



U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

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# Inspection of Corporation Finance Referrals, Memorandum



September 30, 2008  
Report No. 433




OFFICE OF  
INSPECTOR GENERAL

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

**MEMORANDUM**

September 29, 2008

**To:** Linda Thomsen, Director, Division of Enforcement  
John White, Director, Division of Corporation Finance

**From:** H. David Kotz, Inspector General 

**Subject:** *Inspection of Corporation Finance Referrals*, Memorandum Report  
No. 433

This memorandum transmits the Securities and Exchange Commission, Office of Inspector General's (OIG) findings detailing the results of our review of the Division of Corporation Finance's referrals to the Division of Enforcement (Enforcement). We conducted this review as part of our continuous effort to assess management of the Commission's program and operations.

The memorandum report contains 3 recommendations that the Divisions of Enforcement and Corporation Finance should implement to improve the referral process. Enforcement agreed with recommendations 1 and 2, and Corporation Finance agreed with recommendations 1 and 3. Your written responses to the draft report, dated September 3, 2008, are included in their entirety in Appendix I.

Should you have any questions regarding this report, please do not hesitate to contact me. During this audit we appreciate the courtesy and cooperation that you and your staff extended to our auditors.

Attachment

cc: Peter Uhlmann, Chief of Staff, Chairman's Office  
Diego Ruiz, Executive Director, Office of the Executive Director  
Joan McKown, Chief Counsel, Division of Enforcement  
Brian Breheny, Deputy Director, Division of Corporation Finance  
Paula Dubberly, Associate Director (Legal) Division of Corporation Finance  
Lewis Walker, Acting Chief Information Officer, Office of Information  
Technology  
Susan Markel, Chief Accountant, Division of Enforcement  
Mary Kosterlitz, Office Chief, Office of Enforcement Liaison, Division of  
Corporation Finance  
Charles Wright, Counsel, Office of Chief Accountant, Division of  
Enforcement

George Eckard, Assistant Director, Office of Finance and Administration,  
Office of Information Technology

Darlene Pryor, Management Analyst, Office of the Executive Director

Dan Lisewski, Branch Chief, Information Resources Management, Office  
of Information Technology

Rick Hillman, Managing Director of Financial Markets and Community  
Investment, GAO

# Background and Objectives

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## Background

The Securities and Exchange Commission (Commission)<sup>1</sup> Division of Corporation Finance (CF) refers potential securities law violations to the Division of Enforcement (ENF) for investigation. CF categorizes these referrals as involving either delinquent or non-delinquent filers. Delinquent filer referrals pertain to individuals or entities that are not current in their Commission filing obligations. In contrast, non-delinquent filer referrals include all other types of potential securities law violations, such as accounting misstatements and the inadequacy of issuer disclosures. As discussed in the scope section below, this memorandum report focuses on non-delinquent filer referrals.

When CF staff conduct reviews of registrant filings, they may identify potential securities law violations.<sup>2</sup> If CF staff identify a potential securities law violation, they prepare a referral memorandum for CF's Office of Enforcement Liaison (CF-OEL) that describes the potential securities law violation.<sup>3</sup> CF-OEL reviews the referral memorandum and then forwards it to either the ENF Office of the Chief Accountant (ENF-OCA) or ENF staff who are actively working on matters involving the same registrant. If ENF-OCA receives the referral, it reviews the referral and in conjunction with a Senior Officer in Enforcement makes an initial determination of whether ENF staff should investigate the referral. ENF-OCA forwards the referral to ENF staff for investigation if ENF-OCA believes the alleged securities law violation may warrant further investigation. This process determines the merits of a referral based on a variety of factors, such as the age and nature of the alleged securities law violation and the degree of potential harm to investors.

## Objectives, Scope, Methodology

**Objectives.** To identify potential improvements in the referral process.

**Scope.** The Office of Inspector General (OIG) conducted the review between July 2007 and August 2008. We performed an inspection in accordance with the *Quality Standards for Inspections*, January 2005, issued by the President's

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<sup>1</sup> See Appendix II for the acronyms used.

<sup>2</sup> The staff may also identify potential securities law violations from other sources, such as current publications (e.g. newspaper articles), investor complaints, etc.

<sup>3</sup> In some cases, CF-OEL will prepare the memorandum in consultation with CF staff.

Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. However, in September 2007, due to unforeseen changes in the OIG's work priorities, the former Deputy and Acting Inspector General suspended work on the inspection. At that time, the review of non-delinquent filer referrals had just begun.

In February 2008, the newly-appointed Inspector General directed the resumption of the inspection. Thereafter, we reviewed the previously-conducted inspection work. However, given the time lapse since the inspection began, we determined that the data previously obtained (and the work performed on the data) was no longer current. Thus, we concluded that continuing the inspection in its current form was not a viable option. Although we have not completed a comprehensive inspection of the CF referral process at this time, we are issuing this memorandum report, which identifies three findings and recommendations<sup>4</sup> involving non-delinquent filer referrals that we believe would significantly improve the referral process.<sup>5</sup>

**Methodology.** We reviewed supporting documentation, such as policies and procedures, reviewed non-delinquent filer referral memoranda, conducted interviews with Commission staff, and analyzed management reports on non-delinquent filer referrals from Fiscal Years 2006 and 2007.

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<sup>4</sup> See Appendix III for a list of our recommendations.

<sup>5</sup> We may conduct a larger-scale audit of the CF referral process in the future, if circumstances warrant.

# Findings and Recommendations

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## Finding 1: CF-OEL and ENF-OCA's Referral Tracking Systems Should Be Centralized

CF-OEL and ENF-OCA currently use separate Access databases that store similar referral information. As a result, the referral process is inefficient. In addition, there is an increased risk that ENF-OCA does not have a record of all potentially significant referrals.

### Maintaining Separate Access Databases

CF-OEL and ENF-OCA use separate Access databases to track non-delinquent filer referrals. CF-OEL currently has read-only access to ENF-OCA's database. In addition to tracking CF-OEL referrals, ENF-OCA's database also tracks accounting related referrals received from other sources (e.g., anonymous tips). We determined that CF-OEL and ENF-OCA need a centralized referral tracking system for the following reasons:

- The Offices' use of separate databases to maintain similar information is not efficient. In addition, CF-OEL must periodically perform a labor-intensive process using ENF-OCA's database to update its referral data.
- Based on our review of referral memoranda, it appears that ENF-OCA does not always receive a copy of the referral when CF-OEL sends a referral directly to ENF staff. Thus, ENF-OCA would be unaware of a referral unless it learned about it inadvertently (e.g., from the ENF staff working on the referral). This may increase the risk that ENF staff might not act on a potentially significant referral and that neither CF-OEL nor ENF-OCA would be aware of this lack of action because information on the outcome of the referral (e.g., whether it was accepted or rejected and the reasons for that decision) is not always obtained. See Finding Two for a detailed discussion of this issue.

### Recommendation 1:

The Divisions of Corporation Finance and Enforcement, in consultation with the Office of Information Technology, should develop a centralized referral tracking system for non-delinquent filer referrals. The Division of Corporation Finance should record information about the potential securities law violation (e.g., date, registrant, and alleged violation, etc.) in the centralized database, and the Division of Enforcement should record information on the outcome of the referral

(e.g., whether the referral was accepted or rejected, and the reasons for that decision) in the centralized database.

## **Finding 2: Information Concerning The Outcome Of The Referral Should Be Recorded In The ENF-OCA Database**

ENF-OCA does not always record the outcome of referrals in its database, although other sources of outcome data are available to CF-OEL.

CF-OEL currently obtains information about the outcome of non-delinquent filer referrals from either ENF staff or by reviewing ENF-OCA's Access database. However, CF-OEL does not always obtain this information. According to CF-OEL, ENF staff often do not contact them with the relevant information,<sup>6</sup> and the ENF-OCA database frequently does not contain the outcome information. ENF-OCA may not have the outcome information because ENF staff working on a referral often do not provide ENF-OCA with any subsequent information about a referral.

CF-OEL stated that receiving outcome information would be beneficial as it could improve the quality of future referrals by identifying shortcomings in previous referrals. In addition, as discussed in Finding 3, CF-OEL could use outcome information to enhance its role as a gatekeeper regarding CF referrals to ENF.

### **Recommendation 2:**

The Division of Enforcement should record information about the outcome of non-delinquent filer referrals in its current Access database (and eventually in the centralized database system - see Recommendation 1) to improve the referral process, as discussed above.

## **Finding 3: CF-OEL's Role As Gatekeeper Needs Enhancement**

CF-OEL could enhance its role as a gatekeeper if it had outcome information (as discussed above).

CF-OEL reviews referral memoranda to improve the quality of the referral and ensure that, for example, the referral clearly articulates the statutes and rules the

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<sup>6</sup> CF's referral contains a form for ENF staff to complete regarding information on the outcome of the referral. However, according to CF, ENF staff generally do not complete this form. CF and ENF-OCA has also indicated they do not have available resources to seek this type of outcome information proactively from ENF staff.

registrant may have violated. Accordingly, CF-OEL, in effect, acts as a gatekeeper for the referral process. In this role, CF-OEL declines to forward referrals it deems to be inappropriate from CF's perspective or to lack a legal basis. However, CF-OEL's ability to determine whether a referral might be worthy of an investigation from ENF's perspective is limited. CF-OEL stated that it would like to increase its role in the referral process. However, CF-OEL currently lacks the necessary outcome information on referrals to understand fully the types of referrals ENF determines warrant an investigation. We believe that CF-OEL would be able to enhance its current gatekeeper role if ENF provided it with additional information on why ENF accepted or rejected referrals.

**Recommendation 3:**

The Division of Corporation Finance should enhance CF-OEL's gatekeeper role once the outcome information becomes more available (see Recommendation 2).





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

Division of Enforcement

September 15, 2008

Linda Chatman Thomsen  
Director  
(202) 551-4894  
(202) 772-9279 (fax)  
[thomsenl@sec.gov](mailto:thomsenl@sec.gov)

H. David Kotz  
Inspector General  
US Securities & Exchange Commission  
100 F Street NE  
Washington DC 20549

Dear Mr. Kotz:

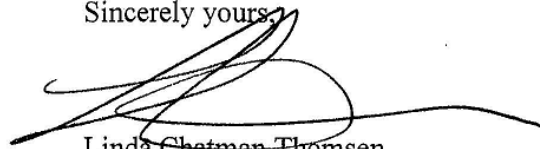
I have received the "Draft Report, *Inspection of Corporation Finance Referrals*, Memorandum Report No. 433."

With respect to Recommendation 1, the Division of Enforcement (Enforcement) concurs. Please note that implementation of the recommendation will be labor intensive and will require significant resources to accomplish; we currently do not have the resources to implement your recommendation. Nevertheless, we will endeavor to work with the Commission's Office of Information Technology and the Division of Corporation Finance to satisfy the recommendation.

With respect to Recommendation 2, Enforcement concurs. While we concur with your recommendation, please understand that the staff of the Office of the Enforcement Liaison in the Division of Corporation Finance (Corp Fin Liaison) who make referrals to Enforcement are also deeply involved in the review and approval of Enforcement action memoranda dealing with their subject matter. Those memoranda include the initial action memoranda seeking formal order authority; those formal order memoranda typically are prepared in the initial stages of any Enforcement investigation. Later, if Enforcement recommends seeking authority to institute proceedings, Corp Fin Liaison staff also review the memorandum to the Commission that provides both factual and legal analysis of the proposed action. In other words, the Corp Fin Liaison staff have decades of experience assessing Enforcement actions and are extensively involved in all aspects of Enforcement matters involving their subject matter. Presumably their experience also informs their judgment regarding referrals.

Please do not hesitate to contact me or Joan McKown, Chief Counsel, if you have any questions.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Linda Chatman Thomsen". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Linda Chatman Thomsen



DIVISION OF  
CORPORATION FINANCE

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

September 16, 2008

H. David Kotz  
Inspector General  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Dear Mr. Kotz:

Thank you for the opportunity to respond to the recommendations in your September 3, 2008 draft report *Inspection of Corporation Finance Referrals*. Although you indicate that your inspection was not comprehensive and that the data your office obtained when it began this inspection in July 2007 is no longer current, you have asked the Division of Corporation Finance to provide you with a written response to Recommendations 1 and 3.

In Recommendation 1, you recommend that the Divisions of Corporation Finance and Enforcement, in consultation with the Office of Information Technology, develop a centralized referral tracking system for non-delinquent filer referrals. Although we concur with your recommendation, implementing it will require significant resources. We will, however, work with the Division of Enforcement and the Office of Information Technology to explore options to satisfy the recommendation.

In Recommendation 3, you recommend that the Division of Corporation Finance enhance its "gatekeeper" role using information about the Division of Enforcement's responses to past referrals in evaluating potential referrals. We welcome any additional information that would increase the effectiveness of our relationship with the Division of Enforcement and we concur with your recommendation.

Please do not hesitate to contact me if you have any questions.

Sincerely,

A handwritten signature in cursive script that reads "John W. White".

John W. White  
Director

## Acronyms

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CF	Division of Corporation Finance
ENF	Division of Enforcement
ENF-OCA	The Division of Enforcement's Office of the Chief Accountant
CF-OEL	The Division of Corporation Finance's Office of Enforcement Liaison
OIG	Office of Inspector General

## Summary of Recommendations

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**Recommendation 1:**

The Divisions of Corporation Finance and Enforcement, in consultation with the Office of Information Technology, should develop a centralized referral tracking system for non-delinquent filer referrals. The Division of Corporation Finance should record information about the potential securities law violation (*e.g.*, date, registrant, alleged violation, *etc.*) in the centralized database, and the Division of Enforcement should record information on the outcome of the referral (*e.g.*, whether the referral was accepted or rejected, and the reasons for that decision) in the centralized database.

**Recommendation 2:**

The Division of Enforcement should record information about the outcome of non-delinquent filer referrals in its current Access database (and eventually in the centralized system - see Recommendation 1) to improve the referral process, as discussed above.

**Recommendation 3:**

The Division of Corporation Finance should enhance CF-OEL's gatekeeper role once the outcome for information becomes more available (see Recommendation 2).

# Audit Request and Ideas

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The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

U.S. Securities and Exchange Commission  
Office of Inspector General  
Attn: Assistant Inspector General, Audits (Audit Request/Idea)  
100 F. Street N.E.  
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Tel. #: 202-551-6061  
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