforcement staff was investigating the defendant. The e-mails pertained to the defendant's apparent backing of a movie that the former regional office attorney alleged posited a certain political agenda. In these e-mails, the former regional office attorney expressed his personal views accusing the defendant of promoting a radical and irresponsible viewpoint by backing this movie. The OIG investigation found that the former regional office attorney continued the e-mails to the complainant again a couple of months later, and copied the then-SEC Chairman on those e-mails.

The OIG investigation revealed that the former regional office attorney was not involved in any way in the investigation into the defendant's trading, and that there was no evidence that the former regional office attorney had any knowledge of that ongoing investigation when he was e-mailing the defendant. The OIG found that the then-SEC Chairman did receive the e-mail exchanges between the former regional office attorney and the defendant and forwarded them to the then-Director of the SEC's Office of Equal Employment Opportunity. However, the OIG investigation revealed that the then-Chairman did not know who the defendant was and was unaware that there was an ongoing Enforcement investigation into the defendant's trading. Nevertheless, the then-Chairman did recuse himself from the meeting and vote to authorize the Enforcement action against the defendant. In all, the OIG investigation did not reveal that the former regional office attorney's e-mail exchange with the complainant had any substantive impact on Enforcement's investigation of the defendant.

In addition, the OIG determined that a senior Enforcement official, who supervised the investigation into the defendant's trading, was also forwarded at least a portion of the later e-mail exchanges between the former regional

office attorney and the complainant. The OIG investigation established that immediately after receiving copies of those e-mail exchanges, the senior Enforcement official informed the former regional office attorney of the ongoing investigation related to the defendant and instructed him to stop communicating with the defendant. There was no evidence that the former regional office attorney communicated any further with the defendant while he remained an SEC employee. However, the OIG found that the senior Enforcement official failed to promptly report this misconduct to his supervisors, the former regional office attorney's supervisors, the Office of Human Resources, or the OIG. Nevertheless, the former Chief of Staff and former Counsel to the then-SEC Chairman did take action several weeks after the then-Chairman was copied on the e-mail exchanges, and the former regional office attorney was then promptly suspended without pay. Subsequently, the former regional office attorney was removed from federal service for continuing to engage in misconduct of a similar nature.

The OIG investigation did not find sufficient evidence to establish that the investigation into the defendant's trading was motivated by politics or other improper motives, or that Enforcement staff targeted the defendant because he was a high-profile or recognized individual. The OIG investigation revealed that an Enforcement staff attorney opened the investigation of the defendant as a result of finding instant messages while searching for the term "jail" in the course of conducting another investigation. While the staff attorney knew who the complainant was, her two immediate supervisors were not aware of who the complainant was at the time the Enforcement investigation was opened. The OIG investigation did not establish that anyone on the Enforcement staff was motivated to bring a case against the complainant because he was a well-known or high-profile individual. The OIG investigation further revealed that the Enforcement staff only learned about the existence of the e-mail exchanges between the former regional office

attorney and the complainant the day before the Wells meeting with the defendant's counsel, and it had no bearing on their investigation. In addition, the OIG found that none of the Enforcement staff working on the investigation discussed the defendant's political views, even after reading the e-mail exchanges between the former regional office attorney and the defendant.

Moreover, the OIG investigation did not find sufficient evidence to substantiate the allegation that the Enforcement staff had a preconceived notion or bias as to the defendant's guilt. The investigation did establish that during the Wells meeting with the defendant's counsel, the trial attorney who had recently been assigned to the matter made the comment, "[The defendant] takes irrational and silly risks every day," or words to that effect. This comment was confirmed by the defendant's counsel, memorialized in a memorandum prepared the next day from notes taken during the meeting, and the trial attorney acknowledged that he made such a comment. The OIG further found that although the comment was made as part of a back-and-forth conversation in a Wells meeting about the strengths and weaknesses of the case against the defendant, and the defendant's propensity to take risks was not altogether irrelevant to the merits of the SEC's case (particularly when his counsel raised the argument that the defendant would not risk everything he had and his reputation for the amount of dollars at stake), the trial attorney could have been more temperate in his language.

The OIG also found that the then-Enforcement Director, who attended the Wells meeting in this matter, made the comment, "That's just noise," or words to that effect, in response to the defendant's counsel's arguments about a witness's credibility. While perhaps the then-Enforcement Director could have chosen a different word to describe her view that certain arguments were irrelevant or extraneous to the merits of the case against the defendant, the OIG did not find use of the word "noise"

in this context to be improper. Overall, the OIG investigation concluded that these comments, standing alone, did not establish a preconceived bias against the defendant, particularly because they were made in the context of responding to the defendant's counsel's arguments.

The OIG also found that a senior Enforcement official sent photographs of the complainant (one or two of which could be considered unflattering) that he obtained from the Internet to the then-Enforcement Director and another senior Enforcement official without commentary. The OIG found that the senior Enforcement official sent these photographs of the complainant because the then-Enforcement Director and the other senior official were unaware of who the complainant was, and to explain why the request for a formal order of investigation in the matter should be presented in executive session. We did not find evidence to establish that the sending of these photographs without any commentary demonstrated evidence of a bias against the defendant that could have tainted the investigation of him.

Further, the OIG investigation did not find sufficient evidence to establish that the Enforcement staff attorney identified by the complainants or anyone else on the Enforcement staff had engaged in a "tamp down" of a particular witness, or otherwise engaged in efforts to prevent witnesses from speaking with the defendant's counsel. First, the witness in question did provide the defendant's counsel with a declaration during their own investigation of the matter and before Enforcement took the witness's testimony. Second, according to the staff attorney, as substantiated by her second-line supervisor, the staff attorney merely stated that the witness's counsel did not have to make the witness available for an interview with the defendant's counsel, and the staff attorney noted that the "only preference [she] expressed was wanting the SEC to go first with the testimony." Third, even according to the witness's counsel's declaration obtained by the defendant's coun-

sel, the staff attorney merely “stated that she would prefer that [counsel] did not produce [the witness] to [the defendant’s] counsel for an interview but that [he] could do what [he] wanted.” Moreover, we did not find that the staff attorney articulating her preference as to the timing of presenting employees to defense counsel would violate ethical standards of conduct or State bar rules. In addition, while the complainants also alleged that SEC Enforcement staff engaged in misconduct when questioning this witness in testimony, the OIG’s review of the transcript of this testimony did not reveal any misconduct.

While the OIG did not find sufficient evidence to substantiate the allegations of misconduct, we referred this matter to management for counseling for the senior Enforcement official for his failing to promptly report the former regional office attorney’s misconduct and for the trial attorney for his comment about the defendant in the Wells meeting. No action had yet been taken by management with respect to the OIG’s recommendations at the end of this reporting period. A public version of the OIG’s report is available on the agency’s website at <http://www.sec.gov/foia/docs/oig-511.pdf>.

### **Investigation into Allegations of Improper Preferential Treatment and Special Access in Connection with an Enforcement Investigation (Report No. OIG-559)**

On January 11, 2011, the OIG opened an investigation as a result of information received in an anonymous complaint. The Honorable Charles Grassley (R-Iowa) also forwarded the anonymous complaint to the OIG and requested that we review the allegations contained in the complaint. The anonymous complaint alleged serious problems with special access and preferential treatment at the SEC. Specifically, the complaint alleged that during Enforcement’s investigation into a public company’s failure to disclose certain subprime securities, a senior SEC official had a secret conversation with a prominent defense lawyer representing the company, who was also a good

friend and former colleague of the senior official. The complaint also alleged that, during this secret conversation, the senior official agreed to drop contested fraud charges against an individual, and that the Enforcement staff were later forced to drop fraud charges that were part of a settlement with another individual in the same case.

The anonymous complaint further alleged that the senior official’s failure to apprise the staff of the secret conversation before it occurred was contrary to previous OIG recommendations designed to address concerns about the appearance problems created by special access and preferential treatment.

The OIG conducted a thorough investigation of the allegations in the anonymous complaint. In conducting its investigation, the OIG reviewed e-mails of nine current SEC employees who worked on the Enforcement investigation in question for the relevant ten-month time period. The OIG also reviewed the entries regarding the Enforcement investigation in two internal databases. In addition, the OIG took the sworn, on-the-record testimony of seven current SEC employees who had knowledge of the facts and circumstances surrounding the matter, and interviewed the defense lawyer who allegedly had the secret conversation with the SEC senior official.

The OIG investigation learned that the SEC in the Enforcement matter at issue had agreed to settle charges against the public company, but initially pursued charges against two company officials. These individuals ultimately consented to the entry of administrative cease-and-desist orders and undertook to pay fines. The OIG investigation found that the settlements the SEC ultimately entered into with the two individual defendants were non-fraud settlements negotiated just one month before the SEC’s action in the matter and a few days after the senior official had a telephone conversation with a former colleague who was representing the company. However, the evidence obtained in the OIG’s investigation did not establish that those settlements were the result of any special

favor. In addition, the OIG found no evidence that the senior official had an unusually close relationship with the defense counsel or that any decision was made based upon any friendship.

Instead, the OIG found that the settlement decisions were made after a negotiation process that included consultation with several members of the Enforcement staff working on the investigation. The OIG investigation also found that the senior official made significant efforts to keep the Enforcement staff informed of the status of the matter and also made considerable efforts to allow them to express their views on the case. Therefore, the OIG investigation concluded that the conversation the senior official had with the defense counsel did not result in any secret deal, but rather, at most, was the beginning of further negotiations and discussions that continued for several days.

In addition, the OIG investigation did not find evidence that the senior official acted contrary to prior OIG recommendations or violated the provisions of the Enforcement Manual applicable to all Enforcement staff regarding external communications, which were included in the manual to address concerns raised in a previous OIG investigation. Although the senior official did not include other staff members on the telephone call with the defense counsel, the evidence showed the senior official did not commit to any specific settlement during that telephone call. The evidence further demonstrated that when the senior official learned that the defense counsel believed a commitment had been made, the senior official immediately reached out to the defense counsel to disabuse any notion that a settlement had been reached. Moreover, the evidence showed that the senior official reported back to the Enforcement staff about the matter and further discussions were conducted with the Enforcement staff before a final decision on the settlement was made. In addition, the senior official informed the Enforcement staff working on the matter that if they were not comfortable with the settlement, the senior

official would reject it and move forward with a contested action.

Accordingly, the OIG investigation did not substantiate the allegations contained in the anonymous complaint, and the report of investigation was issued to management for informational purposes on September 27, 2011.

### **Excessive Payment of Living Expenses for a Headquarters Senior Official in Contravention of OPM Guidance (Report No. OIG-561)**

The OIG opened this investigation on April 27, 2011, after receiving a confidential complaint alleging the SEC engaged in wasteful spending in connection with the hiring of a senior official. On September 9, 2009, the senior official, who was employed by a Texas university, was hired through the Intergovernmental Personnel Act (IPA) to occupy a senior position at SEC headquarters in Washington D.C. The IPA is intended to facilitate cooperation between the federal government and non-federal entities through the temporary assignment of skilled personnel. Through the IPA agreement in question, the SEC reimbursed the university for more than \$300,000 for the senior official's salary and benefits. In addition, the SEC spent approximately \$120,000 for his housing, airfare, and living expenses (including meals) for the 16-month period while he worked in Washington, D.C., but was officially stationed at his home location.

During its investigation, the OIG took the sworn, on-the-record testimony of five individuals with knowledge of the relevant facts and circumstances, including the senior official hired through the IPA. The OIG also conducted a follow-up interview of the senior official hired through the IPA, as well as two other SEC senior officials. The OIG also obtained and searched over 85,000 e-mails of current and former SEC staff members relevant to this matter. The OIG further reviewed other documents related to this matter, includ-

ing travel records, invoices, and several IPA agreements entered into by the SEC.

According to the Office of Personnel Management (OPM), an agency entering into an IPA agreement may offer the recipient either “limited relocation expenses” or a per diem allowance for living expenses during the period of the assignment, but not both. OPM guidance further provided, “An agency should also consider the duration of the assignment. A per diem allowance is meant for shorter assignments.” Consistent with OPM’s guidance, SEC policy had been to limit relocation expenses to \$9,000.

The OIG investigation found that the SEC’s agreement with the senior official in question was contrary to the OPM guidance on IPA agreements and SEC practice based on that guidance. Specifically, the OIG investigation found that the arrangement to pay the senior official’s living expenses was not short-term as OPM guidance indicated such arrangements should be. Instead, the investigation showed that the SEC initially arranged to pay those expenses for one year and renewed the arrangement for a second year.

Moreover, the evidence showed that the SEC offered to pay the senior official’s living expenses without considering the cost to the federal government as a major factor. Further, the offer did not include any limit on how much the SEC would pay for the senior official’s living expenses and was made despite concerns expressed by SEC staff that the arrangement was too costly. The OIG found that even as the costs incurred for the senior official’s living expenses mounted, no effort was made to renegotiate the arrangement with the senior official, even when his IPA agreement was renewed for a second year. The unprecedented arrangement to pay for the senior official’s living expenses while he worked in Washington, D.C., the actual location of his position, ultimately cost the SEC approximately \$100,000 more than the costs that would have

been incurred if OPM guidance and previous SEC practice had been followed.

On September 7, 2011, the OIG issued its report of investigation in this matter. The OIG recommended that the Chief Operating Officer develop guidelines regarding IPA agreements that: (1) mandate that duty stations be located where there is an SEC office; (2) define the circumstances when a per diem arrangement similar to the one at issue in this investigation may be offered; and (3) establish limits on the duration of per diem travel arrangements. No action had yet been taken by management with respect to the OIG’s recommendations at the end of the reporting period. A public version of the OIG’s report is available on the agency’s website at <http://www.sec.gov/foia/docs/oig-561.pdf>.

### **Inappropriate Communications Between an SEC Attorney and an Outside Party (Report No. OIG-555)**

On December 15, 2010, the OIG opened an investigation into allegations received from an SEC regional office that an SEC headquarters supervisory attorney had been communicating inappropriately with an outside party, who was a hedge fund manager. Specifically, it was alleged that the SEC attorney inappropriately discussed with the hedge fund manager the legality of certain actions previously taken by the hedge fund manager, as well as certain actions he proposed to take. It was further alleged that these inappropriate communications dated as far back as 2006, and, according to the regional office that was investigating the hedge fund manager’s activities, made it impossible for Enforcement to litigate a case against him because of his ability to raise these communications as a potential defense.

During its investigation of these allegations, the OIG obtained and searched nearly 8,000 e-mails and took sworn, on-the-record testimony of the attorney who allegedly had the inappropriate conversations and a senior Enforcement attorney who was familiar with the



matter. The OIG also obtained and reviewed testimony transcripts from the regional office's investigation, and interviewed a regional office Enforcement official about the alleged misconduct.

The OIG investigation found that in June 2010, the SEC regional office opened an official investigation into alleged insider trading and possible market manipulation by the hedge fund manager based on a referral from that regional office's Examination staff. According to the regional office Examination staff, the hedge fund manager may have been involved in insider trading and market manipulation stemming from a 2006 purchase of securities of a natural resource company and a subsequent offer to purchase all of the company's outstanding shares at a substantial premium over the preceding day's closing price.

The regional office was especially concerned about two specific communications in April 2006: (1) a telephone conversation during which the SEC attorney allegedly told the hedge fund manager that his purchase of securities prior to announcing a proposed takeover of the company was legal; and (2) an e-mail in which the SEC attorney provided his cell phone number and informed the hedge fund manager that he might "feel freer" to fully express his opinions on a non-SEC line. We found that Enforcement staff at SEC headquarters had looked into the hedge fund manager's 2006 purchase of the natural resource company's securities and, while they did not open an official investigation, likewise were concerned by the SEC attorney's communications with the hedge fund manager.

The OIG investigation learned that because of the telephone and e-mail communications that had taken place between the SEC attorney and the hedge fund manager, both headquarters and regional office Enforcement staff were concerned that the hedge fund manager would: (1) be found to lack the requisite scienter for liability due to his communications with the SEC attorney; and (2) have a

defense against any potential Enforcement action(s) due to these communications, creating unacceptable litigation risk. At the time the OIG investigation was completed, the regional office was in the process of closing its investigation due to, among other factors, a lack of requisite scienter for insider trading liability on the part of the hedge fund manager.

The OIG investigation found that the SEC attorney's communications with the hedge fund manager during 2006 showed a lack of judgment on his part. We determined that these communications, which occurred during a time period when Enforcement was considering recommending possible charges against the fund manager to the Commission, were inappropriate and inconsistent with the duties and responsibilities of a supervisory SEC attorney. The OIG also found that the SEC attorney had communications with the hedge fund manager that predated the 2006 occurrences by several years, indicating a close relationship between the SEC manager and hedge fund manager. Moreover, the OIG found that the SEC attorney's continuing communications with the hedge fund manager, in addition to being inappropriate: (1) prompted Enforcement to ask the SEC attorney's former supervisor to ensure he was not involved in Enforcement's 2006 investigation; (2) caused the hedge fund manager to believe that his 2006 purchase of securities from the natural resource company was legitimate; (3) led to a finding that the hedge fund manager lacked the requisite scienter for liability; and (4) created significant litigation risk for the regional office in 2010.

Additionally, the OIG found that the SEC attorney inappropriately offered his cell phone number to the hedge fund manager so that an outside lawyer could call the SEC attorney to discuss whether the hedge fund manager had done anything wrong. The OIG investigation showed that the SEC attorney informed the hedge fund manager that he would be more willing to express his opinions on a non-SEC telephone line. The OIG found that this statement was inappropriate, created a cloud of

suspicion as to the SEC's attorney's intentions, and was inconsistent with the requirement that federal employees conduct themselves in a manner that ensures complete confidence in the integrity of the federal government.

As a result of its findings in this matter, the OIG issued its report of investigation on August 8, 2011, and recommended that disciplinary action, up to and including dismissal, be taken against the SEC attorney. As of the end of the reporting period, no action had yet been taken by management with respect to the OIG's recommendation.

### **Investigation of Alleged Enforcement Failure to Investigate Possible Violations of the Federal Securities Laws (Report No. OIG-554)**

On December 15, 2010, the OIG opened an investigation into allegations by an anonymous complainant that the SEC had failed to investigate the activities of a hedge fund manager and his brokerage firm. Specifically, the complaint alleged that, in late 2004, the Examination staff in an SEC regional office uncovered the hedge fund manager's massive fraud and referred it to Enforcement. The complaint further alleged that the regional office Examination staff provided Enforcement with an examination report detailing the magnitude of the illegal conduct, but that the matter was never pursued. The complaint also pointed out that the hedge fund manager in question was listed as one of the top 25 people responsible for the 2008 financial crisis by *Time* magazine.

During the course of its investigation, the OIG obtained searched nearly 600,000 e-mails of current and former SEC employees, including supporting attachments. The OIG also reviewed numerous other materials including, but not limited to: (1) the regional office's broker-dealer examination report and accompanying referral memorandum to Enforcement; (2) draft and final versions of internal memoranda to the Commission; and (3) articles concerning the hedge fund manager and his brokerage and

hedge fund operations. In addition, the OIG took the sworn, on-the-record testimony of 16 current and former SEC employees.

The OIG investigation found that from late June to early September 2004, the regional office Examination staff conducted a broker-dealer cause examination of the brokerage firm based on a tip that the hedge fund manager was living an overly-extravagant lifestyle. The regional office Examination staff drafted an examination report and accompanying referral memorandum, and recommended its findings, which included potentially fraudulent markups and a securities parking scheme, to the regional office Enforcement staff for investigation in December 2004. The regional office Enforcement Staff viewed the referral as significant and immediately opened an investigation. After conducting substantial investigative work, however, the regional office decided to transfer the investigation to another SEC regional office to avoid an appearance of a conflict of interest arising from a senior regional office official recently having left the SEC and taken a position with the brokerage firm.

The OIG investigation further found that the second regional office Enforcement Staff expressed skepticism toward the referral from the first regional office, primarily due to the second regional office's belief that the examination report contained several mistakes. At the outset of their investigation, the second regional office Enforcement staff narrowed the scope of the investigation to one of four issues that the Examination staff had referred and the first regional office Enforcement Staff had intended to investigate. The OIG found that the decision to narrow the matter to one particular issue was made solely to simplify the matter, and that the staff in the second regional office did not fully understand the nature of the other issues. After narrowing the scope of the investigation, the second regional office decided to close the matter entirely. The reason cited for that decision was the "lack of a good working theory." The matter was closed without the second regional office Enforcement staff taking

the testimony of the hedge fund manager or any other witnesses.

The OIG also found that prior to closing the investigation, the second regional office Enforcement staff subpoenaed documents, including bank records, from the brokerage firm and its affiliates, as well as additional documents from certain related third parties. Upon reviewing these documents, the second regional office Enforcement staff was unable to establish that money was being funneled to entities other than the hedge fund manager, his brokerage firm, or family members. Without additional evidence of fraud by the hedge fund manager and his brokerage firm other than price mark-ups between sophisticated, institutional investors (*e.g.*, evidence of kickbacks from the hedge fund manager to his customers), the second regional office Enforcement staff determined that they would be unable to demonstrate fraud or violations of the federal securities laws. Before officially closing the case, the second regional office informed the first regional office of its decision and offered the case back to the first regional office. After the offices conferred, the decision was reaffirmed to close the matter. The OIG found that, before the matter was officially closed in 2007, the first regional office Enforcement staff opened a second investigation into the hedge fund manager and certain of his operations, but ultimately did not bring an Enforcement action and closed that matter in 2011.

Overall, the OIG investigation did not find evidence that SEC staff violated the Commission's Canons of Ethics or acted in an improper fashion in connection with the broker-dealer examination and resulting investigations of the hedge fund manager, his brokerage firm, and its affiliated entities. Although a determination was made to close the investigation after a limited amount of investigatory work, we did not find evidence to substantiate the allegation that the SEC failed to investigate the alleged violations of the federal securities laws by the hedge fund manager or his brokerage firm.

The OIG issued its report of investigation in this matter to management for informational purposes on September 28, 2011. The OIG noted in its report that, at the time of the Examination staff's 2004 referral, Enforcement had not yet reorganized into the specialized units that currently comprise the Division. Specifically, in January 2010, Enforcement announced that it had appointed certain SEC managers to head an extensive reorganization of the Division and, according to Enforcement, this extensive reorganization was designed to address many of the difficulties inherent in enforcing the federal securities laws by: (1) improving institutional understanding of complex products and markets; (2) increasing investigators' capability to detect emerging fraud and misconduct earlier and more effectively; (3) increasing investigators' capacity to bring cases quickly; and (4) increasing overall expertise throughout Enforcement. Among the newly-formed specialized units was the Structured and New Products Unit, designed specifically to focus on fraud involving certain complex financial instruments including collateralized debt obligations, which formed the basis for the Examination staff's referral in this matter.

## **Other Inquiries Conducted**

### **Abuse of Leave and Attempt to Defraud the Federal Government by a Regional Office Senior Officer (PI 11-33)**

On June 14, 2011, the OIG received an anonymous complaint alleging that a senior officer in an SEC regional office had used two weeks of sick leave, instead of annual leave, to vacation in Hawaii. The complaint did not specify a timeframe for when the alleged misconduct occurred. In response to the complaint, the OIG opened this preliminary inquiry on June 15, 2011.

In conducting this inquiry, the OIG reviewed the senior officer's official personnel file, as well as her payroll and time and attendance records for 2011. In addition, the OIG obtained and reviewed her e-mails for the time

period relevant to the inquiry. The OIG interviewed a regional office senior official. The OIG attempted to contact the senior officer to schedule her testimony on six separate occasions, but she refused to respond to those communications. Further, the OIG reviewed the senior officer's travel records and contacted several airlines. The OIG also issued a subpoena to an airline for the senior officer's airline tickets and related reservation information. In response to the subpoena, the airline provided the OIG with a copy of an electronic ticket issued to the senior officer for travel during the relevant time period.

The OIG inquiry found that on April 14, 2011, the senior officer requested 80 hours of sick leave for the two weeks from Monday, May 9, 2011 through Friday, May 20, 2011. The OIG also found that she flew to Hawaii on May 8, 2011, and returned on May 19, 2011. The OIG further found that in June 2011, she submitted a request to use another 56 hours of sick leave six weeks after the request. That request was cancelled after the senior officer's new supervisor questioned why she was requesting seven days of sick leave so far in advance.

The OIG further found that prior to the conclusion of the OIG's inquiry, the senior officer announced that she was resigning from the SEC at the end of August 2011. Accordingly, if left uncorrected, she would have been entitled to a lump-sum payment of approximately \$7,800 for the 80 hours of annual leave that should have been deducted from her annual leave balance for her vacation. On August 8, 2011, the OIG issued its memorandum report, summarizing the results of its inquiry and recommending disciplinary action against the senior officer, up to and including dismissal. The OIG also recommended that her balance of unused annual leave be reduced by 80 hours in order to prevent the improper crediting of those hours to her service or her receipt of an improper lump-sum payment for those hours upon her planned departure from the SEC. The senior officer's resignation was effective

before any disciplinary action was taken against her; however, the 80 hours of sick leave was converted to annual leave.

### **Misuse of Government Computer Resources, Office Equipment, and Official Time to Support a Personal Private Business, and Falsification of Time and Attendance Records (PI 10-04)**

The OIG conducted an inquiry into an anonymous complaint that an SEC headquarters employee was receiving preferential treatment from her supervisor by being allowed to earn overtime or compensatory time on a daily basis, while other employees were not allowed to do so. During its inquiry, the OIG reviewed the subject employee's time and attendance records for approximately a 21-month period. The OIG also obtained and reviewed e-mails of the subject employee, her supervisor, and five other employees who worked in the applicable office for approximately the same period of time. The OIG also took the sworn on-the-record testimony of the subject employee and her supervisor.

The OIG's inquiry did not find evidence to substantiate the allegation in the complaint that the subject employee was receiving preferential treatment in connection with overtime. However, the OIG did find evidence that the subject employee submitted excessive claims for overtime and that both the employee and her supervisor used government property and official time to support private businesses.

Specifically, we found that due to staff shortages, a substantial amount of overtime was required in the office where the subject employee worked, and that the employee worked and was compensated for significant amounts of overtime during the period under review. We also found that, on several occasions, the employee claimed more overtime than she actually worked. In addition, we found that the employee regularly claimed overtime pay for lunchtime, which is prohibited by federal rules.

Our inquiry also revealed that the subject employee spent considerable government time, including time for which she received overtime compensation, working on a private for-profit travel business. We found that at least over a two-year period, the employee consistently used her SEC e-mail account to send and receive e-mails for the private business and also used other SEC resources, such as telephone, copy machines and her SEC computer, for this business. We specifically found that the employee used her SEC computer to prepare flyers to solicit new owners to join the business. In fact, the employee admitted that she signed up at least seven other individuals, including her supervisor and two other SEC employees, to start similar private businesses and received referral fees for doing so.

The OIG inquiry further found evidence that after the employee signed up her supervisor for the private business, the supervisor used her SEC e-mail account to send and receive e-mails for her private travel business. In addition, the supervisor admitted that she used her government computer, e-mail and SEC copy machine for the private business, and that she accessed her business website over the Internet from her government computer. Both the subject employee and her supervisor admitted that they had taken required training concerning the use of SEC IT resources and that they knew it violated SEC policy to use government resources for a private business.

The OIG issued a memorandum report to management on September 1, 2011, describing in detail the results of its inquiry. The OIG referred both the subject employee and her supervisor for appropriate disciplinary action, up to and including dismissal. The OIG also recommended that the agency seek reimbursement from the employee for the amount of overtime compensation she improperly received. Finally, the OIG referred the employee's falsification of overtime hours to the United States Attorney's Office for the District of Columbia, which declined prosecution in the matter. At the end of the reporting period,

management action on the OIG's recommendations was pending.

### **Failure to Disclose Outside Position and Earnings and Misuse of Agency Resources (PI 09-70)**

The OIG opened this inquiry after meeting with a confidential informant who claimed that a headquarters employee had performed work for an outside vendor without properly disclosing that outside work in mandatory ethics filings, consulting in advance with the SEC Ethics Office, or obtaining approval for the outside employment. The complainant also alleged that the employee did not report to his work station in accordance with his established work schedule. During its inquiry into the complaint, the OIG also reviewed whether the employee improperly used SEC resources and official time to conduct work in support of his outside employment.

The OIG took the sworn, on-the-record testimony of the employee and his former and present supervisors. We also obtained and searched the employee's e-mails for an 18-month period, as well as e-mails provided by the confidential informant. We also contacted the SEC Ethics Office during our inquiry to obtain information about guidance that Office has provided to SEC employees on the issues of conflicts of interest and outside employment. In addition, the OIG obtained and reviewed: (1) copies of all the employee's Confidential Financial Disclosure Reports (*i.e.*, OGE Forms 450), and correspondence sent about those forms; (2) the employee's time and attendance records for the two years prior to the complaint; and (3) personnel records including the employee's telework agreements and performance evaluations.

The OIG inquiry found that while the employee did fulfill the requirements of his official work schedule and was not required to seek ethics advice or obtain approval for his outside employment, he did hold a paid outside position for approximately one year, which he was



legally bound to disclose in mandatory ethics filings. The OIG determined, however, that the employee did not appropriately report either his outside position, or the associated income, on the financial disclosure forms he filed. The OIG further found that the employee did not file a mandatory disclosure form one year at all, despite repeated reminders to do so. Finally, we determined that the employee improperly used SEC resources and official time in support of his outside employment.

On August 4, 2011, the OIG issued a memorandum report, summarizing the results of its inquiry and referring the matter to management for disciplinary action against the employee. As of the end of the reporting period, no action had yet been taken by management with respect to the OIG's recommendation.

### **Misuse of SEC Business Shuttle and Transit Benefits (PI 11-28)**

The OIG opened this inquiry after receiving e-mails and other documentation from the Office of Human Resources (OHR) revealing that a headquarters employee may have improperly used the SEC business shuttle that runs between the SEC Operations Center located in Alexandria, Virginia, and SEC Station Place headquarters in Washington, D.C., to commute to and from work. Additionally, OHR advised the OIG that during the months the employee may have improperly used the SEC shuttle for commuting purposes, she may have also improperly collected her full month's transportation subsidy from the agency.

During this inquiry, the OIG took the sworn, on-the-record testimony of the employee and obtained and searched her SEC e-mails for a nine-month period. Additionally, we obtained the employee's telework agreement and amendments thereto, as well as her time and attendance records for the relevant period. We examined records reflecting the employee's entries to the Operations Center parking lot for

a total of eight months. We also reviewed the sign-in sheets for every SEC business shuttle that traveled back and forth between Station Place and the Operations Center during the period relevant to our inquiry. Further, we analyzed the amount of transit benefits provided to the employee during the months she was found to have used the SEC business shuttle to commute to and from work. Finally, during the course of this inquiry, the OIG contacted and obtained pertinent information from the SEC Telework Officer, other OHR officials, and an official from the U.S. Department of Transportation, which operates the SEC's transit benefit program.

The OIG inquiry found that the employee violated the SEC's business shuttle policy when she regularly used the shuttle for commuting purposes for a period of seven months. Additionally, we found that during this same time period, she collected transit benefits purportedly for the same commute.

On September 28, 2011, the OIG issued a memorandum report, summarizing the results of its inquiry and referring the matter to management for consideration of disciplinary or other management-based action against the employee. We also recommended that the employee reimburse the SEC for the value of the total number of round trip commuter train fares for the days on which she was subsidized to commute, but instead used the SEC business shuttle. Further, the OIG recommended that the employee's transit subsidies be scrutinized to ensure that she is receiving an appropriate subsidy based upon the number of times she commutes to and from Station Place during the benefit period using public transportation.

Because the OIG's memorandum report was issued just prior to the end of the semiannual reporting period, management had not yet taken action with respect to the OIG's recommendations.



## **Misuse of Agency Resources and Official Time for a Private Business (PI 10-58)**

The OIG opened this inquiry after receiving an anonymous complaint to the OIG complaint hotline, which alleged that a former manager in one SEC regional office, who had transferred to an attorney position in another SEC regional office, had improperly used her supervisory position to arrange “extensive trips” to the location of the second regional office to pursue job opportunities and housing. The OIG also investigated whether the employee used government resources and official time in support of a private business.

During its inquiry, the OIG took the sworn, on-the-record testimony of the employee who was the subject of the complaint. We also obtained and searched the employee’s e-mails for more than a two-year period and carefully reviewed several hundred of these e-mails and attachments. Additionally, we obtained and examined the employee’s official travel records, time and attendance records, and personnel records for the relevant time periods. Finally, the OIG obtained records pertaining to training the employee completed relating to the use of SEC IT resources.

The evidence reviewed in this inquiry revealed that the employee violated Commission policy and rules regarding the use of SEC resources and official time. Specifically, we found that the employee used her SEC computer and e-mail to conduct a private, for-profit music business, despite having repeatedly received training that instructed her not to use SEC resources for unauthorized purposes, including private businesses. We did not substantiate the original complaint that the employee misused her position to arrange inappropriate travel to pursue job opportunities and housing.

The OIG would have referred this matter for appropriate disciplinary action based upon the employee’s misuse of government resources and official time. However, after the employee

testified in the OIG’s investigation and admitted violating SEC policies and rules, she decided to resign from the agency. Therefore, the OIG closed this inquiry on August 4, 2011, without making any recommendations.

## **Allegations of Misconduct by a Regional Office in an Enforcement Investigation (PI 10-19)**

The OIG opened an inquiry as a result of a complaint dated May 29, 2010, from a regional office staff member, which alleged that Enforcement staff had made several misrepresentations to the Commission in an Action Memorandum regarding its recommendation to file an action against a former officer of a public company. Specifically, the complainant alleged that certain sections of the Action Memorandum detailing the public company’s misstated income contained false and inaccurate information. Additionally, the complainant subsequently asserted that the statement in the Action Memorandum that the staff was in the process of reviewing certain documentary evidence was false because no one on the staff reviewed those documents.

To inquire into the allegations in the complaint, the OIG took the sworn, on-the-record testimony of four regional office staff members, including the complainant and members of senior management. In addition, the OIG interviewed two other regional office staff members. The OIG also reviewed e-mails for the relevant time period and documents produced by the regional office and the complainant related to the investigation of the public company.

The OIG inquiry did not find sufficient evidence to substantiate the allegations made by the complainant. Specifically, after questioning several witnesses and reviewing and analyzing numerous relevant records, including a draft of the Action Memorandum and source documents, the OIG did not find evidence that the Action Memorandum contained false information as to the amount of the company’s mis-

stated income. We also found evidence that a regional office staff member had, in fact, reviewed the documents referenced in the Action Memorandum. On July 18, 2011, the OIG issued its memorandum report in this matter, which described in detail the results of the inquiry, to management for informational purposes.

### **Allegations of Misconduct by an Examiner in a Regional Office (PI 11-23)**

The OIG opened this inquiry as a result of a complaint dated February 22, 2011, from an officer of two registered transfer agents. The complainant alleged that an SEC regional office examiner had engaged in “abusive tactics” while conducting examinations of the complainant’s firms.

More specifically, the complainant alleged that during the course of the examinations of his firms, the examiner had: (1) called all of his clients and informed them he was “under federal investigation;” (2) made on-site, unannounced visits to some of his customers, “soliciting complaints and attempting to put words in [their] mouth[s];” and (3) told his former customers that he was engaging in “illegal activities.” He also claimed that the examiner had given preferential treatment to a competing transfer agent.

To inquire into the claims raised in the complaint, the OIG took the sworn, on-the-record testimony of three members of the regional office Examination staff. Additionally, the OIG interviewed the complainant and his wife, who was the President of his firms, as well as a former customer of the complainant’s firms. The OIG also obtained and reviewed relevant examination documents and personnel records.

The OIG inquiry found that the SEC examination staff had contacted customers of the complainant’s transfer agent firms in an effort to obtain information that had first been re-

quested from, and withheld by, those firms. The OIG found that, under those circumstances, it was not improper for the SEC Examination staff to contact the firms’ customers to obtain the information.

In addition, the OIG inquiry did not find sufficient evidence substantiating the claim that the examiner told any of the customers he contacted that the transfer agents were doing anything illegal. Finally, the OIG did not find sufficient evidence to substantiate the claim of preferential treatment by the regional office to another transfer agent. On September 19, 2011, the OIG issued its memorandum report, which discussed in detail the OIG’s findings, to management for informational purposes.

### **Allegation of Possible Failure to Report Revenue on Financial Disclosure Form by Senior Officer (PI 11-01)**

The OIG opened this preliminary inquiry on October 19, 2010, after receiving an anonymous complaint, alleging that an SEC senior officer may have failed to report certain income related to the operations of a business in which he held an ownership interest, as required by the federal financial disclosure laws. The anonymous complaint was triggered by a press article that stated that the senior officer had received a large amount of farm subsidies over a period spanning several years.

In conducting this inquiry, the OIG took the sworn, on-the-record testimony of the senior officer. The OIG also obtained and reviewed the senior officer’s public financial disclosure reports and compared them to the holdings and transactions he had reported in the agency’s financial reporting tracking system, the Ethics Program System. In addition, the OIG consulted with the SEC’s Ethics Counsel about the requirements for reporting certain types of income and her communications with the senior officer about his income from the business in question.

The OIG inquiry found that the senior officer properly filed the required new entrant public financial disclosure report after he joined the SEC. That report required the senior officer to disclose his financial holdings and sources of income for the previous 12 months. The OIG found that the senior officer disclosed his ownership interests in the business referenced in the press article. The OIG further found no evidence that the senior officer had received income based on his ownership interest in that business during the relevant reporting period.

Accordingly, the OIG inquiry did not substantiate the allegation that the senior officer had failed to properly report certain income on his public financial disclosure report. Therefore, on September 1, 2011, the OIG issued its memorandum report, describing the results of the inquiry, to management for informational purposes.

### **Allegations of Waste and Fraud by Headquarters Employees (PI 09-115)**

The OIG conducted an inquiry into an anonymous complaint containing two separate allegations of waste within an SEC headquarters office. First, the complaint alleged that one staff member had not been at work in over a year, was attending college in another state, and her managers were pretending she was working from home. Second, the complaint alleged that a supervisor was rumored to be getting a Master's Degree, while pretending to work from home.

To inquire into the allegations in the complaint, the OIG obtained and received information concerning the employee's SEC employment history and background information on the supervisor's employment and education. The OIG also reviewed the supervisor's e-mails for a nine-month period.

The OIG's inquiry found that the employee who was alleged to be going to college in another state was no longer employed by the agency, having separated in mid-2009. With

regard to the supervisor, the OIG's search of the supervisor's e-mails revealed no evidence that he was pursuing a Master's Degree. Our review of information concerning the supervisor's background revealed that he had already received a Master's Degree several years earlier. Therefore, the OIG closed this preliminary inquiry on June 14, 2011.

### **Complaint of Failure to Investigate Aggressively and Appearance of Impropriety (PI 09-107)**

The OIG performed a preliminary inquiry into numerous allegations made by a complainant arising from his purchase of a certain type of securities. The complaint alleged, among other things, that (1) the SEC had changed its course of action and stopped aggressively pursuing an investigation relating to the issuance and sale of the securities in question after the appointment of a senior Enforcement official who had previously worked for one of the parties involved; (2) this senior official's appointment created an appearance of impropriety; and (3) the SEC had failed to respond to the complainant's submission of his resume to Enforcement in apparent retaliation to his objections to the appointment of the senior official.

During the inquiry, the OIG reviewed numerous materials provided by the complainant, as well as pertinent court filings, information obtained from internal databases, and other materials. The OIG also interviewed four SEC staff members with relevant knowledge.

The OIG inquiry revealed that Enforcement had previously reviewed and considered complaints received concerning the securities the complainant had purchased. Specifically, a senior Enforcement attorney stated that she had numerous lengthy conversations with the complainant. The evidence showed that Enforcement had devoted a significant amount of staff time to reviewing the complainant's allegations, but had decided not to pursue his claims, in part due to the private nature of the claims. Our inquiry did not find evidence that

the senior Enforcement official identified in the complaint was involved in the decision not to pursue the complainant's allegations or in the SEC's investigations and proceedings related to this matter. Finally, we concluded that the SEC's failure to respond to the complainant's submission of his resume as a general request to be part of the Enforcement staff did not itself evidence retaliation for his objections to the senior official's appointment. Therefore, the OIG closed this preliminary inquiry on August 10, 2011.

### **Complaint of Ineffective Performance within the Office of Compliance Inspections and Examinations (PI 10-25)**

The OIG reviewed a letter from a former SEC examiner that was forwarded by the Honorable Mark Warner, U.S. Senator (D-Virginia). The letter contained allegations about ineffectiveness and incompetence within the SEC's Office of Compliance Inspections and Examinations (OCIE). In the letter, the former examiner also sought assistance with her personal employment issues, claiming that her termination from OCIE was discriminatory and retaliatory.

To inquire into the issues raised in the letter, the OIG obtained information from the SEC's OGC pertaining to claims the complainant had filed with the Merit Systems Protection Board (MSPB) and the SEC's Office of Equal Employment Opportunity. We found that the both the MSPB and the Equal Employment Opportunity Commission's Office of Federal Operations (OFO) had upheld the agency's decision to terminate the complainant's employment, finding no evidence of discrimination or retaliation on the SEC's part. We also noted that the complainant had an additional appeal pending with OFO and that the complainant had ample opportunity to present her arguments of discrimination and retaliation before the agencies and offices with primary jurisdiction over such matters.

The OIG also reviewed the complainant's claims of ineffectiveness and incompetence within OCIE and found no allegations of specific misconduct on the part of any OCIE employees or contractors. Accordingly, we referred the claims of ineffectiveness and incompetence to the OIG's Office of Audits for consideration of potential audit issues and closed this inquiry on June 14, 2011.

### **SENTENCING ARISING OUT OF PREVIOUS OIG INVESTIGATION**

An investigation conducted by the OIG during a prior reporting period (OIG-493) had found evidence that an employee had intentionally falsified her employment application and supporting documents submitted to the SEC concerning her position and grade at another federal agency. During the OIG's investigation, the employee admitted falsifying this data because she did not believe she would qualify for the position at the SEC based upon her actual information. Because the employee admitted to committing serious criminal offenses, the OIG had referred the matter to the Public Integrity Section of the Criminal Division of the U.S. DOJ for consideration of prosecution.

Based upon the OIG's referral, the employee was indicted in the United States District Court for the Eastern District of Virginia on four counts of making false statements, three counts of submitting false documents, and one count of engaging in a concealment scheme. The SEC OIG and the Federal Bureau of Investigation's Washington Field Office investigated the case, which was prosecuted by the DOJ Criminal Division's Public Integrity Section and the U.S. Attorney's Office for the Eastern District of Virginia.

During this semiannual reporting period, on July 29, 2011, the defendant pled guilty to Count 1 of the indictment, which charged her with engaging in a fraudulent scheme to conceal material information concerning her criminal history, employment history, and suit-

ability for employment with the federal government. According to the judgment entered by the court, the defendant was sentenced to three years of probation and was required to pay a special assessment.

## **PENDING INVESTIGATIONS**

### **Allegations of Improper Document Destruction (Case No. OIG-567)**

During this reporting period, the OIG opened an investigation into allegations that Enforcement has improperly destroyed records relating to Matters Under Inquiry (MUIs) over the past two decades, and that the SEC made misleading statements in a response sent to the National Archives and Records Administration (NARA) concerning the SEC's potential unauthorized destruction of MUI records. After we opened this investigation, it was further alleged that the SEC does not have authority to destroy three categories of documents that are currently not scheduled with NARA: (1) documents produced by third parties; (2) internal work product; and (3) internal e-mails.

In particular, the OIG is investigating the significance of, and the reasons for, the previous Enforcement policy to dispose of all documents relating to MUIs that were closed without becoming investigations. The OIG is also investigating the impact of this policy on particular MUIs that were closed without being converted to Enforcement investigations. The OIG is further investigating the circumstances surrounding the drafting of the SEC's response to NARA, and whether this response was complete and in compliance with federal regulations.

During this reporting period, the OIG requested and reviewed numerous documents provided by Enforcement and the SEC's Office of Records Management Services. The OIG also obtained and searched the e-mails of six current or former SEC employees for the relevant period of time, which amounted to a total

of over 500,000 e-mails. The OIG took the sworn testimony of 11 current or former SEC employees with knowledge of the relevant facts. In addition, the OIG interviewed 12 current or former SEC employees and one other individual. The OIG further reviewed Enforcement database records for numerous MUIs. Finally, the OIG sought and received a written opinion from NARA on several issues relating to MUI documents and the SEC's response to NARA, and we have been in communication with NARA officials on an ongoing basis during the course of the investigation.

The OIG plans to complete its investigative work and issue its report of investigation early in the next semiannual reporting period.

### **Allegations of Misconduct by a Senior Official (Case No. OIG-564)**

During the reporting period, the OIG commenced an investigation into allegations that a former senior Enforcement official may have played an improper role in the decision not to recommend an enforcement action against a financial institution shortly before leaving the SEC for employment with that financial institution.

Specifically, the OIG is investigating whether Enforcement previously decided to close an investigation of the financial institution, without recommending action against that entity, because the senior Enforcement official was pursuing an employment opportunity with that financial institution. The OIG is also investigating whether there was any relationship or *quid pro quo* between Enforcement's decision to close the investigation of the financial institution and the senior Enforcement official's subsequent employment by the financial institution.

In the course of this investigation, the OIG obtained and searched over 200,000 e-mails of 15 current or former SEC employees for the relevant time period. The OIG also took the sworn testimony of four current SEC employ-



ees. The OIG further conducted interviews of four former SEC employees. In addition, the OIG reviewed documents produced by SEC staff related to the Enforcement investigations and MUIs of the financial institution, as well as Enforcement database records.

The OIG plans to complete its investigative work and issue its report of investigation during the next semiannual reporting period.

### **Allegation of Favorable Treatment Provided by Regional Office to Prominent Law Firm (Case No. OIG-536)**

The OIG is nearing the completion of its investigation of a complaint that regional office attorneys provided favorable treatment to a prominent law firm by failing to properly investigate that firm for its alleged role in computer tampering, and the potential cover-up of that computer tampering, in connection with an ongoing SEC enforcement action involving a fraudulent scheme. The complainants alleged that a computer firm recommended and hired by the prominent law firm, which was representing the wife of the accused fraudster, had significantly tampered with computers seized by the court-appointed receiver in the case from the accused fraudster. The complainants further alleged that regional office staff improperly provided nonpublic information related to this matter to the law firm.

In addition, the complainants claimed that the regional office staff and officials likely “backed off” from investigating or pursuing the law firm for any alleged role in the computer tampering, and alleged cover-up of that tampering, because of the existing revolving door between the regional office and the law firm. The complainants also specifically asserted that a now former regional office official, who was allegedly planning to retire in the near future, had sought employment from this law firm.

During this reporting period, the OIG performed further investigative work, including obtaining documentary evidence, reviewing

pleadings filed in the underlying case, and conducting additional interviews of the confidential complainants and the court-appointed receiver. The OIG intends to conclude its investigative work and issue its report of investigation in the next semiannual reporting period.

### **Allegations Regarding Court-Appointed Receiver (Case No. OIG-565)**

The OIG has received correspondence from various parties regarding the court-appointed receiver in the SEC’s action against Robert Allen Stanford, as well as entities and individuals involved in his alleged Ponzi scheme. During the reporting period, the OIG opened an investigation in response to this correspondence. The issues raised in the various correspondence we received pertain to value added by the Stanford receiver to the receivership estate, the timing of distributions from the receivership estate to investors, and the compensation received by the receiver and the professionals he has retained to assist him. The OIG’s investigation will focus on issues related to the receiver and related SEC oversight that fall within the OIG’s jurisdiction.

The OIG collected approximately 70,000 e-mails of certain current and former SEC employees with knowledge of the relevant facts and began to search for and analyze pertinent e-mails and attachments. The OIG also conducted research of the applicable statutes and regulations.

In the next semiannual reporting period, the OIG will continue its e-mail review and will request and search the e-mails of additional witnesses identified during the course of the investigation. The OIG will also interview and/or take the sworn testimony of individuals who have knowledge of the relevant facts and circumstances. The OIG plans to complete its investigation and issue a report of its findings prior to the end of the next reporting period.



### **Investigation of Forgery, False Statements, and Fraud (Case No. OIG-563)**

During the reporting period, the OIG commenced an investigation upon receiving information that a headquarters employee appeared to have forged her supervisor's signature on a letter containing false statements. Thereafter, the OIG expanded the scope of the investigation to determine whether the employee had provided false information to obtain benefits to which she was not entitled. The OIG is also investigating whether this employee and another headquarters employee submitted false claims to a federal program.

During the reporting period, the SEC OIG obtained and searched the e-mails of five SEC employees for pertinent time periods ranging from 2006 to 2011. The SEC OIG also took the sworn, on-the-record testimony of four SEC staff members and interviewed another SEC employee. The SEC OIG plans to complete its investigative work during the next semiannual reporting period.

### **Allegations of Misconduct, Time and Attendance Abuse, and Ethics Violations at a Regional Office (Case No. OIG-562)**

During the reporting period, the OIG opened an investigation into allegations that numerous regional office staff members engaged in various forms of time and attendance abuse, violations of ethics regulation, and other misconduct.

In the course of this investigation, the OIG carefully reviewed and analyzed the complaints we received. The OIG also researched the applicable statutes, rules, and regulations. In addition, the OIG took the sworn, on-the-record testimony of 23 current SEC employees and conducted interviews of other staff members with knowledge relevant to the investigation.

Further, the OIG reviewed numerous regional office staff members' time and atten-

dance records; relevant travel records, including pertinent travel compensatory worksheets; building entry records for eight regional office employees; the official personnel files of several regional office employees; and records pertaining to prior OIG inquiries or investigations related to the regional office. The OIG also obtained and searched over 350,000 e-mails of five staff members for the relevant time periods.

The OIG intends to finalize the investigation and issue its report of investigation during the next semiannual reporting period.

### **Complaint of Mismanagement and Inappropriate Use of Government Funds (Case No. OIG-557)**

During the previous semiannual reporting period, the OIG opened an investigation into anonymous allegations involving the mismanagement of a computer lab and the related waste of government funds. Specifically, the anonymous complaint alleged that SEC employees have inappropriately used government funds for training purposes without filing requisite training forms, and have inappropriately allocated and spent significant budget dollars for purchasing computer equipment for the lab without proper justification or planning.

The complaint also alleged that employees who work in the lab do not follow IT security policies, use unencrypted laptops during inspections, and have unrestricted access to the Internet. The complaint further included allegations regarding improper hiring procedures, abuse of authority, and waste of SEC resources.

During the reporting period, the OIG conducted on-the-record testimony of one former SEC employee who was familiar with the lab. The OIG also reviewed information provided by other SEC employees who had knowledge of the facts and circumstances surrounding the lab's activities.

The OIG plans to conduct further on-the-record testimony of individuals with relevant knowledge, obtain e-mails of individuals associated with the lab, and request additional documents pertaining to the lab. The OIG intends to complete its investigative work and issue a report detailing its findings during the next reporting period.

### **Allegation of Procurement Violations (Case No. OIG-556)**

The OIG has substantially completed its investigation of an anonymous complaint alleging that the SEC procured an unnecessary assessment. The anonymous complaint further alleged that the SEC inappropriately awarded the contract for the assessment to a firm that the OIG previously found had conveyed material benefits to SEC Office of Administrative Services employees.

During the reporting period, the OIG performed additional work to further assess the facts and circumstances related to the procurement in question. Specifically, the OIG consulted with the General Services Administration (GSA) to obtain a better understanding of the laws, rules, and regulations applicable to this type of procurement. We then conducted additional research into the governing laws, rules, and regulations.

In light of the information provided by GSA and the further research conducted, the OIG took additional sworn, on-the-record testimony of two individuals with knowledge of the facts and circumstances surrounding the procurement. The OIG intends to issue its report of investigation in the next semiannual reporting period, surrounding the allegations and complete its investigation during the next reporting period.





Office of  
Inspector  
General

# SEMIANNUAL REPORT TO CONGRESS

## REVIEW OF LEGISLATION AND REGULATIONS

During the semiannual reporting period, the OIG reviewed legislation and proposed and final rules and regulations relating to the programs and operations of the SEC, pursuant to Section 4(a)(2) of the Inspector General Act of 1978, as amended.

In particular, in response to a request from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, the OIG reviewed the economic analyses performed by the SEC in connection with rulemaking initiatives undertaken pursuant to the Dodd-Frank Act and issued a preliminary report on June 13, 2011. Specifically, the OIG's review focused on the cost-benefit analyses prepared by the SEC for the following six Dodd-Frank Act regulatory initiatives: Credit Risk Retention, 76 Fed. Reg. 24090 (April 29, 2011); Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14472 (March 16, 2011); Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (February 28, 2011); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 8068 (February 11, 2011); Registration of Municipal Advisors, 76 Fed. Reg. 824 (January 6, 2011); and Conflict

Minerals, 75 Fed. Reg. 80948 (December 23, 2010). In order to assess the adequacy of the economic analyses performed by the SEC in connection with each of these rulemakings, the OIG reviewed and analyzed the relevant requirements of the Paperwork Reduction Act, 44 U.S.C. § 3501 *et seq.*, the Regulatory Flexibility Act, 5 U.S.C. § 601 *et seq.*, the National Securities Markets Improvement Act of 1996 (which amended the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940); Executive Order 12866, Regulatory Planning and Review, 58 Fed. Reg. 51735 (October 4, 1993); Executive Order 13563, Improving Regulation and Regulatory Review, 76 Fed. Reg. 3821 (January 18, 2011); and Office of Management and Budget Circular A-4, Regulatory Analysis (September 17, 2003).

While the OIG's review concluded overall that the economic analyses conducted for the six rulemaking initiatives examined were thorough and incorporated the principles of the applicable Executive Orders, the OIG identified certain areas that warranted further OIG review. These areas included, among others, the level of the involvement of the Division of Risk, Strategy, and Financial Innovation in

rulemaking initiatives. The OIG began to conduct a further review of the SEC's economic analyses during the reporting period. During this second phase of its review, the OIG began to examine the following five Dodd-Frank Act rulemaking initiatives to determine whether the SEC consistently and systematically prepared cost-benefits analyses: Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (February 2, 2011); Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Act, 76 Fed. Reg. 4489 (January 26, 2011); Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231 (January 25, 2011); Reporting of Security-Based Swap Transaction Data, 75 Fed. Reg. 64643 (October 20, 2010); and Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (December 2, 2010). The OIG's review is assessing whether the cost-benefits analyses conducted for these five rulemakings met the applicable statutory and regulatory requirements and this assessment will be completed during the next semiannual reporting period.

The OIG also reviewed statutes, rules, and regulations, and their impact on Commission programs and operations, within the context of other reviews, audits, and investigations conducted during the reporting period, as well as in reviewing suggestions received through the OIG's SEC Employee Suggestion Program. For example, in the OIG's *Review of Alternative Work Arrangements, Overtime Compensation, and COOP-Related Activities at the SEC* (Report No. 491), the OIG reviewed legislation focusing on telework by federal employees, including the requirements of the Telework Enhancement Act of 2010, Public Law 111-292, enacted on December 9, 2010, which required, among other things, that agency employees successfully complete an interactive telework training program prior to entering into a written telework agreement. In its report, the OIG made recommendations designed to ensure that the SEC fully complies with the Act's requirements, including that the Office of Human Resources

(OHR) provide comprehensive telework training sessions to SEC employees and managers and require training and recertification for teleworkers and their managers at least every two years.

In its *Audit of SEC's Employee Recognition Program and Recruitment, Relocation, and Retention Incentives* (Report No. 492), the OIG reviewed 5 C.F.R. § 575.110, which sets forth the requirements for written service agreements that must be executed before paying a recruitment incentive. The OIG found that the service agreement form used by the SEC, SEC Form 2299, Securities and Exchange Commission Recruitment Bonus Service Agreement (revised May 2003) did not fully address Section 575.110's requirements, as the form did not fully state the conditions under which the agency may terminate the service agreement before the employee completes the agreed-upon service period. The OIG recommended that OHR revise Form 2299 to incorporate specific reasons that the SEC may and must terminate service agreements for recruitment and relocation bonuses. The OIG's audit also reviewed OHR's policies and procedures for its awards program that are contained in Chapter 451.A of the Personnel Operating Policies and Procedures (POPPS) Manual, entitled, "Employee Recognition Program." The OIG found that much of this guidance was outdated and was not available electronically on the SEC's intranet and recommended that OHR finalize revised policies and procedures for the Employee Recognition Program within three months and publish them on the SEC's intranet site.

Further, in its review entitled *Oversight of and Compliance with Conditions and Representations Related to Exemptive Orders and No-Action Letters* (Report No. 482), the OIG reviewed the SEC's statutory authority to provide exemptive relief contained in Section 28 of the Securities Act of 1933, Sections 12(h) and 36 of the Securities Exchange Act of 1934, Section 6(c) of the Investment Company Act of 1940, and Section 206A of the Investment Advisers Act of 1940.

In its *Review of SEC Contracts for Inclusion of Language Addressing Privacy Act Requirements* (Report No. 496), the OIG reviewed the requirement of Privacy Act of 1974 found at 5 U.S.C. § 552a(m)(1), providing that when an agency contracts for the operation of a system of records to accomplish an agency function, the agency must include in the contract a requirement that the contractor comply with the Privacy Act. The OIG's assessment found that the applicable language in the SEC's contracts could be strengthened and recommended that appropriate language be added to new service contracts that require the handling of personally identifiable information.

In addition, in its report entitled *Investigation of Conflict of Interest Arising from Former General Counsel's Participation in Madoff-Related Matters* (Report No. OIG-560), the OIG reviewed and analyzed 18 U.S.C. § 208, Acts affecting a personal financial interest, as well as the Office of Government Ethics regulations pertaining to Conflicting Financial Interests, 5 C.F.R. Part 2635, Subpart D, and Impartiality in Performing Official Duties, 5 C.F.R. Part 2635, Subpart E. The OIG consulted with the Office of Government Ethics with respect to the application of these provisions to the specific facts uncovered during the OIG's investigation. In conducting its investigation, the OIG also reviewed and analyzed various provisions of the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. § 78aaa *et seq.*, which, among other things, created the Securities Investor Protection Corporation (SIPC) and required SIPC to establish a reserve fund that would

provide protection to customers of bankrupt or financially-troubled brokerage firms. In particular, the OIG reviewed the provisions pertaining to liquidation proceedings under SIPA, and the powers and duties of a trustee appointed under SIPA. *See* 15 U.S.C. §§ 78fff through 78fff-4.

Finally, in response to a suggestion received through the OIG's SEC Employee Suggestion Program established pursuant to Section 966 of the Dodd-Frank Act, the OIG reviewed Rule 203.8 of the SEC's Rules Relating to Investigations, 17 C.F.R. § 203.8, which provides that service of subpoenas issued in formal investigative proceedings be effected in accordance with Rule 232(c) of the SEC's Rules of Practice. The OIG also reviewed Rule 232(c) of the SEC's Rules of Practice, 17 C.F.R. § 201.232(c), which requires that subpoenas be served in the manner prescribed by 17 C.F.R. §§ 201.150 (b) through (d), authorizing delivery by personal service, U.S. mail, express delivery service, or facsimile if certain conditions are met. The suggestion received by the OIG was that the Rules of Practice be revised to allow for the service of subpoenas via e-mail. Based upon this suggestion, the OIG recommended that Enforcement determine if revising the Rules of Practice to allow for service of subpoenas by e-mail would be beneficial. Enforcement is working with OGC to prepare a recommendation to the Commission that, if approved, would amend the Rules of Practice and/or the Rules Relating to Investigations to permit the service of investigative subpoenas by e-mail.







# SEMIANNUAL REPORT TO CONGRESS

## **STATUS OF RECOMMENDATIONS WITH NO MANAGEMENT DECISIONS**

Management decisions have been made on all audit reports issued before the beginning of this reporting period.

## **REVISED MANAGEMENT DECISIONS**

No management decisions were revised during the period.

## **AGREEMENT WITH SIGNIFICANT MANAGEMENT DECISIONS**

The Office of Inspector General agrees with all significant management decisions regarding audit recommendations.

## **INSTANCES WHERE INFORMATION WAS REFUSED**

During this reporting period, there were no instances where information was refused.



# Table 1

## List of Reports: Audits and Evaluations

Report Number	Title	Date Issued
482	Oversight of and Compliance with Conditions and Representations Related to Exemptive Orders and No-Action Letters	6/29/2011
491	Review of Alternative Work Arrangements, Overtime Compensation, and COOP-Related Activities at the SEC	9/28/2011
492	Audit of SEC's Employee Recognition Program and Recruitment, Relocation, and Retention Incentives	8/2/2011
496	Review of SEC Contracts for Inclusion of Language Addressing Privacy Act Requirements	7/18/2011
497	Assessment of SEC's Continuous Monitoring Program	8/11/2011
498	Assessment of the Office of Investor Education and Advocacy's Functions	9/30/2011
--	Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Act Rulemakings	6/13/2011
--	Establishment of the Office of Minority and Women Inclusion	6/15/2011



## Table 2

### Reports Issued with Costs Questioned or Funds Put to Better Use (Including Disallowed Costs)

	Number of Reports	Value
A. REPORTS ISSUED PRIOR TO THIS PERIOD		
For which no management decision had been made on any issue at the commencement of the reporting period	3	\$1,345,367.00
For which some decisions had been made on some issues at the commencement of the reporting period	0	\$0
B. REPORTS ISSUED DURING THIS PERIOD	7	\$556,971,580.24
TOTAL OF CATEGORIES A AND B	10	\$558,316,947.24
C. For which final management decisions were made during this period	5	\$1,238,585.00
D. For which no management decisions were made during this period	4	\$266,773.24
E. For which management decisions were made on some issues during this period	1	\$556,811,589.00
TOTAL OF CATEGORIES C, D AND E	10	\$558,316,947.24





# Table 3

## Reports with Recommendations on Which Corrective Action Has Not Been Completed

### RECOMMENDATIONS OPEN 180 DAYS OR MORE

Report Number and Title	Issue Date	Summary of Recommendation
439 - Student Loan Program	3/27/2008	In consultation with the Union, develop a detailed distribution plan.
446B - SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment (BDRA) Program	9/25/2008	Ensure the BDRA system includes financial information, staff notes, and other written documentation and is used to generate management reports.
456 - Public Transportation Benefit Program	3/27/2009	Implement additional management controls over regional office program operations.
460 - Management and Oversight of Interagency Acquisition Agreements (IAAs) at the SEC	3/26/2010	Promptly identify all IAAs that have expired but have not been closed, and deobligate any funds that remain on the expired agreements.
		Take action to close the IAAs identified for which the performance period expired and deobligate the \$6.9 million in unused funds that remain on the IAAs, in accordance with the appropriate close-out procedures.
474 - Assessment of the SEC's Bounty Program	3/29/2010	Develop a communication plan to address outreach to both the public and SEC personnel regarding the SEC bounty program, which includes efforts to make information available on the SEC's intranet, enhance information available on the SEC's public website, and provide training to employees who are most likely to deal with whistleblower cases.

Report Number and Title	Issue Date	Summary of Recommendation
		<p>Develop and post to the SEC's public website an application form that asks whistleblowers to provide information, including, <i>e.g.</i>, (1) the facts pertinent to the alleged securities law violation and an explanation as to why the subject(s) violated the securities laws; (2) a list of related supporting documentation available in the whistleblower's possession and available from other sources; (3) a description of how the whistleblower learned about or obtained the information that supports the claim, including the whistleblower's relationship to the subject(s); (4) the amount of any monetary rewards obtained by the subject violator(s) (if known) as a result of the securities law violation and how the amount was calculated; and (5) a certification that the application is true, correct, and complete to the best of the whistleblower's knowledge.</p>
		<p>Establish policies on when to follow up with whistleblowers who submit applications to clarify information in the bounty applications and obtain readily available supporting documentation prior to making a decision as to whether a whistleblower's complaint should be further investigated.</p>
		<p>Develop specific criteria for recommending the award of bounties, including a provision that where a whistleblower relies partially upon public information, such reliance will not preclude the individual from receiving a bounty.</p>
		<p>Examine ways in which the Commission can increase communications with whistleblowers by notifying them of the status of their bounty requests without releasing nonpublic or confidential information during the course of an investigation or examination.</p>

Report Number and Title	Issue Date	Summary of Recommendation
		Develop a plan to incorporate controls for tracking tips and complaints from whistleblowers seeking bounties into the development of the tips, complaints, and referrals processes and systems for other tips and complaints, which should provide for the collection of necessary information and require processes that will help ensure that bounty applications are reviewed by experienced Commission staff, decisions whether to pursue whistleblower information are timely made, and whistleblowers who provide significant information leading to a successful action for violation of the securities laws are rewarded.
		Require that a bounty file (hard copy or electronic) be created for each bounty application, which should contain at a minimum the bounty application, any correspondence with the whistleblower, documentation of how the whistleblower's information was utilized, and documentation regarding significant decisions made with regard to the whistleblower's complaint.
		Incorporate best practices from the Department of Justice (DOJ) and the Internal Revenue Service (IRS) into the SEC bounty program with respect to bounty applications, analysis of whistleblower information, tracking of whistleblower complaints, recordkeeping practices, and continual assessment of the whistleblower program.
		Set a timeframe to finalize new policies and procedures for the SEC bounty program that incorporate the best practices from the DOJ and the IRS, as well as any legislative changes to the program.
480 - Review of the SEC's Section 13(f) Reporting Requirements	9/27/2010	Update Form 13F to a more structured format, such as Extensible Markup Language (XML), to make it easier for users and researchers to extract and analyze Section 13(f) data.
481 - The SEC's Implementation of and Compliance with Homeland Security Presidential Directive 12 (HSPD-12)	3/31/2011	Identify and develop a list of all contractors who are employed by the Commission. In addition, coordinate with the Contracting Officer's Technical Representatives and Inspection and Acceptance Officials to implement policies and procedures for ensuring that the list remains up-to-date.

Report Number and Title	Issue Date	Summary of Recommendation
		Provide a copy of the up-to-date consolidated contractor list on a weekly basis to the Personnel Security Branch.
		Upon receipt of the up-to-date consolidated contractor list, determine which contractors do not have successfully adjudicated background investigations on record and develop a plan to begin the required background investigations immediately.
		Upon receipt of the up-to-date consolidated contractor list, ensure that accurate status reporting has been made to the Office of Management and Budget.
		Discontinue adjudicating all eligibility determinations for access to classified information or holding a sensitive position until the SEC has received an appropriate delegation of authority to conduct such determinations from the Director of National Intelligence (DNI).
		Identify all eligibility determinations for access to classified information or holding a sensitive position adjudicated by SEC since June 30, 2008, and, upon receipt of authority from the DNI, conduct a quality control assessment to ensure that the determinations were conducted in accordance with the uniform policies and procedures developed by the DNI.
		Upon receipt of authority from the DNI to make eligibility determinations for access to classified information or holding a sensitive position, use the uniform policies and procedures developed by the DNI when making such determinations.
		Develop policies and procedures for determining the eligibility of contractors requiring temporary access to SEC's facilities and information systems.
		Develop, implement, and post in multiple locations (e.g. agency intranet site, human resource offices, regional offices, contractor orientation, etc.) appeals procedures for individuals who are denied credentials or whose credentials are revoked.
		Develop internal policies and procedures for suitability determinations for foreign nationals.

Report Number and Title	Issue Date	Summary of Recommendation
		Promptly deploy appropriate technology (e.g., laptops with internal card readers, keyboards with card readers, or external card readers) to employees and contractors who do not have card readers.
		Perform periodic analysis of visitor data to ensure visitors are not circumventing the HSPD-12 requirements.
484 - Real Property Leasing Procurement Process	9/30/2010	Revise SEC Regulation (SECR) 11-03 and draft Operating Procedure (OP) 11-03 to ensure that they are adequate and complete and include the information identified in the audit report, finalize OP 11-03, and ensure that the revised documents are posted to the Commission's intranet site and circulated to staff with leasing-related responsibilities.
		Measure the SEC's real property leasing policies and procedures against pertinent provisions of General Services Administration (GSA) regulations, including the GSA Acquisition Manual and Subchapter C of the Federal Management Regulation, as appropriate.
		Ensure that the Leasing Branch's policies and procedures, including OP 11-03 and the attached checklists, provide comprehensive guidance, including pertinent forms and examples, for SEC leasing officials regarding the leasing process that will assist in ensuring compliance with the applicable policies, regulations, and best practices.
		Utilize the "Required Components" section of the Federal Real Property Council's (FRPC) Guidance for Improved Asset Management to develop and finalize the SEC's real property leasing asset management plan, as appropriate. If any required components in the FRPC Guidance are determined not to apply to the SEC, the plan should include an explanation as to why the SEC's unique circumstances render those components unnecessary.



Report Number and Title	Issue Date	Summary of Recommendation
		Develop performance goals for the SEC's real property leasing activities, including both lease acquisition and the monitoring and administration of existing leases; identify key external factors that could significantly affect the achievement of these goals; and periodically evaluate whether these goals are met.
		Develop performance measures to assist in evaluating the effectiveness of the major functions of real property acquisitions and operations, and periodically evaluate performance based on these measures. The performance measures should include metrics for all of the Office of Administrative Services Branches that have a role in real property leasing, including the Real Property Leasing, Construction, and Security Branches.
		Revise SEC Regulation 11-03 and draft OP 11-03 to include complete written policies and procedures for timely acquisition planning pertinent to real property leases, including the preparation of a project plan and schedule with projected dates for achieving various milestones well in advance of the scheduled commencement of a lease.
		Adopt evaluation procedures that involve scoring and ranking various options prior to deciding to vacate leased premises or to terminate a lease, and develop a transparent methodology for formulating scores and rankings.
485 - Assessment of the SEC's Privacy Program	9/29/2010	Evaluate risk assessment processes for scoring risk to ensure that all appropriate factors are adequately weighed, including the identification of risk levels by vendors.
		Implement an agency-wide policy regarding shared folder structure and access rights, ensuring that only the employees involved with a particular case have access to that data. If an employee backs up additional information to the shared resources, only the employee and his or her supervisor should have access.
		Ensure personal storage tab (PST) files are saved to a protected folder.
		Ensure all file rooms and file cabinets are secured.

Report Number and Title	Issue Date	Summary of Recommendation
		Provide Commission staff training on handling, disposal, and storage of portable media storage devices.
487 - Review of Select Time-and-Materials and Labor-Hour Contracts	12/23/2010	Review the \$156,532 in unsupported payments made to Dozier Technologies, Inc., to determine what, if any corrective actions are warranted (e.g., requiring the contractor to provide adequate support, refund monies for unsupported costs, etc.).
488 - Audit of the SEC Budget Execution Cycle	3/29/2011	Develop and establish a formal, ongoing SEC-focused budgetary training program.
489 - 2010 Annual FISMA Executive Summary Report	3/3/2011	(a) Perform a thorough review and identify the universe of all Commission user accounts; (b) Identify all "active" and "inactive" user accounts and determine whether or not the accounts should be disabled; and (c) Take immediate action to disable the accounts of employees and contractors who no longer work at the Commission.
		Complete a logical access integration of the HSPD-12 card no later than December 2011, as reported to the Office of Management and Budget on December 31, 2010.
493 - OCIE Regional Offices' Referrals to Enforcement	3/30/2011	Review the information provided from the OIG survey regarding the situations where examiners expressed serious concerns that action was unsatisfactory, particularly where the examiners believed there was ongoing wrongdoing, and take appropriate action, including potentially reversing previous decisions.
		Take appropriate actions to enforce the policy in all the regional offices that all referrals be made in writing using the standard Enforcement Referral Cover Memorandum or an equivalent record, as appropriate, in light of the new Tips, Complaints, and Referrals system and other programmatic changes.
		Issue policy or guidance requiring examiners in regional offices to formally refer all significant matters to Enforcement, not merely the matters that Enforcement has already decided to accept.
		Take appropriate actions to enforce policy in all regional offices that all referrals be uploaded into the Tips, Complaints, and Referrals system regardless of whether Enforcement has accepted the referral.

Report Number and Title	Issue Date	Summary of Recommendation
		Ensure that all referrals currently in the Super Tracking and Review System (STARS) are appropriately and adequately updated with the information in the Home Office Enforcement Referral Review Committee spreadsheet.
		Continue efforts to establish a complete interface between STARS or its equivalent, the Hub, and the Tips, Complaints, and Referrals system.
		Determine what will be the future of the Home Office Enforcement Referral Review Committee. If the Committee will not continue, they should ensure that its responsibilities are carried out by another office or group that will continue to oversee the referral process and track outstanding referrals in a meaningful way.
495 - SEC's Oversight of the Securities Investor Protection Corporation's (SIPC) Activities	3/30/2011	Document procedures and processes for oversight and monitoring of the SIPC pursuant to the Securities Investor Protection Act (SIPA).
		Complete efforts to update the internal memorandum that describes oversight responsibilities under the SIPA and include current practices and, where appropriate, the legislative amendments that were made to SIPA in July 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act.
		Conduct meetings, on at least an annual basis, to determine when an inspection of SIPC should occur, based on the ongoing liquidations, to ensure systematic and risk based monitoring of SIPC's operations. In these meetings, develop a schedule for future inspections based upon objective criteria or defined risk-factors, such as conducting inspections based upon the number of SIPC liquidations.
		Perform a risk assessment to determine problematic areas or liquidations that are deemed to be complex prior to the next inspection of SIPC, as was done prior to the commencement of the 2003 inspection of SIPC. The scope of each future inspection should take into consideration the risk assessment conducted prior to the inspection.

Report Number and Title	Issue Date	Summary of Recommendation
		Conduct additional oversight of SIPC's assessments of the reasonableness of trustee fees and encourage SIPC to negotiate with outside court-appointed trustees more vigorously to obtain a reduction in fees greater than ten percent.
		Decide on the scope and frequency of the Commission staff's monitoring of SIPC's assessments of the reasonableness of trustee fees paid by SIPC, rather than relying only on inspections of SIPC, which do not occur on a systematic basis.
		Determine whether to request that Congress modify the SIPA to allow bankruptcy judges who preside over SIPA liquidations to assess the reasonableness of administrative fees in all cases where administrative fees are paid by the SIPC.
		Encourage SIPC to designate an employee whose responsibilities include improving investor education and preventing further confusion among investors about coverage available under the SIPA.
		Support SIPC's efforts to improve investor education, including encouraging SIPC to strongly consider and, as appropriate, implement the Office of Investor Education and Advocacy's suggestions to improve investor awareness.
		Utilize more effective methods to communicate with investors in case of the failure of broker-dealers, such as notifying investors of the status of the Commission's efforts throughout the liquidation process or designating an employee, as appropriate, who can communicate directly with investors on matters unique to each liquidation case.
PI-09-05 - SEC Access Card Readers in Regional Offices	2/22/2010	Ensure, on a Commission-wide basis, that all regional offices are capable of capturing and recording building entry and exit information of Commission employees.
PI-09-07 - Employee Recognition Program and Grants of Employee Awards	3/10/2010	Review and update internal regulation and policy for the SEC's Employee Recognition Program (ERP), and post the revised regulation and/or policy to the SEC's intranet site.
		Ensure the revised ERP regulation and/or policy specifically addresses whether informal recognition awards are authorized and, if so, what criteria, standards, and approvals pertain.

Report Number and Title	Issue Date	Summary of Recommendation
		Ensure the revised ERP regulation and/or policy makes clear that appropriated funds may not be used to pay for employee parking as an award.
		Approve requests to use appropriated funds for non-monetary employee awards only after ensuring an authorized agency officer has approved the awards under statutory and regulatory authority.
ROI-470 - Allegations of Conflict of Interest and Investigative Misconduct	2/24/2010	Institute procedures to require that a decision be made, documented, and approved where Enforcement has informed the Commission it is continuing to consider recommending charges.
ROI-491 - Allegation of Fraudulently Obtained Award Fees	3/29/2010	Make efforts to recapture a portion of additional award fees a contractor obtained based on potentially inaccurate data.
ROI-505 - Failure to Timely Investigate Allegations of Financial Fraud	2/26/2010	Ensure as part of changes to complaint handling system that databases used to refer complaints are updated to accurately reflect status of investigations and identity of staff.
		Ensure as part of changes to complaint handling system that referrals are monitored to ensure they are being actively investigated and complainants are provided accurate information.
		Ensure as part of changes to case-closing system that cases that are not actively being investigated are closed promptly.
		Ensure as part of changes to case-closing system that Enforcement staff members have access to accurate information about the status of investigations and staff requests to close investigations.
		Ensure as part of changes to case-closing system that staff at all levels be appropriately trained in case-closing procedures.
ROI-524 - Improper Use of Leave Without Pay (LWOP) to Receive Full-Time Benefits	7/23/2010	Conduct an audit of all SEC employees to determine whether employees regularly use LWOP to create a part-time schedule but have not had their benefits and leave reduced.
ROI-533 - Failure to Uncover Fraud in Investment Adviser Examination	10/26/2010	Establish a recusal policy whereby an individual who previously worked on an examination that did not uncover an existing fraud is recused from working on a subsequent cause examination of that entity.
		Include in examination referral policy and procedures a mechanism for tracking the outcome of an examination, particularly where a follow-up examination is recommended.



Report Number and Title	Issue Date	Summary of Recommendation
ROI-538 - Abuse of Compensatory Time for Travel	2/14/2011	Provide training on the SEC's compensatory time for travel rules and management training.
ROI-540 - Investigation of Possible Violation of Conflict of Interest Restrictions	1/25/2011	Document the Ethics advice provided to SEC employees.
		Add a field to the online recusal system in which employees can add information regarding the specific matters from which they are recused.
		Rectify the online recusal database's inability to store certain information entered on the form.
		Seek modification from the U.S. Office of Government Ethics of the blanket exemption for SK employees from the one-year cooling-off ban.
		Designate an administrative contact to maintain a list of specific matters from which senior officers are recused.
ROI-544 - Failure to Complete Background Investigation Clearance Before Giving Access to SEC Buildings and Computer Systems	1/20/2010	Take immediate measures to determine whether every OIT employee and contractor has been properly cleared by a background investigation and issued an official SEC badge.
		Issue a written policy on proper issuance, and documentation of, visitor badges, specifically noting that visitor badges cannot be issued in lieu of, or while awaiting, a permanent official SEC badge.
		Issue a directive ending the practice of allowing contractors (or others) to begin work of any kind before being cleared in a proper background investigation and being issued an official SEC badge.
		Take steps to deactivate official SEC badges and terminate access to SEC computer systems for terminated or separated employees and contractors.
ROI-551 - Allegations of Unauthorized Disclosures of Non-Public Information During SEC Investigations	3/30/2011	Employ technology that will enable the agency to maintain records of phone calls made from and received by SEC telephones.





## Table 4 Summary of Investigative Activity

<b>Cases</b>	<b>Number</b>
Cases Open as of 3/31/2011	11
Cases Opened during 4/01/2011 - 9/30/2011	7
Cases Closed during 4/01/2011 - 9/30/2011	7
Total Open Cases as of 9/30/2011	11
Referrals to the Department of Justice for Prosecution	2
Prosecutions	0
Convictions	1
Referrals to Agency for Disciplinary Action	6
<b>Preliminary Inquiries</b>	<b>Number</b>
Inquiries Open as of 3/31/2011	73
Inquiries Opened during 4/01/2011 - 9/30/2011	28
Inquiries Closed during 4/01/2011 - 9/30/2011	27
Total Open Inquiries as of 9/30/2011	74
Referrals to the Department of Justice for Prosecution	3
Referrals to Agency for Disciplinary Action	6
<b>Disciplinary Actions</b>	<b>Number</b>
Removals (Including Resignations and Retirements)	3
Demotions	3
Suspensions	5
Reprimands	4
Warnings/Other Actions	9



# Table 5

## Summary of Complaint Activity

<b>Complaints Received During the Period</b>		<b>Number</b>
Complaints Pending Disposition at Beginning of Period		3
Hotline Complaints Received		144
Other Complaints Received		120
Total Complaints Received		264
Complaints on which a Decision was Made		260
Complaints Awaiting Disposition at End of Period		7
<b>Disposition of Complaints During the Period</b>		<b>Number</b>
Complaints Resulting in Investigations		5
Complaints Resulting in Inquiries		28
Complaints Referred to OIG Office of Audits		5
Complaints Referred to OIG Employee Suggestion Program		1
Complaints Referred to Other Agency Components		136
Complaints Referred to Other Agencies		9
Complaints Included in Ongoing Investigations or Inquiries		17
Response Sent/Additional Information Requested		39
No Action Needed		21



# Table 6

## References to Reporting Requirements of the Inspector General Act

*The Inspector General Act of 1978, as amended, specifies reporting requirements for semiannual reports to Congress. The requirements are listed below and indexed to the applicable pages.*

Section	Inspector General Act Reporting Requirement	Pages
4(a)(2)	Review of Legislation and Regulations	93-95
5(a)(1)	Significant Problems, Abuses, and Deficiencies	13-18, 24-48 54-87
5(a)(2)	Recommendations for Corrective Action	19-21, 28-48 54-87
5(a)(3)	Prior Recommendations Not Yet Implemented	103-113
5(a)(4)	Matters Referred to Prosecutive Authorities	54-88, 115
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# **PEER REVIEWS OF OIG OPERATIONS**

## **PEER REVIEW OF THE SEC OIG'S AUDIT OPERATIONS**

During the semiannual reporting period, the SEC OIG did not have an external peer review conducted of its audit operations. Peer reviews of OIG audit operations are required to be conducted every three years. The most recent peer review of the SEC OIG's audit operations was conducted by the Corporation for Public Broadcasting (CPB) OIG. The CPB OIG issued its report on the SEC OIG's audit operations in January 2010. This report concluded that the SEC OIG's system of quality for its audit function was designed to meet the requirements of the quality control standards established by the U.S. Comptroller General in all material respects. The report is available on our website at [http://www.sec-oig.gov/Reports/Other/CPB\\_PeerReviewSEC.pdf](http://www.sec-oig.gov/Reports/Other/CPB_PeerReviewSEC.pdf).

## **PEER REVIEW OF THE SEC OIG'S INVESTIGATIVE OPERATIONS**

During the semiannual reporting period, the SEC OIG did not have an external peer review of its investigative operations. Peer reviews of Designated Federal Entity OIGs, such as the SEC OIG, are conducted on a voluntary basis. The most recent peer review of the SEC OIG's investigative operations was conducted by the U.S. Equal Employment Opportunity Commission (EEOC) OIG. The EEOC OIG issued its report on the SEC OIG's investigative operations in July 2007. This report concluded that the SEC OIG's system of quality for the investigative function conformed to the professional standards established by the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency (now the Council of the Inspectors General on Integrity and Efficiency).



# ANNUAL REPORT ON THE OIG SEC EMPLOYEE SUGGESTION PROGRAM ISSUED PURSUANT TO SECTION 966 OF THE DODD-FRANK ACT

## INTRODUCTION AND BACKGROUND

The Securities and Exchange Commission (SEC or Commission) Office of Inspector General (OIG) established the OIG SEC Employee Suggestion Program in accordance with Section 966 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Under Section 966 of the Dodd-Frank Act, the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.*) (Exchange Act) was amended to include a new Section 4D (15 U.S.C. § 78d-4), which required the Inspector General to establish a suggestion program for employees of the Commission. The OIG established its SEC Employee Suggestion Program on September 27, 2010.

In accordance with Section 4D(d) of the Exchange Act, the SEC OIG has prepared this annual report containing a description of suggestions and allegations received, recommendations made or action taken by the OIG, and action taken by the Commission in response to suggestions or allegations received since the program's inception on September 27, 2010, through September 30, 2011.

Through this program, the OIG receives suggestions from Commission employees for improvements in work efficiency, effectiveness, productivity, and the use of the resources of the Commission, as well as allegations by employees of the Commission of waste, abuse, misconduct, or mismanagement within the Commission. The OIG established an e-mail mailbox and a telephone hotline to facilitate the making of suggestions or allegations under this program.

The OIG adopted formal policies and procedures for the SEC Employee Suggestion Program. These policies and procedures, dated March 30, 2011, encompass both the receipt and handling of employee suggestions and allegations, as well as recognition of employees whose suggestions or disclosures to the OIG may result or have resulted in cost savings to or efficiencies within the Commission.

## SUMMARY OF EMPLOYEE SUGGESTIONS AND ALLEGATIONS RECEIVED

Since the inception of the Employee Suggestion Program, the OIG has received 48 suggestions or allegations. On March 30, 2011, the OIG was forwarded an additional 26 suggestions that had been previously submitted to the SEC's Office of Human Resources' (OHR) now discontinued employee suggestion program.<sup>1</sup> The OIG analyzed all of the 74 employee suggestions and allegations received since the inception of the OIG SEC Employee Suggestion Program. Set forth below are details regarding:

- (1) The nature, number, and potential benefits of any suggestions received.
- (2) The nature, number, and seriousness of any allegations received.
- (3) Any recommendations made or actions taken *by the OIG* in response to substantiated allegations received.
- (4) Any action taken *by the Commission* in response to suggestions or allegations received.

Nature and Potential Benefits of Suggestions <sup>2</sup>	Number
Increase efficiency or productivity	17
Increase effectiveness	20
Increase the use of resources or decrease costs	25

Nature and Seriousness of Allegations	Number
Mismanagement and/or discrimination	8
Waste of Commission resources	6
Physical harm to person or property	1
Misconduct by an employee	3

Action Taken by OIG in Response to Suggestions or Allegations	Number
Memorandum to or communication with the Commission requesting action be taken	35
Referred to OIG Office of Investigations	6
Referred to OIG Office of Audits	6
OIG Office of Investigations opened preliminary inquiry	1
Researched issue, but no further action by Commission was necessary	21

<sup>1</sup> OHR's suggestion program was established in March 2008. However, because that program was not actively monitored or reviewed for an extended period of time, it was subsequently closed. All previously-submitted suggestions were provided to the OIG staff to be addressed as part of the OIG SEC Employee Suggestion Program.

<sup>2</sup> Suggestions and/or allegations may fall into more than one category and, as such, the numbers below may be greater than the total number of suggestions and allegations received.

Action Taken by the Commission <sup>3</sup>	Number
SEC management took specific action to address the suggestion	16
The Commission decided to secure new technology in response to the suggestion	2
SEC management launched internal review	2
The suggestion is currently still being reviewed by SEC management	2
SEC management is considering suggestion in context of existing procedures	7

<sup>3</sup> This table represents the Commission's response to suggestions and allegations that were referred to the Commission for consideration and for which a response was received during the reporting period.

## EXAMPLES OF SUGGESTIONS RECEIVED

### Leave and Earnings Statements

The OIG received suggestions from several employees regarding the receipt of hard copy leave and earnings statements. Specifically, the employees stated that, because leave and earnings statements are available electronically on Employee Express, it is an unnecessary expense to mail hard copies of the leave and earnings statements to employees. Because there were likely many employees not wishing to have hard copy leave and earnings statements mailed to their homes, the OIG submitted this suggestion to management for their consideration.

Management concurred with this suggestion and, in September 2011, in conjunction with the National Treasury Employees Union, issued a memorandum to all employees announcing the discontinuation of paper copies of leave and earnings statements. In addition, an Administrative Notice was issued indicating that such statements would no longer be mailed to employees' homes but would, instead, be available electronically via Employee Express. Management indicated that this change was expected to save the Commission approximately \$40,000 per year.

### Code of Federal Regulations

An employee suggested that cost savings could be achieved if the Commission limited the distribution of paper copies of the Code of Federal Regulations (CFR). The CFR is the codification of the general and permanent rules published in the Federal Register by the executive departments and agencies of the federal government. The Government Printing Office offers paper copies of these regulations for purchase annually. The employee suggested that, because these regulations are available online at no charge, the purchase and distribution of paper versions of the CFR are unnecessary and wasteful.

It was determined that management spent over \$21,000 on paper copies of the CFR in 2011, many of which were later returned by staff as unneeded. The OIG recommended that management take steps to provide information to staff regarding the availability of this resource online and to institute procedures to ensure that paper copies are not ordered unnecessarily. Management agreed with this employee suggestion and, in response, prepared new procedures which will be implemented at the time of the next annual order. Pursuant to these procedures, employees will only obtain a paper copy of the regulations if one is specifically requested and only after acknowledging in writing their understanding of the availability of the information online. Management indicated that this change was expected to save the Commission approximately \$3,230 per year.



## **Unclaimed Property**

The OIG received a suggestion that was previously submitted to the Office of Human Resources' employee suggestion program regarding unclaimed property possibly payable to the SEC. The employee specifically suggested that the SEC should search unclaimed property databases to determine whether funds belonging to the SEC are being held by state governments. The employee's own search uncovered at least nine states that had unclaimed property in the name of the SEC. The OIG asked management to consider this suggestion and the possible implementation of procedures to search for unclaimed property that could result in cash and/or property being return to the SEC.

In response, management established new written procedures to implement a process for searching for and reclaiming such property. As a result of these procedures, the agency has since reclaimed more than \$6,000 in funds belonging to the SEC.

## **Service of Subpoenas**

The OIG received an employee suggestion regarding the procedures for serving subpoenas during the Division of Enforcement's investigative process and the potential benefits of allowing the service of subpoenas via e-mail. Currently, the service of subpoenas is only permitted via personal service, U.S. mail, commercial carrier, or facsimile. The employee stated that amending the Commission's Rules of Practice and Rules Relating to Investigations to allow the service of subpoenas via e-mail would increase staff efficiency by expediting the investigative process and would decrease costs associated with the service of subpoenas via U.S. mail.

The OIG determined that this suggestion could potentially improve efficiency and decrease costs and recommended to the agency that it be considered. Management concurred with this suggestion and, in response, began the preparation of a recommendation to the Commission to amend the Rules of Practice and Rules Relating to Investigations to permit the service of investigative subpoenas via e-mail. Management is currently in the process of researching and developing the appropriate amendments.

## **Teleconference Services**

An employee suggested that the SEC should better communicate costs related to various audio conferencing options. Specifically, the employee suggested that, while the SEC offers a variety of options for audio conferencing services, staff may not be aware of the cost savings associated with certain options. Specifically, certain conferencing options are available through the Commission's telecommunications contract for no extra charge, while other options are charged per use. We determined that this suggestion could potentially result in decreased costs associated with audio conferencing services and recommended that the agency consider this suggestion.

The agency recognized the need to educate staff regarding the costs associated with audio conferencing and, in response, agreed to provide additional communication to the user community and to emphasize to employees the cost benefits of using certain conferencing options.

## **EXAMPLES OF ALLEGATIONS RECEIVED**

### **Protection of Personally Identifiable Information**

The OIG received an allegation that the agency was not utilizing document shredding containers properly and, thus, was not adequately protecting personally identifiable information. Specifically, the employee alleged that shredding bins throughout the agency were often full and, therefore, documents were left on top of these shredding bins. This practice allowed access to nonpublic or personally identifiable information. Improper handling of documents containing personally identifiable information is a violation of various SEC policies and procedures designed to ensure the proper handling of such information.

Because of the importance of protecting nonpublic and personally identifiable information, the OIG submitted this suggestion to management for consideration. Although no official response from management had been received by the end of the reporting period, the OIG was informed that the agency began deployment of new shredding bins to allow for greater capacity and more frequent service to better avoid possible access to nonpublic and personally identifiable information.

### **Referrals to Office of Investigations**

The OIG received five allegations that resulted in referrals to the OIG's Office of Investigations. Two of these allegations related to waste in leasing and were included in the Office of Investigations' recently completed investigation of the SEC's leasing activities. One allegation involved improper personnel practices by a senior official and was referred for inclusion in an ongoing investigation. The Office of Investigations also opened an investigation based on the receipt of an allegation regarding potential conflicts of interest surrounding an enforcement investigation. Finally, an allegation regarding the mishandling of documents was referred for inclusion in an ongoing investigation regarding improper document destruction.

## **CONCLUSION**

The OIG is pleased with the effectiveness of the OIG SEC Employee Suggestion Program. We have received favorable responses from the agency regarding the suggestions submitted for its consideration. These suggestions have resulted in positive changes that will improve the efficiency and effectiveness of employees and increase the use of the agency's resources or decrease waste. Of note, the Commission expects a cost savings of approximately \$50,000 per year as the result of the suggestions received since the OIG SEC Employee Suggestion Program began. The OIG anticipates additional favorable responses to those suggestions which are currently under review by the agency and will continue to encourage the submission of suggestions from employees.



**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Oversight and Investigations Subcommittee of the  
Committee on Financial Services,  
U.S. House of Representatives**

**Friday May 13, 2011  
10:00 a.m.**

### Introduction

Thank you for the opportunity to testify before this Committee on the subject of “The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud.” I appreciate the interest of the Chairman, the Ranking Member, and the other members of the Subcommittee, in the Securities and Exchange Commission (SEC or Commission) and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks by briefly discussing the role of my Office and the oversight efforts we have undertaken during the past few years. The mission of the OIG is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC OIG includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates and supervises independent audits and evaluations related to the Commission’s internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules, and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office’s investigations unit responds to allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or

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full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation as appropriate.

### **Audit Reports**

Over the past three years since I became the Inspector General of the SEC, our audit unit has issued numerous reports involving matters critical to SEC programs and operations and the investing public. These reports have included an examination of the Commission's oversight of Bear Stearns and the factors that led to its collapse, an audit of the Division of Enforcement's (Enforcement) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's real property and leasing procurement process, compliance with Homeland Security Presidential Directive 12, and oversight of the Securities Investment Protection Corporation's activities. In addition, following the OIG's investigative report related to the Madoff Ponzi scheme described below, we performed three comprehensive reviews providing the SEC with 69 specific and concrete recommendations to improve the operations of both Enforcement and the SEC's Office of Compliance Inspections and Examinations (OCIE).

### **Investigative Reports**

The Office's investigations unit has also conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as investigations of allegations of violations of statutes, rules, and regulations, and other

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misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the Commission, Members of Congress, and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removal of employees from the federal service, as well as recommendations for improvements in agency policies, procedures, and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of failures by Enforcement to pursue investigations vigorously or in a timely manner, improper securities trading by Commission employees, conflicts of interest by Commission staff members, post-employment violations, unauthorized disclosure of nonpublic information, procurement violations, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, failure of SEC attorneys to maintain active bar status, falsification of federal documents and compensatory time for travel, abusive conduct and the misuse of official position and government resources.

As noted above, in August 2009, we issued a 457-page report of investigation analyzing the reasons why the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. In March 2010, we issued a thorough and comprehensive report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's (Stanford) \$8 billion alleged Ponzi scheme.

### **Commencement of the OIG's Stanford Investigation**

On October 13, 2009, we opened an investigation into the handling of the SEC's investigation into Robert Allen Stanford and his various companies, including the history and conduct of all the SEC's investigations and examinations regarding Stanford. Between October



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13, 2009 and February 16, 2010, our investigative team made numerous requests to the SEC's Office of Information Technology (OIT) for the e-mails of current and former SEC employees for various periods of time pertinent to the investigation. The e-mails were received, loaded onto computers with specialized search tools, and searched on a continuous basis throughout the course of our investigation.

In all, OIT provided e-mails for a total of 42 current and former SEC employees for various time periods pertinent to the investigation, ranging from 1997 to 2009. We estimate that we obtained and searched over 2.7 million e-mails during the course of the investigation.

On October 27, 2009, we sent comprehensive document requests to both Enforcement and OCIE specifying the documents and records we required to be produced for the investigation. We carefully reviewed and analyzed the information we received as a result of our document production requests. These documents included all records relating to the Fort Worth examinations in 1997 of Stanford Group Company's Broker-Dealer, in 1998 of Stanford Group Company's Investment Advisor, in 2002 of Stanford Group Company's Investment Advisor, and in 2004 of Stanford Group Company's Broker-Dealer. These also included investigative records relating to the Fort Worth Office's 1998 inquiry regarding Stanford Group Company and its Enforcement investigation of Stanford Group Company, which was opened in 2006.

We also sought and reviewed documents from the Financial Industry Regulatory Authority (FINRA), including documents concerning communications between FINRA or its predecessor, the National Association of Securities Dealers (NASD), and the SEC concerning Stanford, and FINRA documents concerning the SEC's examinations and inquiries regarding Stanford.

### **Testimony and Interviews**

The OIG conducted 51 testimonies and interviews of 48 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Stanford and his firms. I personally led the questioning in the testimony and interviews of all the witnesses in this investigation.

Specifically, we conducted on-the-record and under oath testimony of 28 individuals, including all the relevant examiners and investigators who worked on SEC matters relating to Stanford. We also conducted interviews of 20 other witnesses, including former SEC employees, whistleblowers, victims of the alleged Ponzi scheme, and officials from the Texas State Securities Board.

### **Issuance of Comprehensive Report of Investigation**

On March 31, 2010, we issued to the Chairman of the SEC a comprehensive report of our investigation in the Stanford matter containing over 150 pages of analysis and 200 exhibits. The report of investigation detailed all of the SEC's examinations and investigations of Stanford from 1997 through 2009 and the agency's response to all complaints it received regarding the activities of Stanford's companies, tracing the path of these complaints through the Commission from their inception and reviewing what, if any, investigative or examination work was conducted with respect to the allegations in the complaints.

### **Results of the OIG's Stanford Investigation**

The OIG's investigation determined that the SEC's Fort Worth Office was aware since 1997 that Robert Allen Stanford was likely operating a Ponzi scheme, having come to that conclusion a mere two years after Stanford Group Company, Stanford's investment adviser, registered with the SEC in 1995. We found that over the next eight years, the SEC's Fort Worth

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Examination group conducted four examinations of Stanford's operations, finding in each examination that the certificates of deposit (CDs) Stanford was promoting could not have been "legitimate," and that it was "highly unlikely" that the returns Stanford claimed to generate could have been achieved with the purported conservative investment approach utilized. The SEC's Fort Worth examiners conducted examinations of Stanford in 1997, 1998, 2002, and 2004, concluding in each instance that Stanford's CDs were likely a Ponzi scheme or similar fraudulent scheme. The only significant difference in the examination group's findings over the years was that the potential fraud was growing exponentially, from \$250 million to \$1.5 billion.

The first SEC examination occurred in 1997, just two years after Stanford Group Company began operations. After reviewing Stanford Group Company's annual audited financial statements in 1997, SEC examiner Julie Preuitt, who is a witness in this hearing, stated that, based simply on her review of the financial statements, she "became very concerned" about the "extraordinary revenue" from the CDs and immediately suspected the CD sales were fraudulent. In August 1997, after just six days of field work in an examination of Stanford, Ms. Preuitt and the examination team concluded that Stanford International Bank's statements promoting the CDs appeared to be misrepresentations. They noted that while the CD products were promoted as being safe and secure, with investments in "investment-grade bonds," the interest rate, combined with referral fees of between 11% and 13.75% annually, was simply too high to be achieved through the purported low-risk investments.

Ms. Preuitt concluded after the 1997 examination was finished that the CDs' declared above-market returns were "absolutely ludicrous," and that the high referral fees paid for selling the CDs indicated that they were not "legitimate CDs." The Assistant District Administrator for the Fort Worth Examination program concurred, noting that there were "red flags" about

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Stanford's operations that caused her to believe Stanford Group Company was operating a Ponzi scheme, specifically noting the fact that the interest being paid on these CDs "was significantly higher than what you could get on a CD in the United States." She further concluded that it was "highly unlikely" that the returns Stanford claimed to generate could be achieved with the conservative investment approach Stanford claimed to be using.

In the SEC's internal tracking database for examinations, the Fort Worth Broker-Dealer Examination group characterized its conclusion from the 1997 examination of Stanford Group Company as "Possible misrepresentations. Possible Ponzi scheme." We found in our investigation that the Examination staff determined in 1997, as a result of their findings, that an investigation of Stanford by the Enforcement group was warranted, and referred a copy of their examination report to the Enforcement group for review and disposition. In fact, when the former Assistant District Administrator for the Fort Worth Examination program retired in 1997, her "parting words" to Ms. Preuit were to "keep your eye on these people [referring to Stanford] because this looks like a Ponzi scheme to me and some day it's going to blow up."

We also found that in June 1998, the Investment Adviser Examination group in Fort Worth began another examination of Stanford Group Company. This investment adviser examination came to the same conclusions as the broker-dealer examination, finding very suspicious Stanford's "extremely high interest rates and extremely generous compensation" in the form of annual recurring referral fees, and the fact that Stanford Group Company was so "extremely dependent upon that compensation to conduct its day-to-day operations."

In November 2002, the Investment Adviser Examination group conducted yet another examination of Stanford Group Company. In this examination, the staff identified the same red flags that had been noted in the previous two examinations, including the fact that "the

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consistent, above-market reported returns” were “very unlikely” to be able to be achieved with Stanford’s investments.

The investment adviser examiners also found that the list of investors provided by Stanford Group Company was inaccurate, as the list they received of the CD holders did not match up with the total CDs outstanding based upon referral fees. The examiners noted that although they did follow up with Stanford Group Company about this discrepancy, they never obtained “a satisfactory response, and a full list of investors.”

After the examiners began this third examination of Stanford, the SEC received multiple complaints from outside entities reinforcing and bolstering the examiners’ suspicions about Stanford’s operations. However, the SEC failed to follow up on these complaints or take any action to investigate them. On December 5, 2002, the SEC received a complaint from a citizen of Mexico, who raised the same concerns the Examination staff had raised. While the examiners characterized the concerns expressed in this complaint as “legitimate,” we found that the SEC did not respond to the complaint and did not take any action to investigate the claims in the complaint.

In 2003, the SEC Enforcement staff received two new complaints that Stanford was a Ponzi scheme, but we found that nothing was done to pursue either of them. On August 4, 2003, the SEC was forwarded a letter that discussed several similarities between a known Ponzi scheme and Stanford’s operations. Then, on October 10, 2003, the NASD forwarded a letter dated September 1, 2003, from an anonymous Stanford insider to the SEC’s Office of Investor Education and Assistance (OIEA), which stated, in pertinent part:

STANFORD FINANCIAL IS THE SUBJECT OF A LINGERING  
CORPORATE FRAUD SCANDAL PERPETUATED AS A  
“MASSIVE PONZI SCHEME” THAT WILL DESTROY THE  
LIFE SAVINGS OF MANY; DAMAGE THE REPUTATION OF

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### ALL ASSOCIATED PARTIES, RIDICULE SECURITIES AND BANKING AUTHORITIES, AND SHAME THE UNITED STATES OF AMERICA.

Our investigation found that while this letter was minimally reviewed by various Enforcement staff, the Enforcement group decided not to open an investigation or even an inquiry. The Enforcement branch chief responsible for the decision explained his rationale as follows:

[R]ather than spend a lot of resources on something that could end up being something that we could not bring, the decision was made to – to not go forward at that time, or at least to – to not spend the significant resources and – and wait and see if something else would come up.

In October 2004, the Examination staff conducted its fourth examination of Stanford Group Company. The examiners once again analyzed the CD returns using data about the past performance of the equity markets and concluded that Stanford Group Company's sales of the CDs violated numerous federal securities laws.

While the Fort Worth Examination group, and particularly Ms. Preuit, made multiple efforts after each examination to convince the Enforcement group to open and conduct an investigation of Stanford, we found that no meaningful effort was made by the Enforcement group to investigate the potential fraud until late 2005. In 1998, the Enforcement group opened a brief inquiry, but then closed it after only three months, when Stanford failed to produce documents evidencing fraud in response to a voluntary document request. In 2002, no investigation was opened even after the examiners specifically identified in an examination report multiple violations of securities laws by Stanford. In 2003, after receiving the three separate complaints about Stanford's operations, the Enforcement group decided not to open up

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an investigation or even an inquiry, and did not follow up to obtain more information about the complaints.

In late 2005, after a change in leadership in the Enforcement group and in response to the continuing pleas by Ms. Preuitt and the Fort Worth Examination group, who had been watching the potential fraud grow in examination after examination, the Enforcement group finally agreed to seek a formal order from the Commission to investigate Stanford. However, even at that time, the Enforcement group missed an opportunity to bring an action against Stanford Group Company for its admitted failure to conduct any due diligence regarding Stanford's investment portfolio, which could have potentially completely stopped the sales of the Stanford International Bank CDs through the Stanford Group Company investment adviser, and would have provided investors and prospective investors with notice that the SEC considered Stanford Group Company's sales of the CDs to be fraudulent. We found that this particular action was not considered, partially because the new head of the Enforcement group in Fort Worth was not aware of the findings in the investment advisers' examinations in 1998 and 2002, or even that Stanford Group Company had registered as an investment adviser, a fact she learned for the first time in the course of our investigation in January 2010.

We did not find that the reluctance on the part of the SEC's Fort Worth Enforcement group to investigate Stanford was related to any improper professional, social, or financial relationship on the part of any current or former SEC employee. We found evidence, however, that SEC-wide institutional influence within the Enforcement group did factor into its repeated decisions not to undertake a full and thorough investigation of Stanford, notwithstanding staff awareness that the potential fraud was growing. We found that senior Fort Worth officials perceived that they were being judged on the numbers of cases they brought, so-called "stats,"



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and communicated to the Enforcement staff that novel or complex cases were disfavored. Specific testimonial evidence obtained in our investigation showed that, as a result of this emphasis on “stats,” cases that were not considered “quick-hit” or slam-dunk” cases were discouraged. The OIG investigation concluded that because Stanford “was not going to be a quick hit,” it was not considered to be as high a priority as other, easier cases.

The OIG also found that the former head of Enforcement in Fort Worth who played a significant role in multiple decisions over the years to quash investigations of Stanford, sought to represent Stanford on three separate occasions after he left the Commission, and in fact, represented Stanford briefly in 2006 before he was informed by the SEC Ethics Office that it was improper for him to do so.

This individual while working at the SEC was responsible for decisions: (1) in 1998 to close an inquiry opened regarding Stanford after the 1997 examination; (2) in 2002, in lieu of responding to a complaint or investigating the issues it raised, to forward it to the Texas State Securities Board; (3) also in 2002, not to act on the Examination staff’s referral of Stanford for investigation after its investment adviser examination; (4) in 2003, not to investigate Stanford after a complaint was received comparing Stanford’s operations to a known fraud; (5) in 2003, not to investigate Stanford after receiving a complaint from an anonymous insider alleging that Stanford was engaged in a “massive Ponzi scheme;” and (6) in 2005, to bluntly inform senior Examination staff after a presentation was made on Stanford at a quarterly summit meeting that Stanford was not a matter the Enforcement group planned to investigate.

Yet, in June 2005, a mere two months after leaving the SEC, this former head of the Enforcement group in Fort Worth e-mailed the SEC Ethics Office that he had been “approached about representing [Stanford] . . . in connection with (what appears to be) a preliminary inquiry

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by the Fort Worth office.” He further stated, “I am not aware of any conflicts and I do not remember any matters pending on Stanford while I was at the Commission.”

After the SEC Ethics Office denied the former head of Enforcement in Fort Worth’s June 2005 request, in September 2006, Stanford retained this individual to assist with inquiries Stanford was receiving from regulatory authorities, including the SEC. The former head of Enforcement in Fort Worth met with Stanford Financial Group’s General Counsel in Stanford’s Miami office and billed Stanford for his time on this representation. In late November 2006, he called his former subordinate, the Assistant Director working on the Stanford matter in Fort Worth, who asked him during the conversation, “[C]an you work on this?” and in fact told him, “I’m not sure you’re able to work on this.” After this call, the former head of Enforcement in Fort Worth belatedly sought permission from the SEC’s Ethics Office to represent Stanford. The SEC Ethics Office replied that he could not represent Stanford for the same reasons given a year earlier, and he discontinued his representation.

In February 2009, immediately after the SEC sued Stanford, this same former head of Enforcement in Fort Worth contacted the SEC Ethics Office a third time about representing Stanford in connection with the SEC matter – this time to defend Stanford against the lawsuit filed by the SEC. An SEC Ethics official testified that he could not recall another occasion on which a former SEC employee contacted the Ethics Office on three separate occasions trying to represent a client in the same matter. After the SEC Ethics Office informed the former head of Enforcement in Fort Worth for a third time that he could not represent Stanford, he became upset with the decision, arguing that the matter pending in 2009 “was new and was different and unrelated to the matter that had occurred before he left.” When asked during our investigation

why he was so insistent on representing Stanford, he replied, “Every lawyer in Texas and beyond is going to get rich over this case. Okay? And I hated being on the sidelines.”

Thus, our investigation found that the former head of Enforcement in Fort Worth’s representation of Stanford appeared to violate state bar rules that prohibit a former government employee from working on matters in which that individual participated as a government employee.

### **Recommendations of the OIG’s Stanford Report of Investigation**

We provided our Report of Investigation on Stanford to the Chairman of the SEC with the recommendation that the Chairman carefully review its findings and share with Enforcement management the portions of the report that related to the performance failures by those employees who still work at the SEC, so that appropriate action (which may include performance-based action, if applicable) would be taken, on an employee-by-employee basis, to ensure that future decisions about when to open an investigation and when to recommend that the Commission take action are made in a more appropriate and timely manner.

We also made numerous recommendations to improve the operations of several divisions and offices within the SEC. Specifically, we recommended that:

- (1) Enforcement ensure that the potential harm to investors if no action is taken is considered as a factor when deciding whether to bring an Enforcement action, including consideration of whether this factor, in certain situations, outweighs other factors such as litigation risk;
- (2) Enforcement emphasize the significance of bringing cases that are difficult, but important to the protection of investors, in evaluating the performance of an Enforcement staff member or a regional office;

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- (3) Enforcement consider the significance of the presence or absence of United States investors in determining whether to open an investigation or bring an enforcement action that otherwise meets jurisdictional requirements;
- (4) there be improved coordination between the Enforcement and OCIE on investigations, particularly those investigations initiated by an OCIE referral to Enforcement;
- (5) Enforcement re-evaluate the factors utilized to determine when referral of a matter to state securities regulators, in lieu of an SEC investigation, is appropriate;
- (6) there be additional training of Enforcement staff to strengthen their understanding of the laws governing broker-dealers and investment advisers; and
- (7) Enforcement emphasize the need to coordinate with the Office of International Affairs and the Division of Risk, Strategy, and Financial Innovation, as appropriate, early in the course of investigations.

We also referred our Report of Investigation to the Commission's Ethics Counsel for referral to the Bar Counsel offices in the two states in which the former head of Enforcement in Fort Worth was admitted to practice law.

### **OIG Follow-up Efforts and Subsequent Audit**

We have followed up with Enforcement and OCIE regarding the recommendations to improve operations that we made in our Stanford report. All of these recommendations have been implemented and closed to our satisfaction.

In addition, in response to the request of former Chairman of the Senate Banking Committee, the Honorable Christopher Dodd (D - Connecticut), we recently completed an audit of the process by which OCIE refers examination results to Enforcement in all of the SEC's

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regional offices to determine if the concerns about the Fort Worth Regional Office found in the Stanford report also existed in other SEC regional offices.

Our audit found that examiners across the SEC regional offices are generally satisfied with their Enforcement attorney counterparts. For example, we found through a survey of all OCIE examiners throughout the SEC's regional offices that most survey respondents indicated that they are either "completely satisfied" or "somewhat satisfied" with actions taken by Enforcement in response to examination-related referrals. We further found that where there was dissatisfaction with the referral process, the level of concern dramatically dropped over time and particularly in fiscal year 2010, with some respondents identifying the newly-created Asset Management Unit in Enforcement as having significantly assisted with the acceptance rate of OCIE referrals. We also found that the large majority of examiners do not believe that Enforcement will only take referrals that involve high dollar value amounts and cases that can easily be brought against the violator. In addition, many of the survey participants who indicated that they did believe that Enforcement was particularly concerned with dollar thresholds or "stats" noted that this approach was more evident in the past, i.e., "prior to Madoff."

Our audit did find that certain aspects of the referral process that could be improved. We found that OCIE sometimes presented referrals informally to Enforcement prior to proceeding with the formal referral process. As a result, there was a concern that not all referral-worthy matters may be recorded and tracked. We also found that internal concerns over incentives and metrics with regard to the percentage of OCIE referrals being accepted by Enforcement may have led OCIE senior officials to request that a particular referral not be recorded in the Tips, Complaints, and Referrals (TCR) system to avoid the risk of having large numbers of

outstanding referrals. Additionally, we noted that the level of communication between OCIE and Enforcement after a referral is not always consistent in the regional offices. We made seven additional recommendations to address the areas of improvement identified and are currently following up to ensure that these recommendations are implemented.

### **Results of an Investigation of Retaliatory Personnel Actions**

In September 2009, we completed another investigation involving the SEC's Fort Worth office and Ms. Preuitt. In this investigation, we found that Ms. Preuitt and a former colleague in the SEC's Fort Worth office voiced their differences about programmatic issues at a planning meeting concerning management's initiative to begin conducting a certain type of examination. Shortly thereafter, Ms. Preuitt's supervisor called her into several meetings and admonished Ms. Preuitt for her opposition to the office's examination initiative. A few months later, Ms. Preuitt's supervisor issued her a letter of reprimand for, among other things, her efforts to undermine management's authority and frustrate the implementation of the new examination initiative. Shortly thereafter, Ms. Preuitt was involuntarily transferred to non-supervisory duties.

Ms. Preuitt's former colleague, who also voiced opposition to the new examination initiative, complained to senior management at SEC headquarters about the new initiative and about the treatment of Ms. Preuitt. Shortly after he sent his complaint, he was issued a performance counseling memorandum for, among other things, being openly adversarial toward key examination goals. Less than a month later, the colleague was issued a letter of reprimand, for, among other things, discussing purported "unfounded and inaccurate allegations" with SEC senior management.

Our investigation concluded that the complaints made both by Ms. Preuitt and her colleague improperly led to actions being taken against them. We found that it was improper for

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Fort Worth management to take action against employees for voicing opposition to a program initiative and for bringing complaints to senior SEC management. Based upon our investigative findings, we recommended the consideration of performance-based or disciplinary action against two Fort Worth senior management officials.

### **Conclusion**

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our Stanford report. I believe that the Subcommittee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.



**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Economic Development, Public Buildings and  
Emergency Management Subcommittee of the Committee on  
Transportation and Infrastructure,  
U.S. House of Representatives**

**Thursday, June 16, 2011  
10:00 a.m.**

### Introduction

Thank you for the opportunity to testify before this Subcommittee on the lease of Constitution Center by the U.S. Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the Chairman, the Ranking Member, and the other members of the Subcommittee, in the SEC and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks by briefly discussing the role of my Office and the oversight efforts we have undertaken during the past few years. The mission of the OIG is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC OIG includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates, and supervises independent audits and evaluations related to the Commission's internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules, and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office's investigations unit responds to allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or

full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation, as appropriate.

### **Audit Reports**

Over the past three and one-half years since I became the Inspector General of the SEC, our audit unit has issued numerous reports involving matters critical to SEC programs and operations and the investing public. These reports have included an examination of the Commission's oversight of the Bear Stearns Companies, Inc. and the factors that led to its collapse, an audit of the Division of Enforcement's (Enforcement) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's compliance with Homeland Security Presidential Directive 12 and its oversight of the Securities Investment Protection Corporation's activities. In addition, in March 2009, we conducted a review of an agency restacking project in which over \$3 million was expended to relocate approximately 1,750 SEC employees in its headquarters building and, in September 2010, we completed an audit of the SEC's real property and leasing procurement process.

### **Investigative Reports**

The Office's investigations unit has conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as investigations of allegations of violations of statutes, rules, and regulations, and other

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misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the Commission, Members of Congress, and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removal of employees from the federal service, as well as recommendations for improvements in agency policies, procedures, and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of failures by Enforcement to pursue investigations vigorously or in a timely manner, improper securities trading by Commission employees, conflicts of interest by Commission staff members, post-employment violations, unauthorized disclosure of nonpublic information, procurement violations, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, failure of SEC attorneys to maintain active bar status, falsification of federal documents and compensatory time for travel, abusive conduct, and the misuse of official position and government resources.

In August 2009, we issued a 457-page report of investigation analyzing the reasons why the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. In March 2010, we issued a 151-page report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's \$8 billion alleged Ponzi scheme. Most recently, on May 16, 2011, we issued a comprehensive and thorough report of investigation into the circumstances surrounding the SEC's decision to lease approximately 900,000 square feet of office space at a newly-renovated office building known as Constitution Center, which is the subject of this hearing.

### Commencement and Conduct of the OIG's Leasing Investigation

On November 16, 2010, the OIG opened our investigation as a result of receiving numerous written complaints concerning the SEC's decisions and actions relating to Constitution Center. These complaints alleged that the decision to lease space at Constitution Center was ill-conceived, resulted from poor management practices, and was made without Congressional funding for the significant projected growth necessary to support the decision.

As part of our investigative efforts, we made numerous requests to the SEC's Office of Information Technology (OIT) for the e-mails of current and former SEC employees for various periods of time pertinent to the investigation. The e-mails were received, loaded onto computers with specialized search tools, and searched on a continuous basis throughout the course of our investigation. In all, OIT provided e-mails for a total of 27 current and former SEC employees for various time periods pertinent to the investigation. We estimate that we obtained and searched over 1.5 million e-mails during the course of the investigation.

We also made several requests to the SEC's Office of Administrative Services (OAS), which oversees the SEC's leasing function, for documents relating to its leasing practices. We carefully reviewed and analyzed the information we received as a result of our document requests. These documents included all records relating to the Constitution Center lease, as well as documents relating to the leasing of additional office space by the SEC for the past several years.

We took the sworn testimony of 18 witnesses in the investigation and interviewed 11 other individuals with knowledge of facts or circumstances surrounding the SEC's leasing activities.

### **Issuance of Comprehensive Report of Investigation in Leasing Matter**

On May 16, 2011, we issued to the Chairman of the SEC a comprehensive report of our investigation in the leasing matter that contained over 90 pages of analysis and more than 150 exhibits. The report of investigation detailed all of the SEC's recent leasing-related decisions and analyzed all of the facts and circumstances that led to the SEC's decision to lease space at Constitution Center.

### **Results of the OIG's Leasing Investigation**

The OIG investigation found that the circumstances surrounding the SEC's entering into a lease for 900,000 square feet of space at the Constitution Center facility in July 2010 were part of a long history of missteps and misguided leasing decisions made by the SEC since it was granted independent leasing authority by Congress in 1990. The OIG investigation further found that based upon estimates of increased funding, primarily to meet the anticipated requirements of financial reform legislation that was enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), between June and July 2010, OAS conducted a deeply flawed and unsound analysis to justify the need for the SEC to lease 900,000 square feet of space at the Constitution Center facility. We found that OAS grossly overestimated (by more than 300 percent) the amount of space needed for the SEC's projected expansion and used these groundless and unsupportable figures to justify the SEC's commitment to an expenditure of approximately \$557 million over 10 years.

The OIG investigation also found that OAS prepared a faulty Justification and Approval document to support entering into the lease for the Constitution Center facility without competition. This Justification and Approval document was prepared after the SEC had already signed the contract to lease the Constitution Center facility. Further, OAS backdated the

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Justification and Approval, thereby creating the false impression that it had been prepared only a few days after the SEC entered into the lease. In actuality, the Justification and Approval was not finalized until a month later.

A brief summary of our specific findings is set forth as follows. In 1990, Congress provided the SEC with independent leasing authority, which exempted the SEC from General Services Administration (GSA) regulations and directives. See 15 U.S.C. § 78d(b)(3). The House Conference Report for this legislation expressed the clear intention that “the authority granted the Commission to lease its own office space directly will be exercised vigorously by the Commission to achieve actual cost savings and to increase the Commission’s productivity and efficiency.” H.R. Conf. Rep. 101-924, 101<sup>st</sup> Cong, 2d Sess. 1990 at 20.

Subsequent to Congress’s granting of independent leasing authority to the SEC, several expensive missteps related to the SEC’s leasing actions and management of its space have occurred. For example, in May 2005, the SEC disclosed to a House Subcommittee that it had identified unbudgeted costs of approximately \$48 million attributable to misestimates and omissions of costs associated with the construction of its headquarters facilities near Union Station, known as Station Place One and Two. In 2007, merely a year after moving into its new headquarters, the SEC embarked on a major “restacking” project pursuant to which various SEC employees were shuffled to different office spaces in the same buildings at a cost of over \$3 million. An OIG audit of that project found that there was no record of a cost-benefit analysis having been conducted before this undertaking. An OIG survey found that an overwhelming majority of Commission staff affected by the restacking project had been satisfied with the location of their workspace before that project was initiated, and did not believe the project’s benefits were worth the cost and time of construction, packing, moving, and unpacking.



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The OIG investigation further found that, as a result of a mistaken belief that the SEC would receive significant additional funding, OAS made grandiose plans to lease an upscale facility at Constitution Center. On May 14, 2010, the SEC submitted an authorization request to the Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, requesting \$1.507 billion for Fiscal Year (FY) 2012 to fund an increase of 800 new staff positions. On May 20, 2010, the U.S. Senate passed a version of the financial regulatory reform bill that eventually became Dodd-Frank (the U.S. House of Representatives had passed a version of the legislation on December 11, 2009). The SEC estimated that it would need to add another 800 positions in FY 2011 and FY 2012 to implement Dodd-Frank. After the reconciliation process between the two versions of the financial regulatory reform bills, Dodd-Frank became law on July 21, 2010.

Authorization of funding for an executive agency like the SEC does not guarantee that the agency will be appropriated the funds. An authorization request is the first step in the SEC's lengthy budget process. Under that process, an authorization request is submitted to Congress in May of the fiscal year two years prior to the fiscal year for which the authorization is requested (*e.g.*, the FY 2012 authorization request takes place in May 2010). The following September, several months after the authorization request is made, the SEC submits a proposed budget request to the Office of Management and Budget (OMB). In November, the next step of the budget request process takes place: OMB replies to the SEC with a "pass-back," and the SEC and OMB then usually negotiate the amount of the budget request. Several months later, the President formally submits a budget proposal to Congress. Once the President makes the budget request to Congress, Congress then begins the decision-making process as to how much money to appropriate to the SEC and other agencies. SEC employees interviewed in connection with the OIG's leasing investigation acknowledged that an authorization may indicate an intention for

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Congress to provide funding, but circumstances frequently change and, therefore, federal agencies understand that until funds are appropriated, they cannot count on receiving those funds.

Notwithstanding the uncertainty of actually being appropriated the amount requested through the budget process, in May 2010, OAS began planning for an expansion at SEC Headquarters based on the agency's FY 2012 budget request. Initially, the SEC's Associate Executive Director of OAS, Sharon Sheehan, and the former Chief of OAS's Leasing Branch decided that the agency needed to lease approximately 300,000 square feet of space to accommodate the SEC's needs through FY 2012. As of May 2010, the Chief of the Leasing Branch's plan was to solicit offers from three properties within walking distance of Station Place to meet the SEC's additional space needs. However, on June 2, 2010, the Chief of the Leasing Branch received an e-mail from the real estate broker for a facility at Constitution Center, located on 7<sup>th</sup> and D Streets, SW, approximately two miles from the SEC's Station Place facility near Union Station, regarding Constitution Center's availability and some of its features.

The 1.4 million square foot Constitution Center had just been renovated in "one of the largest office redevelopment projects in Washington, DC," according to promotional literature. One of the more attractive features of the Constitution Center facility was its 5,000 square foot lobby with spacious accommodations for a guard desk(s), security screening room, shuttle elevator lobby, and display space, as well as Jerusalem limestone floors, marble walls, wood and metal paneling, decorative lighting and a floor-to-ceiling glass wall facing the landscaped courtyard. The facility promised abundant daylighting, panoramic views of the city and surrounding region, and an open plaza area that contained a one-acre private garden.

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Almost immediately after being contacted by the broker for Constitution Center, OAS decided to expand the previous delineated locality of consideration to add Constitution Center to the other three buildings that would be included in the solicitation for offers for approximately 300,000 square feet of space.

On June 17, 2010, OAS briefed SEC Chairman Mary Schapiro on its immediate expansion plans at SEC Headquarters. At that briefing, the Chief of the Leasing Branch informed the Chairman that the SEC needed to lease immediately 280,000 to 315,000 square feet of office space in Washington, D.C., and identified on a map specific locations for that expansion, including Constitution Center. Both Chairman Schapiro and her former Deputy Chief of Staff, Kayla Gillan, recalled the Chairman expressing clear preference for the locations that were within walking distance of Station Place, as opposed to the Constitution Center facility. Chairman Schapiro also questioned whether the SEC needed 300,000 additional square feet, given that she believed the SEC should concentrate its growth in the agency's regional offices.

The OIG investigation found notwithstanding Chairman Schapiro's expressions in mid-June 2010 of her preference for a facility closer to Station Place and her questioning of why the SEC needed as much as 300,000 square feet of space, by mid-July, OAS came back to the Chairman with an urgent recommendation that the SEC immediately lease 900,000 square feet of space with the only available option being the Constitution Center facility. The OIG investigation found that the analysis OAS performed to justify the need for three times its original estimate of necessary square footage, and its determination that the Constitution Center facility was the only available option, was deeply flawed and based on unfounded and unsupportable projections. We found that, as a consequence of its flawed analysis, OAS grossly

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overestimated the amount of space needed at SEC Headquarters for the SEC's projected expansion.

Specifically, the OIG investigation found that OAS erroneously assumed that all of the new positions projected for FY 2011 and FY 2012 would be allocated to SEC Headquarters and that none of those new positions would be allocated to the SEC's regional offices. This assumption was contrary to the position the Chairman had communicated to OAS at the June 17, 2010 meeting that as much as possible of the SEC's future growth should occur in the regional offices, not at Headquarters. We found that although the need for a calculation reflecting the allocation of a number of the new positions to the regions was discussed, none was ever prepared. Sheehan testified that "OAS had difficulty getting the breakout," and acknowledged that, assuming all of the new positions would be located at Headquarters would "inflate the number."

We also found that OAS conducted its analysis of the SEC's space needs by using a standard of 400 square feet per person when calculating how much space would be needed for the additional positions it believed it would gain as a result of Dodd-Frank and associated increases in the SEC's budget. A Realty Specialist in OAS explained to the OIG that the Chief of the Leasing Branch and she developed the 400 square feet standard by dividing the square footage of office space by the number of people the SEC had authority to hire for the offices in that space at Headquarters and several of the SEC's regional offices. The Realty Specialist described the standard as a "WAG" (wild-assed guess) and a "back of the envelope" calculation, and acknowledged in her OIG testimony that OAS "didn't do this scientifically." OAS's 400 square feet per-person standard was an "all-inclusive number" that included common spaces and amenities. It also included an additional 10 percent for contractors, 10 percent for interns and

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temporary staff, and five percent for future growth. Notwithstanding this “all-inclusive” number, we found that when OAS later performed its calculations to justify the Constitution Center lease, it added even more unnecessary space by double-counting contractors, interns and temporary staff and by improperly incorporating future growth into the projections of space needed. We also found that each one of these estimates was wildly inflated and unsupported by the data OAS was using.

The OIG investigation found that the OAS inflated its estimate of new positions that would require space by including an estimate of the number of contractors who would be hired in addition to the number of SEC employees. In early June 2010, OAS Associate Executive Director Sheehan asked the OAS Branch Chief for Space Management & Mail Operations to obtain information about the number of contractors in the agency. On June 12, 2010, the Branch Chief reported back, “Right now, based on the Contractor numbers I have at [Station Place], I can justify us using a 10%, Contractor to Position, factor.” The Branch Chief later learned that OAS needed the numbers to be larger. He testified as follows regarding his understanding of why the Chief of the Leasing Branch needed the number to be larger: “[W]hat I understand she was trying to do was to make sure that whatever size lease she entered into was enough to meet our needs. And I think that in this case, if we were going to take the whole building, the numbers needed to be larger.” Ultimately, OAS ignored the data that had been gathered during the first two weeks of June 2010, which indicated the correct contractor ratio was 10 percent, and inflated its calculation of space by adding contractors using a completely arbitrary 20 percent ratio.

In addition, we found that OAS’s estimate of new positions that would need space included an estimate of the number of interns and temporary staff who would be hired, in

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addition to new employees. OAS's estimate of interns and temporary staff to be hired assumed a ratio of 16.5 percent (9 percent for interns and 7.5 percent for temporary staff). However, the OIG found that OAS's estimate of intern and temporary staff positions was significantly higher than the estimate in the data it had received. On July 16, 2010, a management program analyst in the SEC's Office of Human Resources provided OAS with "the [peak] numbers [for interns and temporary staff]," which ranged from approximately 4 to 7 percent for the six fiscal years of data analyzed.

Further, the OIG investigation found that OAS's calculations increased the amount of space required for every person to be hired in FY 2011 and FY 2012 by 10 percent for "inventory" representing "vacant offices you have for expansion and unanticipated growth, that kind of thing," according to an OAS Assistant Director. However, as was the case with the estimate for contractors, temporary staff and interns, an inventory factor had already been incorporated into the calculation of the 400 square foot standard. Moreover, the 10 percent inventory factor added was double the 5 percent factor previously determined to be appropriate.

We also found that OAS's estimate of new positions that would need space included an assumption not only about FY 2011 and FY 2012, but also reflected an assumption that, in FY 2013, Congress would increase the SEC's appropriation by 50 percent of the assumed FY 2012 increase. We found that the assumption of 50 percent growth in 2013 was arbitrary and unsupported. Based on the assumed FY 2013 growth, OAS calculated that the SEC would add another 295 positions in that year and again assumed that all of those positions would be allocated to SEC Headquarters. We found that this estimate was not based upon any firm numbers or projections and was contrary to the SEC's planning and budget process, which does not project growth more than two years into the future.

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The OIG investigation found that OAS used the above-described overinflated estimates to calculate a space need of 934,000 square feet. On Friday, July 23, 2010, Executive Director Diego Ruiz met with Chairman Schapiro, Chief of Staff Didem Nisanci, and then-Deputy Chief of Staff Gillan to recommend that the SEC lease 900,000 square feet of space at Constitution Center. Gillan recalled the July 23, 2010 meeting with Ruiz, and stated that Ruiz had come to her “and said that he needed to see Mary [Schapiro] quickly because he needed to make a quick decision on Constitution Center. That the other possible space opportunities had evaporated, gone to others, were no longer available. And that this one was really all that was left and that we needed to act quickly.”

Chairman Schapiro testified as follows regarding the July 23<sup>rd</sup> meeting with Ruiz:

I remember explicitly being told there really wasn't any other space available that could fulfill our needs and that there was a time – a sense of we were about to lose this. We had lost other space that we had apparently indicated an interest in and that we were about to lose this. So there was a sense of urgency on their part.

Gillan testified that Ruiz did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC Headquarters needed an additional 900,000 square feet was predicated, in part, on the assumption that all of the agency's new positions in FY 2011 and FY 2012 would be allocated to Headquarters. Gillan testified, “[I]n fact, that's inconsistent with what I had understood, because ... [Chairman Schapiro] specifically said that, to the extent possible, she wanted new hires to go to the regions.” Gillan also testified that Ruiz did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC Headquarters needed an additional 900,000 square feet was predicated, in part, on OAS's projections of significant growth in FY 2013.



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On July 23, 2010, Ruiz sent an e-mail to Sheehan and others stating, “Met with Chairman this morning, and we have her approval to move forward.” The OIG investigation found that the SEC negotiated the contract for 900,000 square feet at Constitution Center in three business days, signing the contract on July 28, 2010. On July 27, 2010, the SEC staff involved in that negotiation discussed the fact that they had “no bargaining power” because “Sharon [Sheehan] wants this signed tomorrow.” Internal e-mails show that OAS feared losing the building to the National Aeronautics and Space Administration, which had also expressed an interest in the facility.

On July 28, 2010, the SEC executed a Letter Contract committing the SEC to lease approximately 900,000 square feet of space at Constitution Center. The contract established a multiphase delivery schedule, in which Phase 1, approximately 350,000 square feet, would be delivered no later than September 2011, and Phase 2, approximately 550,000 square feet, would be delivered no later than September 2012. The contract stated that “the SEC’s interests require that [the owner] be given a binding commitment so that the space required will be committed to the SEC and initial build out for the Phase 1 space can commence immediately ....” The lease term in the contract was ten years. The Chief of the Leasing Branch estimated the costs associated with the SEC’s leasing and occupying Constitution Center would be \$556,811,589.

The Letter Contract also granted the SEC the right of first refusal for the remaining approximately 500,000 square feet of space at Constitution Center until December 15, 2010. If the SEC had exercised this option, it would have leased the entire 1.4 million square feet of space at Constitution Center. The Chief of the Leasing Branch testified that OAS wanted a right of first refusal on all of the remaining space at Constitution Center “because the Congress was throwing money at us” and “Sharon [Sheehan] was always hoping that we wouldn’t have

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anybody else in the building. That we would be able to ultimately justify the need for the whole building or something.”

After the SEC committed itself to the ten-year lease term at a cost of \$556,811,589, it entered into a Justification and Approval for Other than Full and Open Competition, which is required by the Federal Acquisition Regulation (FAR) when an agency decides not to allow for full and open competition on a procurement or lease. The FAR permits other than full and open competition “when the agency’s need for the supplies or services is of such an unusual and compelling urgency that the Government would be **seriously injured** unless the agency is permitted to limit the number of sources from which it solicits bids or proposals.” 48 C.F.R. § 6.302-2 (emphasis added).

The OIG investigation found that the Justification and Approval to lease space at Constitution Center without competition was inadequate, not properly reviewed, and backdated. The Justification and Approval provided as follows:

To fulfill these new responsibilities it is necessary to significantly increase full-time staff and supporting contractors by approximately 2,335 personnel to be located at the SEC’s headquarters in Washington, DC. However, the SEC’s current headquarters is full. Accordingly the SEC has a requirement of an unusual and compelling urgency to obtain approximately 900,000 rentable square feet (r.s.f.) of additional headquarters space in the Washington, D.C. Central Business District, as this is the amount of space required to accommodate the approximately 2,335 new staff and contractors in headquarters.

The Justification and Approval asserted that the 900,000 square feet “must be in a single building or integrated facility to support the SEC’s functional requirements and operational efficiency.”

An OAS Management and Program Analyst signed the Justification and Approval as the SEC’s Competition Advocate. She testified that she did not take any steps to verify that the

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information in the Justification and Approval was accurate, “[o]ther than asking the contracting officer, you know, just general questions, ‘Is this indeed urgent and compelling[?].’” She further testified that when she signed the Justification and Approval, she was not aware that funding for the projected growth had not been appropriated. She also did not have an understanding of when the projected 2,335 personnel were expected to be hired. Further, she acknowledged in testimony that the SEC would, in fact, not be “seriously injured” if it lost the opportunity to rent one contiguous building and had to rent multiple buildings to fill its space needs.

The FAR also requires that a Justification and Approval for Other than Full and Open Competition be posted publicly “within 30 days after contract award.” The Letter Contract was signed on July 28, 2010. Accordingly, the deadline for publication of the Justification and Approval was August 27, 2010. On September 3, 2010, the SEC publicly posted the Justification and Approval on the Federal Business Opportunities website. The document was signed by four individuals, with all four signatures dated August 2, 2010.

However, the OIG investigation found that the Justification and Approval was not finalized until September 2, 2010, and substantial revisions were being made up to that date. We found that three of the four signatories executed the signature page on August 2, 2010, before a draft even remotely close to the final version existed. The OIG found that the SEC’s Competition Advocate executed the signature page on August 31, 2010, and initially backdated her signature to August 27, 2010, but subsequently whited-out the “7” on the date to make it appear that she also had signed the document on August 2, 2010. The actions of the signatories to the Justification and Approval gave the public the false impression that the document was finalized a few days after the Letter Contract was signed, and there was only a delay in its publication.

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The OIG investigation also found that there is significant uncertainty among the SEC staff regarding important requirements in connection with government leasing and there are serious questions as to whether the SEC complied with several of those requirements in connection with its leasing of Constitution Center. Appendix B of OMB Circular No. A-11 states, “Agencies are required to submit to OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact: Any proposed lease of a capital asset where total Government payments over the full term of the lease would exceed \$50 million.” Although the evidence showed the SEC initially contemplated providing OMB with the written notification and senior agency officials believed that OMB had been formally notified, no written notification to OMB was provided.

In addition, we found that there is a possibility that the SEC violated the Antideficiency Act in connection with its lease of Constitution Center. The Antideficiency Act prohibits officers or employees of the government from involving the government “in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.” 31 U.S.C. § 1341(a)(1)(B). The incurring of an obligation in excess or advance of appropriations violates the Antideficiency Act. Notwithstanding its July 28, 2010 commitment to a ten-year lease at Constitution Center, the SEC did not obligate the entire amount of rent payments due under the lease. Although the SEC has been granted independent leasing authority statutorily and is generally granted authority to enter into multiyear leases in its annual appropriations, the U.S. Government Accountability Office (GAO) has found that “[t]he existence of multiyear leasing authority by itself does not necessarily tell [an agency] how to record obligations under a lease.” GAO has distinguished agencies that have “specific statutory direction” to obligate funds for multiyear leases one year a time, such as the GSA, from agencies such as the Federal

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Emergency Management Agency (FEMA), which do not have such explicit direction. Because the SEC, like FEMA, does not have specific statutory direction to obligate funds for its multiyear leases on an annual basis, its lease obligations may have to be obligated in their entirety at the time they are incurred. Thus, SEC may have violated the Antideficiency Act in connection with its commitment to lease space at Constitution Center.

In early October 2010, the SEC informed the owner of the building that it could not use approximately 600,000 of the 900,000 square feet of space it had contracted for at Constitution Center and asked for the owner's assistance in finding other tenants for that space. In November 2010, the owner of the building began negotiations with the Federal Housing Finance Agency (FHFA) and the Office of the Comptroller of the Currency (OCC) to lease portions of Constitution Center. In January 2011, OCC and FHFA entered into contracts for space at Constitution Center, leaving approximately 350,000 square feet to which the SEC remains committed. On January 18, 2011, counsel for the building owner sent a demand letter to the SEC, asserting that the SEC's actions had caused him to incur \$93,979,493 in costs at Constitution Center.

The OIG investigation further found that a "closed" and "rigid" atmosphere within OAS may have contributed to the irresponsible decisions made with respect to the Constitution Center lease. In the course of this OIG investigation, several witnesses who sought to remain anonymous came forward to the OIG to provide information concerning the environment and the decision-making processes within OAS. These witnesses described an environment in which inexperienced senior management make unwise decisions without any input from employees who have significant knowledge and experience. We found that questioning of upper management decisions by the staff is "not allowed" and that OAS Executive Director Sheehan

surrounds herself with “yes-men” and “does not want to hear what [experienced staff] will tell her.” These individuals testified that upon learning of the SEC’s decision to lease 900,000 square feet of space at Constitution Center, they “just couldn’t understand how [OAS] could justify that amount of space ...” and were “flabbergasted” by the decisions. One experienced employee testified that OAS management had “grandiose plans” and was significantly influenced by the upscale nature of the facility.

### **Recommendations of the OIG’s Report of Investigation**

We provided our Report of Investigation to the SEC with the recommendation that the newly-appointed Chief Operating Officer/Executive Director carefully review the report’s findings and conduct a thorough and comprehensive review and assessment of all matters currently under the purview of OAS. We further recommend that the Chief Operating Officer/Executive Director, upon conclusion of such review and assessment, determine the appropriate disciplinary and/or performance-based action to be taken for matters that relate to subject of the report of investigation, including, at a minimum, consideration of disciplinary action against two individuals, up to and including dismissal, and consideration of disciplinary action against a third individual.

We also recommended that the SEC request a formal opinion from the Comptroller General as to whether the Commission violated the Antideficiency Act by failing to obligate appropriate funds for the Constitution Center lease.

My Office is committed to following up with respect to all of the recommendations we made in our Report of Investigation to ensure that appropriate changes and improvements are made in the SEC’s leasing operations as a result of our findings.

### Conclusion

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our leasing report. I believe that the Subcommittee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.

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**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Economic Development, Public Buildings and  
Emergency Management Subcommittee of the Committee on  
Transportation and Infrastructure,  
U.S. House of Representatives**

**Wednesday, July 6, 2011  
2:00 p.m.**

### Introduction

Thank you for the opportunity to testify before this Subcommittee on the lease of Constitution Center by the U.S. Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the Chairman, the Ranking Member, and the other members of the Subcommittee, in the SEC and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

### Role of and Reports Issued by the OIG

The mission of the OIG is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The OIG's audit unit conducts, coordinates and supervises independent audits and evaluations related to the internal programs and operations of the Commission. The Office's investigations unit conducts thorough and independent investigations in response to allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff and contractors.

Over the past three and one-half years since I became the Inspector General of the SEC, my Office has issued numerous audits and investigative reports involving matters critical to SEC programs and operations and the investing public. On the audit side, some of the significant reports we have issued have included an examination of the Commission's oversight of Bear Stearns and the factors that led to its collapse, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's compliance with Homeland Security Presidential Directive 12 and its oversight of the Securities Investment Protection Corporation's activities. Investigative reports issued during this same period have addressed a myriad of issues, including the failures of the SEC to uncover the

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Bernard Madoff \$50 billion Ponzi scheme and the Robert Allen Stanford \$8 billion alleged Ponzi scheme, improper securities trading by Commission employees, conflicts of interest by Commission staff members, post-employment violations, unauthorized disclosure of nonpublic information, and procurement violations.

Many of the reports we have issued have identified costs savings, including questioned costs and funds that could be put to better use. The OIG has calculated that for the period from October 1, 2009 through June 30, 2011, the return on investment for the OIG (*i.e.*, total identified costs savings divided by the OIG's budget) is 64.2 to 1.

### **The OIG's Leasing Investigation**

On June 16, 2011, I testified before this Subcommittee about a May 16, 2011 report of investigation we issued into the circumstances surrounding the SEC's decision to lease approximately 900,000 square feet of office space at a newly-renovated office building known as Constitution Center.

As described in my previous testimony, we opened our investigation on November 16, 2010, as a result of receiving numerous written complaints concerning the SEC's decisions and actions relating to Constitution Center. These complaints alleged that the decision to lease space at Constitution Center was ill-conceived, resulted from poor management practices, and was made without Congressional funding for the significant projected growth necessary to support the decision.

My previous testimony described in detail our investigative efforts, including the review of over 1.5 million e-mails during the course of the investigation and the testimony or interviews of 29 individuals with knowledge of facts or circumstances surrounding the SEC's leasing activities.

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I also testified concerning the results of our investigation, which found that the circumstances surrounding the SEC's entering into a lease for 900,000 square feet of space at the Constitution Center facility in July 2010 were part of a long history of missteps and misguided leasing decisions made by the SEC since it was granted independent leasing authority by Congress in 1990. The investigation further found that based upon estimates of increased funding, primarily to meet the anticipated requirements of financial reform legislation that was enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), between June and July 2010, the SEC's Office of Administrative Services (OAS) conducted a deeply flawed and unsound analysis to justify the need for the SEC to lease 900,000 square feet of space at the Constitution Center facility. Specifically, we found that OAS grossly overestimated (by more than 300 percent) the amount of space needed for the SEC's projected expansion and used these groundless and unsupportable figures to justify the SEC's commitment to an expenditure of approximately \$557 million over 10 years.

In my earlier testimony, I also described how the OIG investigation found that OAS prepared a faulty Justification and Approval document to support entering into the lease for the Constitution Center facility without full and open competition. We determined that this Justification and Approval document was prepared after the SEC had already signed the contract to lease the Constitution Center facility. Further, we found that OAS backdated the Justification and Approval, thereby creating the false impression that it had been prepared only a few days after the SEC entered into the lease when, in actuality, the Justification and Approval was not finalized until a month later. Additional details regarding the findings of our leasing investigation were provided in my June 16, 2011 testimony, as well as in the 91-page report of investigation with over 150 exhibits, which has been provided to the Subcommittee.

### Recommendations of the OIG's Leasing Investigation

Our report of investigation made numerous recommendations designed to ensure that the requisite improvements to policies and procedures are made and that appropriate disciplinary action is taken. Specifically, we recommended that the SEC's Chief Operating Officer carefully review the report's findings and conduct a thorough and comprehensive review and assessment of all matters currently under the purview of OAS including, but not limited to:

- (1) The adequacy of written policies and procedures currently in place for all aspects of the SEC's leasing program, including, but not limited to, putting in place written procedures for leasing approvals;
- (2) The methods and processes utilized to accurately project spacing needs based on concrete and supportable data;
- (3) The determination to employ a standard of 400 square feet per person for planning agency space needs;
- (4) The necessity of retaining architects, furniture brokers, or other consultants to assist in the work generally performed by OAS officials; and
- (5) All pending decisions in which OAS is committing the SEC to expend funds, including decisions relating to regional office lease renewals.

We further recommended that the Chief Operating Officer, upon conclusion of this review and assessment, determine the appropriate disciplinary and/or performance-based action to be taken for matters related to the findings in this report of investigation, as well as other issues identified during the review and assessment. We specified that such disciplinary action should include, at a minimum, consideration of disciplinary action, up to and including dismissal, against two senior individuals, and consideration of disciplinary action against a third individual, for their actions in connection with the gross overestimation of the amount of space needed at SEC Headquarters for the SEC's projected expansion, failures to provide complete and

accurate information to the Chairman's office, and the preparation of a faulty and back-dated Justification and Approval to support eliminating competition.

Finally, we recommended that the Office of Financial Management, in consultation with the Office of General Counsel, request a formal opinion from the Comptroller General as to whether the Commission violated the Antideficiency Act, by failing to obligate appropriate funds for the Constitution Center lease.

### **Follow-Up Efforts**

My Office is committed to following up with respect to all of the recommendations we made in our report of investigation to ensure that appropriate changes and improvements are made in the SEC's leasing operations as a result of our findings.

Subsequent to the issuance of our report of investigation on May 16, 2011, my Office has requested and received a corrective action plan with regard to the substantive recommendations we made for improvements in the operations of the Office of Administrative Services. We will monitor the planned activities carefully to ensure that the necessary improvements are made. We have also communicated with the SEC's Office of General Counsel with regard to its review of the evidentiary record to determine appropriate disciplinary action, and have provided the Office of General Counsel with records requested to assist in those efforts. We intend to monitor the disciplinary process to ensure that the individuals who we identified as being responsible for the failures and improprieties described in our report are held appropriately accountable for their actions.

In addition to these efforts, we have met with the newly-installed acting head of the Office of Administrative Services to provide additional information concerning the failings and deficiencies we have identified in that Office. As a result of this briefing, a large renovation

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project that had been initiated by the previous head of the Office of Administrative Services has been discontinued.

We understand that the Chief Operating Officer, under the direction of Chairman Schapiro, has already begun to implement the improvements needed in the SEC's leasing functions. We are confident that under Chairman Schapiro's leadership, the SEC will continue to review our report and take appropriate steps to implement our recommendations and ensure that fundamental changes are made in the SEC's leasing operations so the errors and failings we found in our investigation are remedied and not repeated in the future.

### **Conclusion**

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our leasing report. I believe that the Subcommittee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.

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**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Federal Financial Management, Government  
Information, Federal Services, and International Security  
Subcommittee of the U.S. Senate Committee on  
Homeland Security and Government Affairs**

**Thursday, August 4, 2011  
2:30 p.m.**

### Introduction

Thank you for the opportunity to testify before this Subcommittee on the subject of “Federal Leased Property: Are Federal Agencies Getting a Bad Deal?” as the Inspector General of the U.S. Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the Chairman, the Ranking Member, and the other members of the Subcommittee, in the SEC and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks by briefly discussing the role of my Office and the oversight efforts we have undertaken during the past few years. The mission of the OIG is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC OIG includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates, and supervises independent audits and evaluations related to the Commission’s internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules, and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office’s investigations unit responds to allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or

full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation, as appropriate.

### **Audit Reports**

Over the past three and one-half years since I became the Inspector General of the SEC, our audit unit has issued numerous reports involving matters critical to SEC programs and operations and the investing public. These reports have included an examination of the Commission's oversight of the Bear Stearns Companies, Inc. and the factors that led to its collapse, an audit of the Division of Enforcement's (Enforcement) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's compliance with Homeland Security Presidential Directive 12 and its oversight of the Securities Investment Protection Corporation's activities. In addition, in March 2009, we conducted a review of an agency restacking project in which over \$3 million was expended to relocate approximately 1,750 SEC employees in its headquarters building and, in September 2010, we completed an audit of the SEC's real property and leasing procurement process.

### **Investigative Reports**

The Office's investigations unit has conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as investigations of allegations of violations of statutes, rules, and regulations, and other

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misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the Commission, Members of Congress, and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removal of employees from the federal service, as well as recommendations for improvements in agency policies, procedures, and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of failures by Enforcement to pursue investigations vigorously or in a timely manner, improper securities trading by Commission employees, conflicts of interest by Commission staff members, post-employment violations, unauthorized disclosure of nonpublic information, procurement violations, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, failure of SEC attorneys to maintain active bar status, falsification of federal documents and compensatory time for travel, abusive conduct, and the misuse of official position and government resources.

In August 2009, we issued a 457-page report of investigation analyzing the reasons why the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. In March 2010, we issued a 151-page report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's \$8 billion alleged Ponzi scheme. Most recently, on May 16, 2011, we issued a comprehensive and thorough report of investigation into the circumstances surrounding the SEC's decision to lease approximately 900,000 square feet of office space at a newly-renovated office building known as Constitution Center, which is the subject of this hearing.

### Commencement and Conduct of the OIG's Leasing Investigation

On November 16, 2010, the OIG opened an investigation as a result of receiving numerous written complaints concerning the SEC's decisions and actions relating to the leasing of office space at the Constitution Center office building in Washington, D.C. These complaints alleged that the decision to lease space at Constitution Center was ill-conceived, resulted from poor management practices, and was made without Congressional funding for the significant projected growth necessary to support the decision.

As part of our investigative efforts, we took the sworn testimony of 18 witnesses in the investigation and interviewed 11 other individuals with knowledge of facts or circumstances surrounding the SEC's leasing of this space.

We made numerous requests to the SEC's Office of Information Technology (OIT) for the e-mails of current and former SEC employees for various periods of time pertinent to the investigation. The e-mails were received, loaded onto computers with specialized search tools, and searched on a continuous basis throughout the course of our investigation. In all, OIT provided e-mails for a total of 27 current and former SEC employees for various time periods pertinent to the investigation. We estimate that we obtained and searched over 1.5 million e-mails during the course of the investigation.

We also made several requests to the SEC's Office of Administrative Services (OAS), which oversees the SEC's leasing function, for documents relating to its leasing practices. We carefully reviewed and analyzed the information we received as a result of our document requests. These documents included all records relating to the Constitution Center lease, as well as documents relating to the leasing of additional office space by the SEC for the past several years.

### **Issuance of Comprehensive Report of Investigation in Leasing Matter**

On May 16, 2011, we issued to the Chairman of the SEC a comprehensive report of our investigation in the leasing matter that contained over 90 pages of analysis and more than 150 exhibits. The report of investigation detailed all of the SEC's recent leasing-related decisions and analyzed all of the facts and circumstances that led to the SEC's decision to lease space at Constitution Center.

### **Results of the OIG's Leasing Investigation**

The OIG investigation found that the circumstances surrounding the SEC's entering into a lease for 900,000 square feet of space at the Constitution Center facility in July 2010 were part of a long history of missteps and misguided leasing decisions made by the SEC since it was granted independent leasing authority by Congress in 1990. The OIG investigation further found that based upon estimates of increased funding, primarily to meet the anticipated requirements of financial reform legislation that was enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), between June and July 2010, OAS conducted a deeply flawed and unsound analysis to justify the need for the SEC to lease 900,000 square feet of space at the Constitution Center facility. We found that OAS grossly overestimated (by more than 300 percent) the amount of space needed for the SEC's projected expansion and used these groundless and unsupportable figures to justify the SEC's commitment to an expenditure of approximately \$557 million over 10 years.

The OIG investigation also found that OAS prepared a faulty Justification and Approval document to support entering into the lease for the Constitution Center facility without competition. This Justification and Approval document was prepared after the SEC had already signed the contract to lease the Constitution Center facility. Further, OAS backdated the

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Justification and Approval, thereby creating the false impression that it had been prepared only a few days after the SEC entered into the lease. In actuality, the Justification and Approval was not finalized until a month later.

A brief summary of our specific findings is set forth as follows. In 1990, Congress provided the SEC with independent leasing authority, which exempted the SEC from General Services Administration (GSA) regulations and directives. See 15 U.S.C. § 78d(b)(3). The House Conference Report for this legislation expressed the clear intention that “the authority granted the Commission to lease its own office space directly will be exercised vigorously by the Commission to achieve actual cost savings and to increase the Commission’s productivity and efficiency.” H.R. Conf. Rep. 101-924, 101<sup>st</sup> Cong, 2d Sess. 1990 at 20.

Subsequent to Congress’s granting of independent leasing authority to the SEC, several expensive missteps related to the SEC’s leasing actions and management of its space have occurred. For example, in May 2005, the SEC disclosed to a House Subcommittee that it had identified unbudgeted costs of approximately \$48 million attributable to misestimates and omissions of costs associated with the construction of its headquarters facilities near Union Station, known as Station Place One and Two. In 2007, merely a year after moving into its new headquarters, the SEC embarked on a major “restacking” project pursuant to which various SEC employees were shuffled to different office spaces in the same buildings at a cost of over \$3 million. An OIG audit of that project found that there was no record of a cost-benefit analysis having been conducted before this undertaking. An OIG survey found that an overwhelming majority of Commission staff affected by the restacking project had been satisfied with the location of their workspace before that project was initiated, and did not believe the project’s benefits were worth the cost and time of construction, packing, moving, and unpacking.

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The OIG investigation further found that, as a result of a mistaken belief that the SEC would receive significant additional funding, OAS made grandiose plans to lease the upscale facility at Constitution Center. On May 14, 2010, the SEC submitted an authorization request to the Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, requesting \$1.507 billion for Fiscal Year (FY) 2012 to fund an increase of 800 new staff positions. On May 20, 2010, the U.S. Senate passed a version of the financial regulatory reform bill that eventually became Dodd-Frank (the U.S. House of Representatives had passed a version of the legislation on December 11, 2009). The SEC estimated that it would need to add another 800 positions in FY 2011 and FY 2012 to implement Dodd-Frank. After the reconciliation process between the two versions of the financial regulatory reform bills, Dodd-Frank became law on July 21, 2010.

Authorization of funding for an executive agency like the SEC does not guarantee that the agency will be appropriated the funds. An authorization request is the first step in the SEC's lengthy budget process. Under that process, an authorization request is submitted to Congress in May of the fiscal year two years prior to the fiscal year for which the authorization is requested (*e.g.*, the FY 2012 authorization request takes place in May 2010). The following September, several months after the authorization request is made, the SEC submits a proposed budget request to the Office of Management and Budget (OMB). In November, the next step of the budget request process takes place: OMB replies to the SEC with a "pass-back," and the SEC and OMB then usually negotiate the amount of the budget request. Several months later, the President formally submits a budget proposal to Congress. Once the President makes the budget request to Congress, Congress then begins the decision-making process as to how much money to appropriate to the SEC and other agencies. SEC employees interviewed in connection with the OIG's leasing investigation acknowledged that an authorization may indicate an intention for



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Congress to provide funding, but circumstances frequently change and, therefore, federal agencies understand that until funds are appropriated, they cannot count on receiving those funds.

Notwithstanding the uncertainty of actually being appropriated the amount requested through the budget process, in May 2010, OAS began planning for an expansion at SEC Headquarters based on the agency's FY 2012 budget request. Initially, the SEC's Associate Executive Director of OAS, Sharon Sheehan, and the former Chief of OAS's Leasing Branch decided that the agency needed to lease approximately 300,000 square feet of space to accommodate the SEC's needs through FY 2012. As of May 2010, the Chief of the Leasing Branch's plan was to solicit offers from three properties within walking distance of Station Place to meet the SEC's additional space needs. However, on June 2, 2010, the Chief of the Leasing Branch received an e-mail from the real estate broker for a facility at Constitution Center, located on 7<sup>th</sup> and D Streets, SW, approximately two miles from the SEC's Station Place facility near Union Station, regarding Constitution Center's availability and some of its features.

The 1.4 million square foot Constitution Center had just been renovated in "one of the largest office redevelopment projects in Washington, DC," according to promotional literature. One of the more attractive features of the Constitution Center facility was its 5,000 square foot lobby with spacious accommodations for a guard desk(s), security screening room, shuttle elevator lobby, and display space, as well as Jerusalem limestone floors, marble walls, wood and metal paneling, decorative lighting and a floor-to-ceiling glass wall facing the landscaped courtyard. The facility promised abundant daylighting, panoramic views of the city and surrounding region, and an open plaza area that contained a one-acre private garden.

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Almost immediately after being contacted by the broker for Constitution Center, OAS decided to expand the previous delineated locality of consideration to add Constitution Center to the other three buildings that would be included in the solicitation for offers for approximately 300,000 square feet of space.

On June 17, 2010, OAS briefed SEC Chairman Mary Schapiro on its immediate expansion plans at SEC Headquarters. At that briefing, the Chief of the Leasing Branch informed the Chairman that the SEC needed to lease immediately 280,000 to 315,000 square feet of office space in Washington, D.C., and identified on a map specific locations for that expansion, including Constitution Center. Both Chairman Schapiro and her former Deputy Chief of Staff, Kayla Gillan, recalled the Chairman expressing clear preference for the locations that were within walking distance of Station Place, as opposed to the Constitution Center facility. Chairman Schapiro also questioned whether the SEC needed 300,000 additional square feet, given that she believed the SEC should concentrate its growth in the agency's regional offices.

The OIG investigation found notwithstanding Chairman Schapiro's expressions in mid-June 2010 of her preference for a facility closer to Station Place and her questioning of why the SEC needed as much as 300,000 square feet of space, by mid-July, OAS came back to the Chairman with an urgent recommendation that the SEC immediately lease 900,000 square feet of space with the only available option being the Constitution Center facility. The OIG investigation found that the analysis OAS performed to justify the need for three times its original estimate of necessary square footage, and its determination that the Constitution Center facility was the only available option, was deeply flawed and based on unfounded and unsupportable projections. We found that, as a consequence of its flawed analysis, OAS grossly

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overestimated the amount of space needed at SEC Headquarters for the SEC's projected expansion.

Specifically, the OIG investigation found that OAS erroneously assumed that all of the new positions projected for FY 2011 and FY 2012 would be allocated to SEC Headquarters and that none of those new positions would be allocated to the SEC's regional offices. This assumption was contrary to the position the Chairman had communicated to OAS at the June 17, 2010 meeting that as much as possible of the SEC's future growth should occur in the regional offices, not at Headquarters. We found that although the need for a calculation reflecting the allocation of a number of the new positions to the regions was discussed, none was ever prepared. Sheehan testified that "OAS had difficulty getting the breakout," and acknowledged that, assuming all of the new positions would be located at Headquarters would "inflate the number."

We also found that OAS conducted its analysis of the SEC's space needs by using a standard of 400 square feet per person when calculating how much space would be needed for the additional positions it believed it would gain as a result of Dodd-Frank and associated increases in the SEC's budget. A Realty Specialist in OAS explained to the OIG that the Chief of the Leasing Branch and she developed the 400 square feet standard by dividing the square footage of office space by the number of people the SEC had authority to hire for the offices in that space at Headquarters and several of the SEC's regional offices. The Realty Specialist described the standard as a "WAG" (wild-assed guess) and a "back of the envelope" calculation, and acknowledged in her OIG testimony that OAS "didn't do this scientifically." OAS's 400 square feet per-person standard was an "all-inclusive number" that included common spaces and amenities. It also included an additional 10 percent for contractors, 10 percent for interns and

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temporary staff, and five percent for future growth. Notwithstanding this “all-inclusive” number, we found that when OAS later performed its calculations to justify the Constitution Center lease, it added even more unnecessary space by double-counting contractors, interns and temporary staff and by improperly incorporating future growth into the projections of space needed. We also found that each one of these estimates was wildly inflated and unsupported by the data being used by OAS.

The OIG investigation found that OAS inflated its estimate of new positions that would require space by including an estimate of the number of contractors who would be hired in addition to the number of SEC employees. In early June 2010, OAS Associate Executive Director Sheehan asked the OAS Branch Chief for Space Management & Mail Operations to obtain information about the number of contractors in the agency. On June 12, 2010, the Branch Chief reported back, “Right now, based on the Contractor numbers I have at [Station Place], I can justify us using a 10%, Contractor to Position, factor.” The Branch Chief later learned that OAS needed the numbers to be larger. He testified as follows regarding his understanding of why the Chief of the Leasing Branch needed the number to be larger: “[W]hat I understand she was trying to do was to make sure that whatever size lease she entered into was enough to meet our needs. And I think that in this case, if we were going to take the whole building, the numbers needed to be larger.” Ultimately, OAS ignored the data that had been gathered during the first two weeks of June 2010, which indicated the correct contractor ratio was 10 percent, and inflated its calculation of space by adding contractors using a completely arbitrary 20 percent ratio.

In addition, we found that OAS’s estimate of new positions that would need space included an estimate of the number of interns and temporary staff who would be hired, in

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addition to new employees. OAS's estimate of interns and temporary staff to be hired assumed a ratio of 16.5 percent (9 percent for interns and 7.5 percent for temporary staff). However, the OIG found that OAS's estimate of intern and temporary staff positions was significantly higher than the estimate in the data it had received. On July 16, 2010, a management program analyst in the SEC's Office of Human Resources provided OAS with "the [peak] numbers [for interns and temporary staff]," which ranged from approximately 4 to 7 percent for the six fiscal years of data analyzed.

Further, the OIG investigation found that OAS's calculations increased the amount of space required for every person to be hired in FY 2011 and FY 2012 by 10 percent for "inventory" representing "vacant offices you have for expansion and unanticipated growth, that kind of thing," according to an OAS Assistant Director. However, as was the case with the estimate for contractors, temporary staff and interns, an inventory factor had already been incorporated into the calculation of the 400 square foot standard. Moreover, the 10 percent inventory factor added was double the 5 percent factor previously determined to be appropriate.

We also found that OAS's estimate of new positions that would need space included an assumption not only about FY 2011 and FY 2012, but also reflected an assumption that, in FY 2013, Congress would increase the SEC's appropriation by 50 percent of the assumed FY 2012 increase. We found that the assumption of 50 percent growth in 2013 was arbitrary and unsupported. Based on the assumed FY 2013 growth, OAS calculated that the SEC would add another 295 positions in that year and again assumed that all of those positions would be allocated to SEC Headquarters. We found that this estimate was not based upon any firm numbers or projections and was contrary to the SEC's planning and budget process, which does not project growth more than two years into the future.

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The OIG investigation found that OAS used the above-described overinflated estimates to calculate a space need of 934,000 square feet. On Friday, July 23, 2010, Executive Director Diego Ruiz met with Chairman Schapiro, Chief of Staff Didem Nisanci, and then-Deputy Chief of Staff Gillan to recommend that the SEC lease 900,000 square feet of space at Constitution Center. Gillan recalled the July 23, 2010 meeting with Ruiz, and stated that Ruiz had come to her “and said that he needed to see Mary [Schapiro] quickly because he needed to make a quick decision on Constitution Center. That the other possible space opportunities had evaporated, gone to others, were no longer available. And that this one was really all that was left and that we needed to act quickly.”

Chairman Schapiro testified as follows regarding the July 23<sup>rd</sup> meeting with Ruiz:

I remember explicitly being told there really wasn't any other space available that could fulfill our needs and that there was a time – a sense of we were about to lose this. We had lost other space that we had apparently indicated an interest in and that we were about to lose this. So there was a sense of urgency on their part.

Gillan testified that Ruiz did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC Headquarters needed an additional 900,000 square feet was predicated, in part, on the assumption that all of the agency's new positions in FY 2011 and FY 2012 would be allocated to Headquarters. Gillan testified, “[I]n fact, that's inconsistent with what I had understood, because ... [Chairman Schapiro] specifically said that, to the extent possible, she wanted new hires to go to the regions.” Gillan also testified that Ruiz did not explain in the July 23, 2010 meeting, or at any other time, that the assertion that SEC Headquarters needed an additional 900,000 square feet was predicated, in part, on OAS's projections of significant growth in FY 2013.

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On July 23, 2010, Ruiz sent an e-mail to Sheehan and others stating, “Met with Chairman this morning, and we have her approval to move forward.” The OIG investigation found that the SEC negotiated the contract for 900,000 square feet at Constitution Center in three business days, signing the contract on July 28, 2010. On July 27, 2010, the SEC staff involved in that negotiation discussed the fact that they had “no bargaining power” because “Sharon [Sheehan] wants this signed tomorrow.” Internal e-mails show that OAS feared losing the building to the National Aeronautics and Space Administration, which had also expressed an interest in the facility.

On July 28, 2010, the SEC executed a Letter Contract committing the SEC to lease approximately 900,000 square feet of space at Constitution Center. The contract established a multiphase delivery schedule, in which Phase 1, approximately 350,000 square feet, would be delivered no later than September 2011, and Phase 2, approximately 550,000 square feet, would be delivered no later than September 2012. The contract stated that “the SEC’s interests require that [the owner] be given a binding commitment so that the space required will be committed to the SEC and initial build out for the Phase 1 space can commence immediately . . . .” The lease term in the contract was ten years. The Chief of the Leasing Branch estimated the costs associated with the SEC’s leasing and occupying Constitution Center would be \$556,811,589.

The Letter Contract also granted the SEC the right of first refusal for the remaining approximately 500,000 square feet of space at Constitution Center until December 15, 2010. If the SEC had exercised this option, it would have leased the entire 1.4 million square feet of space at Constitution Center. The Chief of the Leasing Branch testified that OAS wanted a right of first refusal on all of the remaining space at Constitution Center “because the Congress was throwing money at us” and “Sharon [Sheehan] was always hoping that we wouldn’t have

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anybody else in the building. That we would be able to ultimately justify the need for the whole building or something.”

After the SEC committed itself to the ten-year lease term at a cost of \$556,811,589, it entered into a Justification and Approval for Other than Full and Open Competition, which is required by the Federal Acquisition Regulation (FAR) when an agency decides not to allow for full and open competition on a procurement or lease. The FAR permits other than full and open competition “when the agency’s need for the supplies or services is of such an unusual and compelling urgency that the Government would be **seriously injured** unless the agency is permitted to limit the number of sources from which it solicits bids or proposals.” 48 C.F.R. § 6.302-2 (emphasis added).

The OIG investigation found that the Justification and Approval to lease space at Constitution Center without competition was inadequate, not properly reviewed, and backdated. The Justification and Approval provided as follows:

To fulfill these new responsibilities it is necessary to significantly increase full-time staff and supporting contractors by approximately 2,335 personnel to be located at the SEC’s headquarters in Washington, DC. However, the SEC’s current headquarters is full. Accordingly the SEC has a requirement of an unusual and compelling urgency to obtain approximately 900,000 rentable square feet (r.s.f.) of additional headquarters space in the Washington, D.C. Central Business District, as this is the amount of space required to accommodate the approximately 2,335 new staff and contractors in headquarters.

The Justification and Approval asserted that the 900,000 square feet “must be in a single building or integrated facility to support the SEC’s functional requirements and operational efficiency.”

An OAS Management and Program Analyst signed the Justification and Approval as the SEC’s Competition Advocate. She testified that she did not take any steps to verify that the information in the Justification and Approval was accurate, “[o]ther than asking the contracting



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officer, you know, just general questions, ‘Is this indeed urgent and compelling[?]’” She further testified that when she signed the Justification and Approval, she was not aware that funding for the projected growth had not been appropriated. She also did not have an understanding of when the projected 2,335 personnel were expected to be hired. Further, she acknowledged in testimony that the SEC would, in fact, not be “seriously injured” if it lost the opportunity to rent one contiguous building and had to rent multiple buildings to fill its space needs.

The FAR also requires that a Justification and Approval for Other than Full and Open Competition be posted publicly “within 30 days after contract award.” The Letter Contract was signed on July 28, 2010. Accordingly, the deadline for publication of the Justification and Approval was August 27, 2010. However, the SEC did not publicly post the Justification and Approval on the Federal Business Opportunities website until September 3, 2010. The document was signed by four individuals, with all four signatures dated August 2, 2010.

However, the OIG investigation found that the Justification and Approval was not finalized until September 2, 2010, and substantial revisions were being made up to that date. We found that three of the four signatories executed the signature page on August 2, 2010, before a draft even remotely close to the final version existed. The OIG found that the SEC’s Competition Advocate executed the signature page on August 31, 2010, and initially backdated her signature to August 27, 2010, but subsequently whited-out the “7” on the date to make it appear that she also had signed the document on August 2, 2010. The actions of the signatories to the Justification and Approval gave the public the false impression that the document was finalized a few days after the Letter Contract was signed, and that there was only a delay in its publication.

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The OIG investigation also found that there is significant uncertainty among the SEC staff regarding important requirements in connection with government leasing and there are serious questions as to whether the SEC complied with several of those requirements in connection with its leasing of Constitution Center. Appendix B of OMB Circular No. A-11 states, “Agencies are required to submit to OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact: Any proposed lease of a capital asset where total Government payments over the full term of the lease would exceed \$50 million.” Although the evidence showed the SEC initially contemplated providing OMB with the written notification and senior agency officials believed that OMB had been formally notified, no written notification to OMB was provided.

In addition, we found that there is a possibility that the SEC violated the Antideficiency Act in connection with its lease of Constitution Center. The Antideficiency Act prohibits officers or employees of the government from involving the government “in a contract or obligation for the payment of money before an appropriation is made unless authorized by law.” 31 U.S.C. § 1341(a)(1)(B). The incurring of an obligation in excess or advance of appropriations violates the Antideficiency Act. Notwithstanding its July 28, 2010 commitment to a ten-year lease at Constitution Center, the SEC did not obligate the entire amount of rent payments due under the lease. Although the SEC has been granted independent leasing authority statutorily and is generally granted authority to enter into multiyear leases in its annual appropriations, the U.S. Government Accountability Office (GAO) has found that “[t]he existence of multiyear leasing authority by itself does not necessarily tell [an agency] how to record obligations under a lease.” GAO has distinguished agencies that have “specific statutory direction” to obligate funds for multiyear leases one year a time, such as the GSA, from agencies such as the Federal Emergency

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Management Agency (FEMA), which do not have such explicit direction. Because the SEC, like FEMA, does not have specific statutory direction to obligate funds for its multiyear leases on an annual basis, its lease obligations may have to be obligated in their entirety at the time they are incurred. Thus, SEC may have violated the Antideficiency Act in connection with its commitment to lease space at Constitution Center.

In early October 2010, the SEC informed the owner of the building that it could not use approximately 600,000 of the 900,000 square feet of space it had contracted for at Constitution Center and asked for the owner's assistance in finding other tenants for that space. In November 2010, the owner of the building began negotiations with the Federal Housing Finance Agency (FHFA) and the Office of the Comptroller of the Currency (OCC) to lease portions of Constitution Center. In January 2011, OCC and FHFA entered into contracts for space at Constitution Center, leaving approximately 350,000 square feet to which the SEC remains committed. On January 18, 2011, counsel for the building owner sent a demand letter to the SEC, asserting that the SEC's actions had caused him to incur \$93,979,493 in costs at Constitution Center.

The OIG investigation further found that a "closed" and "rigid" atmosphere within OAS may have contributed to the irresponsible decisions made with respect to the Constitution Center lease. In the course of this OIG investigation, several witnesses who sought to remain anonymous came forward to the OIG to provide information concerning the environment and the decision-making processes within OAS. These witnesses described an environment in which inexperienced senior management make unwise decisions without any input from employees who have significant knowledge and experience. We found that questioning of upper management decisions by the staff is "not allowed" and that OAS Executive Director Sheehan

surrounds herself with “yes-men” and “does not want to hear what [experienced staff] will tell her.” These individuals testified that upon learning of the SEC’s decision to lease 900,000 square feet of space at Constitution Center, they “just couldn’t understand how [OAS] could justify that amount of space ...” and were “flabbergasted” by the decisions. One experienced employee testified that OAS management had “grandiose plans” and was significantly influenced by the upscale nature of the facility.

### **Recommendations of the OIG’s Leasing Investigation**

Our Report of Investigation made numerous recommendations designed to ensure that the requisite improvements to policies and procedures are made and that appropriate disciplinary action is taken. Specifically, we recommended that the Chief Operating Officer carefully review the report’s findings and conduct a thorough and comprehensive review and assessment of all matters currently under the purview of OAS including, but not limited to:

- (1) The adequacy of written policies and procedures currently in place for all aspects of the SEC’s leasing program, including, but not limited to, putting in place written procedures for leasing approvals;
- (2) The methods and processes utilized to accurately project spacing needs based on concrete and supportable data;
- (3) The determination to employ a standard of 400 square feet per person for planning agency space needs;
- (4) The necessity of retaining architects, furniture brokers, or other consultants to assist in the work generally performed by OAS officials; and
- (5) All pending decisions in which OAS is committing the SEC to expend funds, including decisions relating to regional office lease renewals.

We further recommended that the Chief Operating Officer, upon conclusion of this review and assessment, determine the appropriate disciplinary and/or performance-based action to be taken for matters related to subject of this report of investigation, as well as other issues identified during the review and assessment. We specified that such disciplinary action should

include, at a minimum, consideration of disciplinary action, up to and including dismissal, against two senior individuals, and consideration of disciplinary action against a third individual, for their actions in connection with the gross overestimation of the amount of space needed at SEC Headquarters for the SEC's projected expansion, failures to provide complete and accurate information to the Chairman's office, and the preparation of a faulty and back-dated Justification and Approval to support eliminating competition.

Finally, we recommended that the Office of Financial Management, in consultation with the Office of General Counsel, request a formal opinion from the Comptroller General as to whether the Commission violated the Antideficiency Act, by failing to obligate appropriate funds for the Constitution Center lease.

### **Follow-Up Efforts**

My Office is committed to following up with respect to all of the recommendations we made in our Report of Investigation to ensure that appropriate changes and improvements are made in the SEC's leasing operations as a result of our findings.

Subsequent to the issuance of our Report of Investigation on May 16, 2011, my Office received a corrective action plan with regard to the substantive recommendations we made for improvements in the operations of the Office of Administrative Services. We are also monitoring the planned activities carefully to ensure that the necessary improvements have been made. We have communicated with the SEC's Office of General Counsel with regard to its review of the evidentiary record to determine appropriate disciplinary action, and have provided the Office of General Counsel with records requested to assist in those efforts. We are monitoring the disciplinary process to ensure that the individuals who we identified as being

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responsible for the failures and improprieties described in our report are held appropriately accountable for their actions.

We understand that the Chief Operating Officer, under the direction of Chairman Schapiro, has already begun to implement the improvements needed in the SEC's leasing functions. We are confident that under Chairman Schapiro's leadership, the SEC will continue to review our report and take appropriate steps to implement our recommendations and ensure that fundamental changes are made in the SEC's leasing operations so the errors and failings we found in our investigation are remedied and not repeated in the future.

### **Conclusion**

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our leasing report. I believe that the Subcommittee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.

**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Subcommittee on Oversight and Investigations,  
Committee on Financial Services, and Subcommittee on  
TARP, Financial Services and Bailouts of Public and Private  
Programs, Committee on Oversight and Government  
Reform, U.S. House of Representatives**

**Thursday, September 22, 2011  
2:00 p.m.**

### Introduction

Thank you for the opportunity to testify before the Subcommittees on the subject of “Potential Conflicts of Interest at the SEC: The Becker Case” as the Inspector General of the U.S. Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the Chairmen, the Ranking Members, and the other members of the Subcommittees, in the SEC and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks by briefly discussing the role of my Office and the oversight efforts we have undertaken during the past few years. The mission of the OIG is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the SEC. The SEC OIG includes the positions of the Inspector General, Deputy Inspector General, and Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates, and supervises independent audits and evaluations related to the Commission’s internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules, and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office’s investigations unit responds to allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff and contractors. We carefully



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review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation, as appropriate.

### **Audit Reports**

Over the past three and one-half years since I became the Inspector General of the SEC, our audit unit has issued numerous reports involving matters critical to SEC programs and operations and the investing public. These reports have included an examination of the Commission's oversight of the Bear Stearns Companies, Inc. and the factors that led to its collapse, an audit of the Division of Enforcement's (Enforcement) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's real property and leasing procurement process and the SEC's oversight of the Securities Investment Protection Corporation's activities.

### **Investigative Reports**

The Office's investigations unit has conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as investigations of allegations of violations of statutes, rules, and regulations, and other misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the

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Commission, Members of Congress, and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removal of employees from the federal service, as well as recommendations for improvements in agency policies, procedures, and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of failures by Enforcement to pursue investigations vigorously or in a timely manner, improper securities trading by Commission employees, conflicts of interest by Commission staff members, violations of the applicable laws and regulations regarding post-employment activities, unauthorized disclosure of nonpublic information, procurement violations, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, falsification of federal documents and compensatory time for travel, and the misuse of official position and government resources.

In August 2009, we issued a 457-page report of investigation analyzing the reasons why the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. In March 2010, we issued a 151-page report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's \$8 billion alleged Ponzi scheme. In May 2011, we issued a 91-page report of investigation into the circumstances surrounding the SEC's decision to lease approximately 900,000 square feet of office space at a newly-renovated office building known as Constitution Center, at a projected cost of over \$550 million over ten years.

More recently, on September 16, 2011, we completed a report entitled, "Investigation of Conflict of Interest Arising from Former General Counsel's Participation in Madoff-Related Matters," which is the subject of this hearing and is discussed in greater detail below.

### **Commencement and Conduct of the OIG's Conflict-of-Interest Investigation**

On March 4, 2011, Chairman Mary Schapiro requested that the OIG investigate any conflicts of interest arising from the participation of David M. Becker, the former General Counsel and Senior Policy Director of the Commission, in determining the SEC's position in the liquidation proceeding brought by the Securities Investor Protection Corporation (SIPC) of Bernard L. Madoff Investment Securities, LLC (the Madoff Liquidation). The Chairman's request came after she received Congressional inquiries prompted by press reports beginning on February 22, 2011, that the Trustee administering the Madoff Liquidation had brought a clawback suit seeking to recover fictitious profits that had accrued to Becker and his brother as beneficiaries of their mother's estate when a Madoff account she held was liquidated after her death. The OIG opened an investigation the same day it received the Chairman's request.

During the course of its investigation, the OIG obtained and searched over 5.1 million e-mails for a total of 45 current and former SEC employees for various time periods pertinent to the investigation, ranging from 1998 to 2011. The OIG also obtained and analyzed internal SEC documents, documentation provided by the Madoff Trustee, Irving H. Picard, Esq., court filings, and press reports. In addition, the OIG conducted testimony or interviews of 40 witnesses with knowledge of facts or circumstances surrounding the Madoff Liquidation and Becker's work at the SEC.

### **Issuance of Comprehensive Report of Investigation in Conflict-of-Interest Matter**

On September 16, 2011, we issued to the Chairman of the SEC a comprehensive report of our investigation in the conflict-of-interest matter that contained nearly 120 pages of analysis and 200 exhibits. The report of investigation detailed all of the facts and circumstances surrounding the SEC's former General Counsel and Senior Policy Director David Becker's participation in

issues in the Madoff Liquidation and other Madoff-related matters, notwithstanding his interest in the Madoff account of his mother's estate.

### **Results of the OIG's Investigation**

Overall, the OIG investigation found that Becker participated personally and substantially in particular matters in which he had a personal financial interest by virtue of his inheritance of the proceeds of his mother's estate's Madoff account and that the matters on which he advised could have directly impacted his financial position. We found that Becker played a significant and leading role in the determination of what recommendation the staff would make to the Commission regarding the position the SEC would advocate as to the calculation of a customer's net equity in the Madoff Liquidation. Under the Securities Investor Protection Act of 1970 (SIPA), where SIPC has initiated the liquidation of a brokerage firm, net equity is the amount that a customer can claim to recover in the liquidation proceeding. The method for determining the Madoff customers' net equity was, therefore, critical to determining the amount the Trustee would pay to customers in the Madoff Liquidation. Testimony obtained from SIPC officials and numerous SEC witnesses, as well as documentary evidence reviewed, demonstrated that there was a direct connection between the method used to determine net equity and clawback actions by the Trustee, including the overall amount of funds the Trustee would seek to claw back and the calculation of amounts sought in individual clawback suits. In addition to Becker's work on the net equity issue, we also found that Becker, in his role as SEC General Counsel and Senior Policy Director, provided comments on a proposed amendment to SIPA that would have severely curtailed the Trustee's power to bring clawback suits against individuals like him in the Madoff Liquidation.

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The following is a summary of the findings of our investigation. We found that Becker, along with his two brothers, inherited an interest in a Madoff account owned by his mother's estate after she died in 2004. Becker testified that he became aware of his mother's estate's Madoff account in or about February 2009 and knew that the account had been opened by his father prior to his death in 2000, was transferred to his mother's estate after her death in 2004, and was liquidated for approximately \$2 million. According to the complaint filed by the Madoff Trustee against Becker and his brothers in February 2011, approximately \$1.5 million of the \$2 million in the Madoff account constituted fictitious profits and, therefore, should properly be clawed back into the fund of customer property for distribution to other Madoff customers.

The OIG investigation found that at the time Becker participated on behalf of the SEC in the net equity issue presented in the Madoff Liquidation, he understood there was a possibility the Trustee would bring a clawback suit against him for the fictitious profits, but asserted that he did not know the likelihood of such a suit. He also acknowledged at the time that it was at least "theoretically conceivable" that the determination of the extent of SIPA coverage to be afforded Madoff customers could impact whether the Trustee would bring clawback actions against "persons at the margin," which he considered himself to be. Notwithstanding this knowledge, Becker, who also served as the SEC's alternate Designated Agency Ethics Official (*i.e.*, the alternate official responsible for coordinating and managing the SEC's ethics program), worked on particular matters that could impact the likelihood, and even possibility, of a clawback suit against him, as well as the amount that could be recovered in such a clawback action.

Specifically, the OIG investigation found that after Becker rejoined the SEC as General Counsel and Senior Policy Director in February 2009, the SEC's approach with respect to the net equity determination changed. SIPC and the Trustee proposed to pay customer claims based

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upon a money-in/money-out method of distribution, under which a Madoff investor would be able to make a net equity claim only for the amount initially invested with Madoff, less any amounts withdrawn over time (Money In/Money Out Method). SIPC and the Trustee believed that the Money In/Money Out method was the only method that was consistent with SIPA as a matter of law, and that SIPA did not allow customers to receive any amount over and above their initial investment with Madoff, *i.e.*, the fictitious returns shown on their Madoff account statements. As of February 2009, SEC officials concurred with SIPC and the Trustee that the Money In/Money Out Method was the appropriate method for determining customer net equity and SIPC officials understood that the Commission was likewise in agreement with this approach.

After Becker rejoined the Commission in late February 2009, and the SEC received submissions from representatives of Madoff claimants who disagreed with the Money In/Money Out Method for determining net equity, including a May 1, 2009 letter to Becker, which advocated a last account statement method for determining customer net equity. Under that method, customers would receive the amount listed as being in their accounts on the last Madoff account statement the customers received (*i.e.*, including the fictitious profits reflected on their statements) (Last Account Statement Method).

The OIG investigation found that after receiving the May 1, 2009 letter, Becker and the Office of General Counsel (OGC) initially gave serious consideration to the Last Account Statement Method. The OIG investigation further found that the prevailing opinion within the SEC and SIPC was that using the Last Account Statement Method would have eliminated the Trustee's ability to bring clawback suits such as the one brought against Becker. Becker himself testified to the OIG that he recalled that one of the reasons given by the Madoff Trustee for his

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opposition to using the Last Account Statement Method was that if this method was adopted, “we couldn’t do any clawbacks.” Becker and OGC eventually rejected the Last Account Statement Method and variations of that approach, determining that they could not be reconciled with the law, but continued to consider other methods that would allow Madoff customers to receive more than the amount of their initial investments with Madoff. After consultation with officials from Division of Risk, Strategy, and Financial Management (Risk Fin), Becker ultimately decided to recommend to the Commission a method under which an inflation rate, such as the Consumer Price Index, would be added to the amount of Madoff customers’ initial investments with Madoff to determine the amount they would receive (Constant Dollar Approach).

Accordingly, in late October 2009, eight months after Becker rejoined the Commission, Becker signed an Advice Memorandum to the Commission, which proposed that the Commission support the Madoff Trustee’s Money In/Money Out Method, but adjust this approach in a manner that accounts for the “time value” of funds invested in Madoff’s scheme pursuant to the Constant Dollar Approach. At an Executive Session of the Commission convened to consider this matter, Becker requested that the Commission authorize the staff to “prepare testimony and write a brief taking the position supporting the trustee on [money-in/money-out], but saying the [money] needs to be described in constant dollar terms.” Based upon Becker’s recommendation and representations made in the Executive Session, the Commission ultimately voted not to object to the staff’s recommendation of the Constant Dollar Approach to the net equity determination.

The OIG investigation found that neither SIPC nor the Trustee believed that the Constant Dollar Approach was appropriate or in conformance with the statute. The President and Chief

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Executive Officer (CEO) of SIPC stated to the OIG that he specifically recalled telling Becker, in a telephone conversation during which Becker informed him that the Commission would use the Constant Dollar Approach, that there was no justification for such an approach under SIPA. Moreover, the SIPC President and CEO made clear that every proffered methodology, other than the Money In/Money Out Method that was agreed upon by the SEC prior to Becker's rejoining the Commission, would have directly affected Becker's mother's estate's account, and every proffered methodology would have improved Becker's financial position or the financial position of the account. The SIPC President and CEO explained that using the Constant Dollar Approach would increase the amount that customers' accounts were owed, and accordingly, decrease any amount the Madoff Trustee could have recovered in a clawback suit.

The SIPC President and CEO also stated that, upon learning of Becker's mother's Madoff account, he performed "back of the envelope calculations" to determine the difference of bringing clawback suits under the Constant Dollar Approach, as opposed to the Money In/Money Out Method. Under this calculation, the SIPC President and CEO concluded that by utilizing the Constant Dollar Approach, the amount sought in the clawback suit against Becker and his brothers would be reduced by approximately \$140,000. The OIG recreated the analysis and calculated that a benefit to Becker and his brothers of approximately \$138,500 would result from applying the Constant Dollar Approach in the Becker clawback suit, by adjusting the amount of principal invested of approximately \$500,000 by a percentage inflation adjustment calculated from the Department of Labor's Bureau of Labor Statistics Consumer Price Index Table.

The OIG investigation also found that Becker participated in another particular matter while serving as SEC General Counsel and Senior Policy Director that could have impacted his financial position. In October 2009, the SEC's Office of Intergovernmental and Legislative



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Affairs (OLA) forwarded Becker a draft amendment to SIPC, as well as TM's analysis of that proposal, and asked Becker if there was "any reason SEC staff should weigh in tomorrow on an amendment to be considered during a House Financial Services Committee markup regarding the ability of the SIPC trustee to do clawbacks." The proposed amendment entitled, "Clarification Regarding Liquidation Proceedings," would have amended SIPA to preclude a SIPC trustee from bringing clawback actions against a customer "absent proof that the customer did not have a legitimate expectation that the assets in his account belonged to him." The effect of this amendment would be to preclude the Trustee from bringing clawback actions like the one against Becker, which were the majority of the clawback suits brought, *i.e.*, suits that did not rely on any knowledge of the alleged wrongdoing.

Although the OIG investigation did find that Becker consulted with the SEC Ethics Office regarding his interest in his mother's estate's Madoff account on two separate occasions and that Becker was advised that there was no conflict, we identified concerns about the role and culture of the Ethics Office at the time it provided Becker with clearance to work on the Madoff Liquidation. William Lenox, the now-former Ethics Counsel with whom Becker consulted on both occasions about whether he should be recused from working on the Madoff Liquidation, reported directly to Becker. In fact, just seven months after Lenox provided advice regarding Becker's participation in the Madoff Liquidation, Becker provided a performance evaluation of Lenox, which concluded, "The performance of the ethics office has been superb . . . . The quality of the ethics advice is very high . . . ." Lenox also held Becker in extremely high regard. He testified that he had "[g]reat professional respect" for Becker and "an appreciation for his humor and his abilities as a lawyer," and further described Becker as a "great man and a great lawyer." Lenox also testified he factored into his analysis of whether Becker should be recused from the

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Madoff Liquidation the fact that “he was a reputed securities lawyer who was making a decision to come back and serve the public and protect investors, and he was here to do this sort of analysis.”

In addition, Lenox explained his belief that as Ethics Counsel, the most important thing was that people trust him, and noted that people trusted him with “incredibly personal information.” He viewed his job as “to create a culture where people would seek advice, and to alert those employees – all employees – where the danger lines were, and to encourage them to come and seek ethics advice, because that provides a level of protection.” He stated, “The people who, in the ethics community, that I respect the least are the ones who always say no. If you are a constant naysayer, one, nobody comes to secure advice; two, you’re not actually doing your job.” He further noted, “The key, as I saw it in my job as [Designated Agency Ethics Official] and as ethics counsel, was to make decisions. That’s the reason I was promoted. I was willing to make decisions. That requires a certain amount of willingness to be second-guessed by other people. If you always say no, you’ll never be second-guessed. That was not what I saw my role to be.”

Lenox specifically discussed Becker’s mother’s estate’s Madoff account with him on two separate occasions: first, upon Becker’s return to the SEC in February 2009, and, second, when he received the May 1, 2009 letter advocating the Last Account Statement Method. Only the second discussion was documented in writing, but at no time did Lenox advise that Becker should not participate in any Madoff-related matters and, as discussed below, this advice appears to have been based on incorrect assumptions. The OIG investigation further found that Becker never advised Lenox of the request for his opinion of the SIPA amendment, which would have

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precluded clawbacks against individuals in Becker's position, and never sought his advice on whether providing advice on the amendment was improper.

In the second discussion in early May 2009, Becker disclosed to Lenox the details of his mother's account with Madoff, including generally when it was opened and closed, and approximately how much money was invested. He also explained to Lenox that the Madoff Trustee had been bringing clawback suits and that a clawback suit could "[i]n theory" be brought against him. Becker also acknowledged that it was possible that the extent to which SIPA coverage would be available could make it "less likely that the [t]rustee would bring claw back actions against persons at the margin" like him.

Lenox responded, in part, "There is no direct and predictable effect between the resolution of the meaning of 'securities positions' and the trustee's claw back decision. For this reason, you do not have a financial conflict of interest and you may participate." When the OIG interviewed Lenox in this investigation, we learned that Lenox's opinion was based upon the incorrect understanding that the SEC's participation in the Madoff Liquidation was solely an advisory one, when, in fact, the SEC is a party to the liquidation proceeding and may request the court to compel SIPC to do as it wishes. Becker himself acknowledged in his OIG testimony that consistent with its role as a party, the SEC's participation in the net equity issue in the Madoff Liquidation was not theoretical. Becker noted that it was his understanding that if SIPC disagreed, the SEC should eventually recommend that the court adopt the SEC's position, not SIPC's position, and indicated that "[t]he Commission had done that in the past and may do it again."

We found that Lenox's advice was also based upon the incorrect assumption that the interpretation of SIPA for purposes of claim determination was a separate and distinct legal

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question from the trustee's decision of from whom to institute a clawback suit, and completely ignored any impact on the calculation of the amount to be clawed back. We also found no evidence that Lenox took any further steps to better understand the extent and nature of Becker's involvement in the Madoff Liquidation, and Becker testified that he did not recall Lenox asking for additional facts or directing him to seek additional guidance if new facts arose.

The OIG investigation further found that notwithstanding the importance Lenox had placed on appearance matters in his communications to SEC employees, he did not even reference appearance considerations in his May 2009 written advice to Becker. Nonetheless, Lenox testified that he did consider appearance issues when advising Becker and, in fact, concluded that Becker's participation in the Madoff Liquidation matter passed the "appearance of impropriety test." Lenox himself had described that test in an ethics bulletin issued to all SEC employees as follows:

What are the optics of the situation; what is the context of the facts and circumstances? Would it pass what has often been referred to as the *New York Times* or *Washington Post* test? If what you propose doing becomes the subject of an article in the press, would you not care or would it look like you were doing something wrong? Even if you wouldn't care, what effect would the story have on the SEC and your fellow employees?

Even with the advantage of hindsight and given the intense press scrutiny and criticism of Becker's work on Madoff-related matters in the *Washington Post* and *New York Times*, Lenox indicated in testimony before the OIG that he stands by his conclusion that Becker's involvement in the SEC determinations in the Madoff Liquidation passed this appearance test.

The OIG investigation further found that the Ethics Office considered Becker's participation differently in other matters than it did in the Madoff Liquidation and that Becker himself took a more conservative stance on recusals in other non-Madoff matters. Moreover, the OIG investigation found that the Ethics Office considered recusals in Madoff-related matters

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differently in situations that did not involve Becker. In fact, shortly after Madoff confessed, Lenox, as Ethics Counsel, sent a memorandum to all Commission employees regarding mandatory recusal from *SEC v. Madoff* in a broad variety of circumstances. The memorandum stated, “[A]ny member of the SEC staff who has had more than insubstantial personal contacts with Bernard L. Madoff or Mr. Madoff’s family shall be recused from any ongoing investigation of matters related to *SEC v. Madoff*.” The memorandum further set forth certain contacts that required recusal, including being invited to or visiting any Madoff family members’ homes or being an active member of the same social or charitable organizations.

The OIG investigation found that with respect to employees within OGC besides Becker, the Ethics Office took a more conservative approach for recusal from Madoff-related matters, including the Madoff Liquidation. For example, the Ethics Office advised an OGC staff attorney that she had a conflict from working on any aspect of the Madoff Liquidation because she “spent a very small amount of time in private practice working on a question related to the Madoff bankruptcy.”

The OIG investigation also found that former Ethics Counsel Lenox was not the only individual in the Commission who was aware of Becker’s mother’s estate having an account with Madoff prior to the time this issue appeared in the press in February 2011. Both Becker and Chairman Schapiro recalled that, around the time of his return to the SEC in February 2009, Becker discussed his mother’s estate’s Madoff account with her. While their recollections of the substance of the conversation are not entirely consistent, the evidence clearly shows that Becker advised Chairman Schapiro that his mother had had an account with Madoff, she had died several years before, and the account had been liquidated. Chairman Schapiro did not recall asking Becker any questions after he told her about his mother’s account, and did not recall

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whether Becker said anything about seeking advice from the Ethics Counsel regarding the account, although Becker testified he must have mentioned to her that he would consult with Lenox. At that time, Chairman Schapiro did not consider Becker's personal financial gain "in any way, shape, or form" or whether he would be subject to a clawback action. Indeed, Chairman Schapiro testified that she would have had Becker recused from the net equity determination if she had known he was potentially subject to a clawback suit or "understood that he had any financial interest in how this [was] resolved . . . ."

In addition, the issue of Becker's mother's estate's Madoff account was discussed by several SEC senior officials in the fall of 2009, when the SEC learned that the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises was scheduling a hearing on SIPC and Madoff victims. Shortly after the SEC learned that the Congressional testimony would focus on legal aspects of the SIPC/Madoff issues, Chairman Schapiro suggested that Becker testify on behalf of the SEC at the hearing. The OLA Director then had a conversation with Becker, during which Becker informed him that his mother had a Madoff account from which he "had gotten an inheritance." Becker also testified that he told the OLA Director that "if [he did] testify, [he] would put at the beginning, [he] would mention [his], the fact of [his] mother's account with Madoff." Becker testified that after this conversation, the OLA Director contacted him later in the day and said, "You know, now that I think about it, I think it would be better if somebody else testified. My concern is – not that there's anything inappropriate, but my concern is [ ] that when you're in a political environment, people might want to make something of that, and it would be a distraction rather than focusing on what the Commission's position was and why."

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Becker testified that either the evening of his conversation with the OLA Director or the following morning, he spoke with Chairman Schapiro about his mother's account. Chairman Schapiro recalled the conversation with Becker and stated, "I recall saying that if David [Becker] did testify, we needed to make it absolutely clear to Congress that there was this connection, remote though I believed it to be, that his long-deceased mother had had an account at Madoff, so that nobody would be surprised by that, so that we were completely forthcoming with Congress." Becker testified that he was certain that it was he who said in the meeting with Chairman Schapiro that if he were to testify, he would disclose his mother's account with Madoff. The OIG investigation found that eventually, the OLA Director made the decision not to have Becker testify. The SEC Deputy Solicitor, who had been suggested by Becker as a possible replacement witness, testified in Becker's stead at the subcommittee hearing which occurred on December 9, 2009, and involved discussions of clawbacks. In the end, Becker's Madoff interest was not disclosed to Congress.

Moreover, the OIG investigation found that although the decision was made that should Becker testify before Congress, he would disclose his mother's Madoff account, during this November 2009 timeframe, the fact of Becker's interest in his mother's estate's Madoff account was not disclosed to the Commissioners or the bankruptcy court, notwithstanding the fact that the Commission was considering Becker's recommendation on the net equity position to take in court at this very time. SEC Commissioner Aguilar testified that it was "incredibly surprising and incredibly disappointing that there was enough awareness to know that the conflict existed to prevent [Becker] from giving [this] testimony, yet the decision-makers at the Commission were not provided that information."

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In all, the OIG investigation found that, prior to the public disclosure of Becker's mother's Madoff account, at least seven SEC officials were informed at one time or another about that account, including the Chairman, the then-Deputy General Counsel and current General Counsel, the Deputy Solicitor who testified at the hearing in Becker's stead, the OLA Director, a Special Counsel to the Chairman, and two Ethics officials (Lenox and one of his colleagues in the Ethics Office). Yet, none of these individuals recognized a conflict or took any action to suggest that Becker consider recusing himself from the Madoff Liquidation.

After we concluded the fact-finding phase of our investigation, we provided to the Acting Director of the Office of Government Ethics (OGE) a summary of the salient facts uncovered in the investigation, as reflected in our report. We requested that OGE review those facts and provide the OIG with its opinion regarding Becker's participation in matters as the SEC's General Counsel and Senior Policy Director that could have given rise to a conflict of interest. After reviewing the summary of facts provided by the OIG, the Acting Director of OGE advised us that in his opinion, as well as that of senior attorneys on his staff, Becker's work both on the policy determination of the calculation of net equity in connection with clawback actions stemming from the Madoff matter, and his work on the proposed legislation affecting clawbacks should be referred to the United States Department of Justice for consideration of whether Becker violated 18 U.S.C. § 208, a criminal conflict of interest provision. Based upon this guidance, the OIG has referred the results of its investigation to the Public Integrity Section of the Criminal Division of the United States Department of Justice.

### **Recommendations of the OIG's Investigation**

Based upon the findings in our report, we recommended that, in light of David Becker's role in signing the October 28, 2009 Advice Memorandum and participating in the November



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2009 Executive Session at which the Commission considered OGC's recommendation that the Commission take the position that net equity for purposes of paying Madoff customer claims should be calculated in constant dollars by adjusting for the effects of inflation, the Commission reconsider its position on this issue by conducting a re-vote in a process free from any possible bias or taint. We further recommended that once the re-vote has been conducted, the Commission should advise the United States Bankruptcy Court for the Southern District of New York of its results and the position that the Commission is adopting.

The OIG also recommended with respect to the Ethics Office that:

- (1) The SEC Ethics Counsel should report directly to the Chairman, rather than to the General Counsel.
- (2) The SEC Ethics Office should take all necessary steps, including the implementation of appropriate policies and procedures, to ensure that all advice provided by the Ethics Office is well-reasoned, complete, objective, and consistent, and that Ethics officials ensure that they have all the necessary information in order to properly determine if an employee's proposed actions may violate rules or statutes or create an appearance of impropriety.
- (3) The SEC Ethics Office should take all necessary actions to ensure that all ethics advice provided in significant matters, such as those involving financial conflict of interest, are documented in an appropriate and consistent manner.

We are confident that under Chairman Schapiro's leadership, the SEC will review our report and take appropriate steps to implement our recommendations to ensure that the concerns identified in our investigation are appropriately addressed.

### **Conclusion**

In conclusion, I appreciate the interest of the Chairmen, the Ranking Members, and the Subcommittees in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our conflict-of-interest report. I believe that the Subcommittees' and Congress's

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continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.

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