REPORT OF INVESTIGATION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
OFFICE OF INSPECTOR GENERAL

Case No. OIG-496

Allegations of Conflict of Interest, Improper Use of Non-Public Information and Failure to Take Sufficient Action Against Fraudulent Company

January 8, 2010

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Introduction and Summary of Results of Investigation

On July 10, 2008, the Securities and Exchange Commission ("SEC" or "Commission") Office of Inspector General ("OIG") opened an investigation after SEC Chairman Christopher Cox's former Chief of Staff asked the OIG to review allegations against a former Division of Enforcement ("Enforcement") attorney. The allegations were outlined in a *Wall Street Journal* article about hedge fund Greenlight Capital LLC ("Greenlight Capital") manager David Einhorn's ("Einhorn") then soon-to-be released book, *Fooling Some of the People All of the Time - A Long Short Story* ("Einhorn's book"). The article stated that one of Einhorn's complaints was that (b)(7)(C) who aggressively questioned Einhorn about his short-selling of Allied Capital Corporation ("Allied") stock, became a registered (b)(7)(C) for Allied after he left the SEC. In addition, the article noted that Allied obtained purloined copies of Einhorn's telephone records. The former Chief of Staff was concerned, *inter alia*, that (b)(7)(C) may have engaged in illegal activity and taken non-public SEC investigatory materials, including Einhorn's telephone records.

In 2005, the OIG conducted a brief preliminary inquiry into similar allegations outlined in a letter from Einhorn's counsel, Richard Zabel ("Zabel"), to the OIG.[1] The 2005 inquiry

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[1] That letter alleged that (b)(7)(C) may have been: (1) (b)(7)(C) Congress regarding the Commission's investigation of Allied, which Zabel claimed (b)(7)(C) participated in, and (2) using to Allied's advantage non-public information about Einhorn and Einhorn's hedge fund Greenlight Capital, which (b)(7)(C) learned through his participation in the Enforcement investigation of Allied. Zabel attached the form which registered (b)(7)(C) as a (b)(7)(C) for Allied. Zabel claimed that (b)(7)(C) may have violated a criminal statute, Commission rules, and/or attorney bar rules.

found that an Enforcement investigation into Allied was opened after (b)(7)(C) left the Commission but that there was no specific violation of any law, rule, regulation or statute by (b)(7)(C) After reviewing the information provided in 2008 by then Chief of Staff, the OIG reopened the issues in that inquiry and broadened its investigation to include additional allegations Einhorn made in his book. Published in mid-2008, Einhorn's book recounted the much-publicized heated feud between Einhorn and Allied, which continues today. The feud began in May 2002 when Einhorn gave a negative speech at a conference about Allied and described why Greenlight Capital had a short position in Allied. Einhorn's speech compelled many to also short and sell Allied's stock the next day. Allied responded, according to Einhorn, in a "Washington, D.C.-style spin job," attacking Einhorn.

Einhorn's book included allegations of the SEC's failure to take appropriate action related to Allied's wrongdoing. Einhorn wrote that he sent about a dozen letters with detailed information and evidence related to his allegations of wrongdoing at Allied to several SEC officials, but never received a telephone call or written response. Einhorn stated that he did not have any idea whether anyone at the SEC followed up on the information he provided. In those letters, and in his book, Einhorn claimed that Allied overvalued many of its investments. Einhorn also stated that he believed he was investigated by the SEC at the behest of Allied, noting the unusual timing of receiving a subpoena for his testimony and documents after Enforcement attorneys called him the same day he asked Allied a question on a conference call.

The OIG conducted a comprehensive investigation of the allegations in Einhorn's book. The investigation revealed that Allied successfully lobbied the SEC to begin investigating Einhorn and his hedge fund Greenlight Capital without specific evidence of wrongdoing, after Einhorn's negative speech about Allied in May 2002. The OIG investigation found that Enforcement's investigation of Einhorn and his hedge fund, among other hedge funds including (b)(7)(C),(b)(8) was commenced shortly after Allied met with Enforcement officials in June 2002. The (b)(7)(C),(b)(8) investigation was supervised by (b)(7)(C), who just over a year later left the Commission and became a (b)(7)(C) for Allied. We found that during the (b)(7)(C),(b)(8) investigation, (b)(7)(C) aggressively questioned Einhorn in testimony, subpoenaed several boxes of documents and sought Einhorn's telephone records and list of his clients. We also found that (b)(7)(C) made numerous, successful efforts to learn about Allied during the course of the (b)(7)(C),(b)(8) investigation.

The OIG investigation further revealed that during the same time Allied was able to convince the SEC to investigate Einhorn, even without any evidence of wrongdoing, Einhorn was submitting specific and detailed letters to the SEC outlining evidence of Allied's overvalued investments and requesting the SEC to investigate Allied. We found that although the SEC's Office of Compliance Inspections and Examinations ("OCIE") had begun an examination of

Allied based upon Einhorn's allegations, Enforcement staff was unaware that OCIE was examining Allied and the lead Enforcement attorney was prevented from contacting a Senior Official to learn that Einhorn began submitting letters outlining evidence of Allied's wrongdoing.

The OIG investigation also found that very soon after Enforcement began looking at the allegations against Einhorn, they concluded that there was no credible evidence to demonstrate that the activities of his hedge fund violated any federal securities laws. However, although the investigation against Einhorn was as a practical matter completed by mid-2003, the investigation was not formally closed until December 2006 and Einhorn was never notified that he was no longer a subject of investigation despite his request for such notification.

We further found that in 2003, while supervising the investigation against Einhorn and others, (b)(7)(C) was asked to leave Enforcement because of performance problems. In (b)(7)(C) immediately after leaving the SEC, (b)(7)(C) joined the law firm of Venable LLP ("Venable"). In October 2004, (b)(7)(C) formally registered as a (b)(7)(C) for Allied. The OIG investigation disclosed that (b)(7)(C) obtained clearance from the Commission's Ethics Office to register as a (b)(7)(C) for Allied based on representations he made that he had not worked on any Allied-related matters while working at the SEC. In fact, the evidence showed that (b)(7)(C) had worked on the investigation of Einhorn which Allied had lobbied for, and in the course of this investigation, learned a substantial amount of sensitive, non-public information regarding Einhorn and Allied. However, the OIG found no evidence that (b)(7)(C) took any non-public or case-related documents with him when he left the SEC. Nor did we obtain evidence that (b)(7)(C) received any non-public information from any SEC employee after leaving the SEC.

The OIG investigation revealed that in March 2005, Einhorn raised concerns that Allied illegally gained access to his telephone records. In 2007, after a grand jury was convened, Allied informed the SEC and United States Attorney's Office ("USAO") that (b)(7)(C) had engaged in the offense of pretexting (impersonating someone to obtain their telephone records) against Einhorn on behalf of Allied. Allied then filed an SEC Form "10-Q" acknowledging that one of its agents had illegally obtained Einhorn's telephone records, although it claimed not to have authorized the pretexting. The OIG found that the SEC took no action against Allied related to the pretexting.

Moreover, although Enforcement found no evidence of wrongdoing against Einhorn based upon Allied's unsupported allegations, Einhorn's claims against Allied were validated to a great extent by OCIE's examination. However, the record shows that OCIE's examination, prolonged by delays, was unusual in many ways. Specifically, it was conducted primarily by only one headquarters' examiner with very close supervision by the Associate Director in OCIE.

In addition, although the exam lasted for 18 months, there was no visit to Allied's offices, even though they were located just blocks from the SEC. We also found that the Associate Director supervising the exam knew (b)(7)(C) who formerly worked at the SEC, and indicated that he trusted (b)(7)(C) and had the view that anyone who had worked at the SEC was "not going to be doing anything illegal."

The examiner on the Allied examination testified that she received considerable "pushback" from the Associate Director with regard to her findings against Allied. Specifically, the examiner expressed concerns about the method that Allied utilized to raise cash to pay dividends, noting that Allied had not had sufficient cash from earnings to pay dividends since 1999 without the issuance of additional stock. The examiner was concerned that the manner in which Allied was financing its dividends was akin to a "Ponzi scheme." Moreover, all of the work papers from that examination were later inexplicably deleted from the OCIE shared computer drive.

In April 2004, the record shows that OCIE referred three findings from its examination of Allied to Enforcement, including the concern about how Allied financed its dividends with which the Associate Director disagreed. The OIG determined that the issue of how Allied financed its dividends was never investigated by Enforcement. In May 2004, Enforcement finally began its investigation of the claims raised by Einhorn in May and June 2002. We found that Enforcement determined by mid-2006 that more than a dozen of Allied's investments had significant problems with the calculation of their value and that Allied had materially overstated its net book income on SEC Forms "10-K" for several years.

However, after investigating the matter for three years, in June 2007, just after Allied told the SEC its agent engaged in pretexting, the Commission entered into a settlement agreement with Allied. In that agreement, Allied agreed to continue to employ a Chief Valuation Officer to oversee its quarterly valuation process and third-party valuation consultants to assist in its quarterly valuation process for two years. No penalty was assessed against Allied or any of its officers or directors. The OIG investigation further disclosed that Allied's counsel had requested and obtained a "pre-Wells" meeting with Enforcement in which a former SEC Enforcement Director, and other attorneys representing Allied, successfully lobbied Enforcement not to bring fraud charges against Allied or (b)(7)(C) who Enforcement found to have overvalued some of Allied's investments, but instead to have Allied accept a "books and records" charge. We further found that under the settlement with Allied there were no efforts made by the Commission, or even provisions in the settlement order, to monitor compliance by Allied with that agreement.

Finally, we found that after the OIG initiated its investigation and Einhorn's book was published about his experiences with Allied and the SEC, (b)(8)

(b)(8)

In all, the OIG's findings during this investigation raise concerns about how decisions were made within the SEC with regard to the initiating and concluding of the examination and investigations. While we did not find any evidence of specific wrongdoing on the part of current SEC employees, we found that serious and credible allegations against Allied were not initially investigated, and instead Allied was able to successfully lobby the SEC to look into allegations against its rival Einhorn without any specific evidence of wrongdoing.

We also found that there was a lack of communication between OCIE and Enforcement with respect to pending examinations and investigations. Moreover, a former Enforcement manager (who had such significant performance problems he was asked to leave Enforcement) was able to obtain a significant amount of sensitive information he may have disclosed to Allied when he became a registered (b)(7)(C) for Allied a year after leaving the SEC. Further, we found concerns with both the OCIE examination of Allied and the resulting Enforcement investigation, and believe there are questions about the extent to which Allied's SEC connections and aggressive tactics may have influenced Enforcement's and OCIE's decisions in these matters.

We are recommending that the Directors of OCIE and Enforcement carefully review this report of investigation and the history of the examination and investigations that are described in this report and give consideration to promulgating and/or clarifying procedures with regard to:

(1) how examinations and investigations are initiated where there are requests from outside persons or entities, including whether specific allegations of wrongdoing have been provided, in determining whether to commence an examination or investigation;

(2) informing individuals and entities under investigation that they are no longer subjects of an investigation in a timely manner, as required by the Enforcement Manual;

(3) ensuring that other than traditional Wells meetings are not utilized by aggressive counsel to influence decisions in Enforcement actions;

(4) incorporating provisions in Enforcement settlement agreements that ensure requirements are adequately monitored for compliance;

(5) limiting the ability of OCIE personnel to delete examination work papers from OCIE computer systems;

(6) ensuring that OCIE management is not unduly influenced by the presence of former SEC employees in examinations and that all issues identified as potential federal securities law violations be carefully considered for referral to Enforcement; and

(7) documenting the reasons specific issues referred to Enforcement from OCIE are not investigated.

We also recommend that the Ethics Office consider methods to ensure that there is no appearance of impropriety where former SEC staff attorneys represent a company shortly after their work at the SEC provided them with specific and sensitive information related to that company.

Scope of Investigation

The OIG obtained and reviewed voluminous documents related to this matter, including staff e-mails, work papers from an OCIE examination of Allied, and Enforcement documents related to both the (b)(7)(C),(b)(8) and Allied investigations.

The OIG took sworn, on-the-record testimony of:

(1) (b)(7)(C) Staff Accountant, Office of Compliance Inspections and Examinations (February 11, 2009);

(2) David Einhorn, founder and co-President of Greenlight Capital (March 9, 2009);

(3) (b)(7)(C) former OCIE examiner and Branch Chief (July 20, 2009);

(4) (b)(7)(C) Senior Counsel, Division of Enforcement (July 21, 2009);

(5) (b)(7)(C) Senior Counsel, Division of Enforcement (July 30, 2009);

(6) (b)(7)(C) Assistant Director, Division of Enforcement (August 7, 2009);

(7) (b)(7)(C) Associate Counsel, Division of Enforcement (August 11, 2009);

(8) (b)(7)(C) Associate Director, Office of Compliance Inspections and Examinations (August 24, 2009); and

(9) Unidentified Senior Official, Division of Investment Management (September 11, 2009).[2]

The OIG also conducted on-the-record interviews of:

(1) (b)(7)(C) Philadelphia Regional Office Branch Chief (July 24, 2009); and

(2) (b)(7)(C) Senior Advisor to Director, Division of Investment Management (July 28, 2009).

In addition, the OIG conducted several telephone interviews of former Enforcement attorney (b)(7)(C) who refused to appear for OIG testimony.[3]

The OIG also obtained the Official Personnel Folders ("OPFs") of (1) (b)(7)(C) (b)(7)(C) (b)(7)(C) and (2) (b)(7)(C)

Relevant Commission and Government Regulations and Rules

The Commission's Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission (hereinafter "Conduct Regulation"), at 17 C.F.R. § 200.735-1 *et seq.*, sets forth the standards of ethical conduct required of Commission members (*i.e.*, Commissioners) and current and former employees (hereinafter referred to collectively as employees). The Conduct Regulation states in part:

> The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy. In view of the effect which Commission action frequently has on the public, it is

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2 This Senior Official requested confidentiality; therefore, this person is referenced throughout this report as "Senior Official."

3 The OIG had frequent e-mail and telephone communication with (b)(7)(C) from early February through the end of April 2009. Exhibits 1; 2 & 3. (b)(7)(C) initially contacted the OIG after recognizing allegations against himself in the OIG's September 2008 Semi-Annual Report. Exhibit 1. Despite numerous promises to provide a "written narrative" to the OIG (b)(7)(C) never provided any written response. *See* Exhibit 3. (b)(7)(C) also refused to submit to testimony before the OIG. *Id.*

> important that . . . employees . . . maintain unusually high standards of honesty, integrity, impartiality and conduct. 17 C.F.R. § 200.735-2.

The Conduct Regulation's Rule 8 prohibits former Commission employees from *appearing before the Commission* in a representative capacity in a particular matter in which they participated personally and substantially while an employee for a period of either one or two years. 17 C.F.R. § 200.735-8 (italics added). A single investigation is presumed to constitute a particular matter for at least two years irrespective of changes in the issues. *Id.* A matter is defined as a "discrete and isolatable transaction or set of transactions between indentifiable parties." *Id.* Rule 8 further states that no waiver will be granted if the proposed representation would create a significant appearance of impropriety or would otherwise adversely affect the interests of the government. *Id.*

The Commission's staff has the obligation to continuously and diligently examine and investigate instances of securities fraud, as set forth in the Commission's Canon of Ethics. 17 CFR § 200.50, *et seq.* The Canon of Ethics states that "[i]t is characteristic of the administrative process that the Members of the Commission and their place in public opinion are affected by the advice and conduct of the staff, particularly the professional and executive employees." 17 C.F.R. § 200.51. Hence, "it is the policy of the Commission to require that employees bear in mind the principles in the Canons." *Id.*

The Canon provides, "In administering the law, members of this Commission should vigorously enforce compliance with the law by all persons affected thereby. 17 C.F.R. § 200.55. The Canon also affirms that, "A member should not be swayed by partisan demands, public clamor or considerations of personal popularity or notoriety; so also he should be above fear of unjust criticism by anyone." 17 CFR § 200.58. The Canon further states, "A member should not, by his conduct, permit the impression to prevail that any person can improperly influence him, or that any person unduly enjoys his favor or that he is affected in any way by the rank, position, prestige, or affluence of any person." 17 CFR § 200.61.

* * * * *

Results of the Investigation

I. Background Findings

A. Allied Capital Corporation

1. One of the Largest and Most Prominent BDCs

According to SEC officials, Allied Capital Corporation, headquartered in Washington, D.C., is one of the largest and most well-known publicly traded business development companies. Transcript of Testimony of (b)(7)(C) August 24, 2009, attached hereto as Exhibit 4, at 15; Transcript of Testimony of Unidentified Senior Official in Investment Management ("Senior Official Tr."), September 11, 2009, attached hereto as Exhibit 5 at 18; Einhorn's book at 43. A business development company ("BDC") is a company that is created to help grow small companies in the initial stages of their development. Exhibit 6. BDCs were created in a 1980 amendment to the Investment Company Act of 1940 ("1940 Act"). *Id.* To qualify as a BDC, companies must be registered with the SEC in compliance with Section 54 of the 1940 Act. Exhibit 7. A major difference between a BDC and a venture capital fund is that BDCs allow smaller, non-accredited investors to invest in startup companies. *See* http://www.investopedia.com.

According to (b)(7)(C) BDCs are a tiny subset of registered investment companies because there are only about ten to fifteen BDCs. (b)(7)(C) Tr. at 11. (b)(7)(C) explained, "BDCs, by their very nature, are akin to either private equity or venture capital type of fund, but it happens to be a registered fund. They can and do invest in illiquid instruments that don't trade." *Id.* at 12. Therefore, according to (b)(7)(C) valuation is often an issue because of the nature of their investments. *Id.* at 11.

Allied's securities are registered pursuant to Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act"). Exhibit 7. Accordingly, Allied is required to make periodic filings with the SEC. *Id.* According to Allied, BDCs "were created by Congress to encourage the flow of capital to companies that have limited access to long-term investment capital and other needed resources." http://www.alliedcapital.com/who/bdcplatform.asp. In addition, "Allied provides privately negotiated debt and equity financing to middle market companies, with a primary focus on private finance." Exhibit 7. Allied further described:

> BDC regulations require the BDC to maintain a conservative capital structure, limiting the amount of money a BDC may borrow; provide transparency to investors through periodic public reporting; and limit transactions with affiliates. BDCs are also

> required to assist portfolio companies by offering managerial advice and other resources.
> http://www.alliedcapital.com/who/bdcplatform.asp.

According to Allied, it was founded in 1958 (as a small business investment company) and has financed thousands of small and middle market companies in the United States. *Id.* At the end of June 2009, its portfolio included investments in 92 different companies "that generate aggregate annual revenues of approximately $10 billion and employ more than 49,000 people." *Id.* According to Einhorn, in 2004 Allied described itself as having a "private finance portfolio [including] investments in over 100 companies with aggregate revenues of in excess of $11 billion, supporting more than 100,000 jobs." Einhorn's book at 256.

B. Even Though Regulated by SEC as an Investment Company and Considered High Risk, BDCs Could Go Unexamined for Several Years

As noted above, to qualify as a BDC, companies must be registered with the SEC under the 1940 Act. Exhibit 6. BDCs are designed to accommodate private company investments. *Id.* They have their own unique statutory framework and their own unique issues. Senior Official Tr. at 15-16. According to (b)(7)(C) "My view of BDCs is every one of them is an enforcement case waiting to happen." (b)(7)(C) Tr. at 64. Yet, OCIE does not currently have a system for attributing risk profiles for investment companies, only investment advisors.[4] *Id.* at 17. While the Commission has resisted assigning risk profiles for investment companies as it does for investment advisors, managers at the Commission consider BDCs to be high risk. (b)(7)(C) Interview of (b)(7)(C), July 24, 2009, attached hereto as Exhibit 8 at 8; (b)(7)(C) Tr. at 17; *see also* Senior Official Tr. at 16-17. According to (b)(7)(C) although BDCs are considered high risk firms, there is no designated time frame in which BDCs are to be examined by the SEC. (b)(7)(C) Tr. at 17. Therefore, according to (b)(7)(C) BDCs can go more than five years without being examined.[5] *Id.* at 18.

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4 *See also* SEC OIG "Review of the Commission's Processes for Selecting Investment Advisors and Investment Companies for Examination" (November 19, 2009), available at http://www.sec-oig.gov/Reports/AuditsInspections/2009/470.pdf.

5 However (b)(7)(C) testified he does not find that observation troubling because BDCs are such a small segment of the marketplace and only affect a small number of shareholders. (b)(7)(C) Tr. at 17. A Senior Official in the Division of Investment Management ("Investment Management") stated that Investment Mangement spends a disproportionate amount of time on issues related to BDCs, given their number and size, compared to other investment companies. Senior Official Tr. at 17.

C. Valuation of BDC Investments

BDCs are required to value each individual investment on a quarterly basis. *See* Exhibit 6. As a BDC, Allied primarily invests in illiquid securities which lack readily available market quotations. *Id.* When market quotations are not readily available, funds must value portfolio securities and all other assets by using fair value as determined in good faith by the board of directors of the funds, pursuant to the requirements of the 1940 Act and SEC guidance issued thereunder, as well as generally accepted accounting principles ("GAAP") and the Financial Accounting Standards Board requirements. *See* Exhibit 9.

According to a Senior Official in the Division of Investment Mangement, there is no statute or rule-based methodology that funds are required to use to determine fair value. Senior Official Tr. at 83-84. The Commission has issued guidance in two relevant Accounting Series Releases ("ASR") related to fair value - ASR 113 and ASR 118. Exhibits 10 & 11. Those ASRs were issued in 1969 and 1970, respectively.

ASR 113 states, "As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale." Exhibit 10. It continues, "This depends on their inherent worth . . . adjusted for any diminution in value resulting from the restrictive feature." *Id.* ASR 113 cautions companies against using an "automatic formula" to determine value. *Id.* ASR 118 states that no single standard exists for determining fair value of assets for which market quotations are not readily available, and that the board of directors should review "all appropriate factors relevant to the value" of the securities. Exhibit 11. In 1999, a Senior Official in Investment Management wrote a letter to the Investment Company Institute which stated that ASRs 113 and 118 continued to represent the views of the Commission related to fair value. Exhibit 12.

This current-sale valuation test became an issue between Allied and Einhorn. Allied issued a white paper, which Einhorn was highly critical of, entitled, *"Valuation of Illiquid Securities Held by Business Development Companies."* Exhibit 13. Allied took the position in that paper that the application of fair value by a BDC for its illiquid portfolio is often difficult to align with the specific requirements of ASRs 113 and 118. Allied stated, "The concept of 'current sale' for purposes of determining fair value in ASR 118 is difficult, if not impossible, to apply in the case of a BDC's portfolio." *Id.* Allied concluded, "In general, the SBA [Small Business Administration] Policy is far more applicable to the portfolio of a BDC than the valuation guidance set forth by the SEC in the ASRs. *Id.*

Both the Senior Official in Investment Management and (b)(7)(C) agree that additional updated guidance is needed. Senior Official Tr. at 89 & (b)(7)(C) Tr. at 14. Investment

Management has prepared many drafts of valuation interpretive releases for the Commission's consideration over recent years, but the Commission has deferred consideration. Senior Official Tr. at 88-90 (b)(7)(C) Tr. at 14. Investment Management issued a select bibliography on valuation of securities held by registered investment companies in an "attempt to fill in the gap" until updated guidance can be issued. Senior Official Tr. at 93; Exhibit 9.

II. The 2002 (b)(7)(C),(b)(8) Investigation

A. Allied Successfully Urged the SEC to Investigate Einhorn and his Hedge Fund, Greenlight Capital, Without Evidence of Wrongdoing After Einhorn's Negative Speech About Allied

1. Einhorn's Speech

On May 15, 2002, Einhorn gave a speech at the Ira W. Sohn Research Conference for charity where he and other portfolio managers were asked to share their most compelling investment ideas. *See* http://www.foolingsomepeople.com (includes the complete videotaped speech). During his speech, Einhorn described why he believed Allied stock would decline and Greenlight Capital held a short position in it. *Id.* Specifically, Einhorn expressed his view that Allied had a number of impaired investments that it held at inflated values which resulted in overstated results. *Id.* Einhorn concentrated on its valuation methodologies for Allied's portfolio investments. *Id.*

During the speech, several in the audience were on their Blackberries, although when asked about this in his SEC testimony, Einhorn said he did not realize this. Einhorn's book at 161; Exhibit 14 at 97-98. According to Einhorn, the day after the speech, the New York Stock Exchange closed Allied shares for trading because there were so many sell orders it could not open Allied's trading in an orderly fashion. Einhorn's book at 55.

Einhorn notes on his website related to his book,

> What followed was a firestorm of controversy. Allied responded with a Washington-style spin-job - attacking Einhorn and disseminating half-truths and outright lies. Rather than protect investors by reviewing Einhorn's well-documented case against Allied, the SEC – at the behest of the politically connected Allied – instead investigated Einhorn for stock manipulation. Over the ensuing six years, the SEC allowed Allied to make the problem

> bigger by approving more than a dozen additional stock offerings that raised over $1 billion from new investors.
> http://www.foolingsomepeople.com

This speech by Einhorn set off a well-publicized feud between Allied and Einhorn that continues today. *See, e.g.*, February 8, 2007 *Forbes Magazine*, "Allied Capital's Blood Feud." As discussed below, a couple of weeks after the speech, Einhorn contacted the SEC by telephone and then in writing with detailed allegations of fraud by Allied. At the same time, Allied successfully sought a meeting with SEC officials to urge an Enforcement investigation of Einhorn. Enforcement almost immediately began investigating Einhorn related to his speech about Allied. While the agency did begin a lengthy examination of Allied as a result of Einhorn's allegations, it took Enforcement another two years before beginning its investigation of Allied.

2. Allied Stepped Up its Political Efforts

Einhorn alleges in his book that Allied is politically connected, pointing out that Allied is headquartered on Pennsylvania Avenue in Washington, D.C. In addition, Einhorn stated that Allied had connections to the SEC. Allied's (b)(7)(C) had worked for the SEC, and (b)(7)(C) (b)(7)(C) a former SEC Commissioner, later served as a senior advisor to Allied. Einhorn's book at 255-263. Einhorn claims that Allied "accelerated its political efforts" once the SEC investigation of Allied began. *Id.* at 256.

According to Einhorn, Allied began a political action committee in October 2004, just four months after Allied announced the SEC began an investigation of it. Einhorn's book at 257. That same month, (b)(7)(C) registered as a (b)(7)(C) for Allied. Exhibit 15. As Einhorn indicates in his book (b)(7)(C) had not been a (b)(7)(C) Einhorn's book at 258. At that point, (b)(7)(C) was working as a partner for the law firm Venable; according to Venable's website at the time, (b)(7)(C) practice focus was to "advise[] public companies, securities industry professionals and other clients on matters of securities law regulation and compliance." Exhibit 16. In addition, Allied hired Lanny Davis, former White House counsel for President Bill Clinton, to guide Allied management during the time after Einhorn's speech. Einhorn's book at 84.

(b)(7)(C) a senior advisor to the Director of Investment Management ("Investment Management"), was asked by the Director to be a point person on BDCs. Transcript of Interview of (b)(7)(C) Tr."), July 28, 2009, attached hereto as Exhibit 17, at 9. As a result (b)(7)(C) began preparing a draft paper about Allied. Exhibit 6. According to (b)(7)(C) Allied and another BDC are the two most prominent BDCs, and BDCs are politically connected. (b)(7)(C) Tr. at 7. (b)(7)(C) said he quickly learned that BDCs have "a lot of contacts on the 10th floor," meaning with the SEC Chairman and Commissioners, and in

Congress. *Id.* at 9 (b)(7)(C) added that given their size they had a lot of influence; he said BDCs were "fighting out of their weight class."[6] *Id.* at 15.

3. Allied Met with the SEC to Urge Investigation of Einhorn

According to a Senior Official in Investment Management, Allied requested a meeting with Enforcement in June 2002 to try to convince them to investigate Einhorn. Senior Official Tr. at 47-48. The Senior Official testified that (b)(7)(C) (b)(7)(C) attended, as did he. *Id.* He also recalled that Allied's (b)(7)(C) was there, as was (b)(7)(C) who was representing Allied. *Id.* at 48. (b)(7)(C) and (b)(7)(C) did most of the talking at that meeting, according to the Senior Official. *Id.* When asked what evidence Allied presented that Einhorn and Greenlight Capital had engaged in wrongdoing the Senior Official testified,

> Well, they had his speech, they had his admission that he was short. They had their beliefs that they were doing the right thing.

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6 More recently, BDCs have been actively meeting with Congress and the Commission. According to a Senior Official from Investment Management, BDCs have found allies on Capitol Hill who are willing to encourage the SEC to amend and liberalize the rules pertaining to the types of companies in which they may invest. Senior Official Tr. at 22. From approximately September 2008 until January 2009, there were more than ten meetings between BDCs and the SEC Chairman and Commissioners. *Id.* at 29; *see also* Exhibit 18.

7 (b)(7)(C) is currently a (b)(7)(C) and (b)(7)(C) (b)(7)(C) of Allied. *See* http://www.alliedcapital.com/who/bio. According to Allied's website, (b)(7)(C) has been with Allied since (b)(7)(C) having been a (b)(7)(C) at Allied since (b)(7)(C) *Id.* From (b)(7)(C) until after the time of the settlement order from the Commission (b)(7)(C) was the (b)(7)(C)

According to several witnesses, Allied often referred to (b)(7)(C) prior work experience at the SEC. See, e.g., Einhorn's book at 123 & Transcript of Testimony of (b)(7)(C) (b)(7)(C) Tr."), July 30, 2009, attached hereto as Exhibit 19, at 45. (b)(7)(C) (b)(7)(C) lead investigator on the Allied investigation, discussed below, testified that he heard all the time how (b)(7)(C) had worked at the SEC because Allied would bring it up in their representations. (b)(7)(C) Tr. at 46. Then (b)(7)(C) learned that (b)(7)(C) had worked in Enforcement as a staff accountant (b)(7)(C) (b)(7)(C) *Id.* at 45.

> From their perspective, they were in the right and he was in the wrong and Enforcement should hop to it.
> *Id.* at 51.

The result of the meeting, the Senior Official said, was that the facts presented two possible wrongdoers: Einhorn or Allied. *Id.* at 49. The Senior Official testified that he took the position that Allied should be investigated. *Id.* at 52. But instead, Enforcement started investigating Einhorn first. *Id.* at 49.

(b)(7)(C) also confirmed that Allied identified Einhorn as a possible subject during a potentially different meeting with then Enforcement Associate Director (b)(7)(C). Exhibit 20. According to (b)(7)(C) Allied had given a presentation to Enforcement on the anatomy of a short attack by companies such as (b)(7)(C),(b)(8) and Greenlight Capital. *Id.* (b)(7)(C) stated that (b)(7)(C) came to the SEC along with two in-house attorneys, their (b)(7)(C) (b)(7)(C) and investor relations personnel.[8] *Id.* It was during that presentation, (b)(7)(C) told the OIG, that Enforcement came to include Greenlight Capital as a subject of an investigation. *Id.* (b)(7)(C) also said the first time he heard about Allied's wrongdoing was from Allied itself a year before when they indicated that others were alleging Allied was a Ponzi scheme. *Id.*

(b)(7)(C) the lead attorney on the (b)(7)(C),(b)(8) investigation, testified that she believed the (b)(7)(C),(b)(8) case began as a referral from the New York Stock Exchange in December 2002, and that Enforcement's Market Surveillance group received a complaint about aberrations in Farmer Mac's trading. Transcript of Testimony of (b)(7)(C) July 21, 2009, attached hereto as Exhibit 21, at 24. However, according to (b)(7)(C) (b)(5) the source of the investigation was "issuer complaints."[9] *See* Exhibits 22 & 20. (b)(5)

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[8] (b)(7)(C) explained to the OIG that the Chairman of Farmer Mac (Federal Agricultural Mortgage Corp.), who was represented by former Enforcement Director (b)(7)(C) (b)(7)(C), sent a complaint to either (b)(7)(C) (b)(7)(C) or (b)(7)(C), naming Allied as another potential victim. Exhibit 20. (b)(7)(C) remembered that he called (b)(5) (b)(5), as a result (b)(5) another company whose stock was being manipulated. *Id.* (b)(7)(C) then told us that (b)(5) gave him (b)(7)(C) name. *Id.*

[9] (b)(5)

(b)(5)

B. Einhorn Began Contacting the SEC with Specific, Detailed Allegations and Evidence of Wrongdoing by Allied at Same Time Allied Arranged Meetings to Urge SEC to Investigate Einhorn

About two weeks after his above-referenced speech, Einhorn contacted the Senior Official in Investment Management by telephone. Senior Official Tr. at 42. The Senior Official testified he received this call from Einhorn "out of the blue." *Id.* at 41. During that first call, Einhorn said he wanted to talk to him about Allied and valuation. *Id.* at 42. The Senior Official told Einhorn he could not talk about Allied, but that he would be glad to speak to him about how valuation is to be done under the Investment Company Act of 1940. *Id.*

According to the Senior Official, Einhorn called back shortly thereafter. *Id.* at 44. The Senior Official recalled that Einhorn asked if it was alright if the phone call were recorded, and the Senior Official said he agreed to having the conversation recorded. *Id.* Einhorn then explained he knew the Senior Official could not talk about Allied, but that he did want to talk about valuation issues. *Id.* The Senior Official testified it was clear Einhorn wanted to talk about Allied,

> I didn't think he was just theoretically interested in valuation by investment companies. There aren't too many people out there in the world that would do that. I could put one and one together and figure out his interest in Allied valuation.
> *Id.* at 46.

During the conversation, Einhorn asked the Senior Official whether the 1940 Act current fair value test was to be used for mutual funds rather than BDCs which hold illiquid securities. Exhibit 23 & Einhorn book at 79-80. The Senior Official responded, "Disagree," and explained to Einhorn that he was aware that closed-end funds such as BDCs have argued "it's

(b)(5)

inappropriate for a fund to value [its investments] at what the fund would expect to get for it at some point in the future because the appropriate standard is, "what can you get for it today?'" *Id.* Einhorn responded, "Right, but their commentary, their response would be, look, nobody ever sells these loans and the only time anybody ever sells these loans is when they're in financial distress or when the owner's in financial distress and has to conduct a fire sale." *Id.* The Senior Official replied, "I would say that would be all the more reason to hold it at a lower value because that's what it's worth." *Id.* At the end of that call, the Senior Official testified that if what Einhorn was saying was true, it was "worthy of further inquiry by the SEC." *Id.* at 46-47.

Just after that phone call, on May 31, 2002, Einhorn began writing to the SEC with detailed complaints about Allied.[10] Exhibit 24. In all, Einhorn sent about a dozen letters to the SEC and met twice with Enforcement staff regarding Allied. Exhibit 25. In that first letter addressed to the Senior Official, Einhorn wrote, "We are writing to call your attention to certain disclosures and accounting treatments by Allied Capital Corporation ("ALD") that we believe are worthy of investigation." Exhibit 24. He added, "To summarize the main point, we believe that ALD does not comply with the Investment Company Act of 1940." *Id.* Einhorn provided specific examples of its investments and his "systemic valuation concerns" and attached Allied's white paper on valuation of illiquid securities it held, a May 2002 Merrill Lynch report on Allied, and a transcription of an Allied conference call, among other things. *Id.* The Senior Official testified he believed he forwarded to OCIE and Enforcement. Senior Official Tr. at 47.

Einhorn sent two more letters to the Senior Official in Investment Management about Allied - on July 31, 2002 and on September 3, 2002. Exhibits 26 & 27. In the July 2002 letter to the Senior Official, Einhorn addressed the recorded conversation he had with the Senior Official, since Allied expressed concern about this conversation. Exhibit 26. In addition, Einhorn addressed Allied's white paper, discussed above, which discussed why SEC fair value accounting guidance should not apply to a BDC such as Allied stating, "[T]he concept of 'current sale' for purposes of determining fair value in ASR 118 [SEC guidance] is difficult, if not impossible to apply in the case of a BDC's portfolio." *Id.* Again, Einhorn attached several documents, including a report prepared by Greenlight Capital called, "An Analysis of Allied Capital: Questions of Valuation Technique." *Id.* That report apparently had been posted on Greenlight Capital's website after the speech.

The September 2002 letter to the Senior Official expressed concerns about, among other things, recent conference calls with Allied and changes in Allied's disclosure language related to its valuation of investments and Allied's "gross overvaluation" of its stake in Business Loan

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[10] We note that Einhorn stated in these letters, "In full disclosure Greenlight has a short position in ALD [Allied] common stock." *See e.g.*, Exhibit 24.

Express ("BLX"), Allied's largest investment and the second largest small business lending company according to Einhorn (which he had complained about in the earlier letters to the SEC). Exhibit 27.

Thereafter, Einhorn continued to send several letters to the SEC with allegations against Allied to various staff and officials at the SEC from October 2003 through January 2008. *See* Exhibits 28 - 34. Einhorn sent letters t(b)(7)(C) on October 16, 2003 and December 12, 2003. Exhibits 28 & 29. These letters were supplemental reports with updates about Allied's alleged wrongdoing, following a meeting Einhorn had with(b)(7)(C) and(b)(7)(C) on August 13, 2003. *See* Exhibit 28. In his sixth letter about ongoing fraud at Allied, Einhorn wrote to(b)(7)(C) on April 26, 2004, "Allied continues to raise hundreds of millions of dollars of new investor capital through registration statements declared effective by the SEC . . . . Because Allied's disclosures are permeated with inflated valuations and performance smoothing, investors who rely on them are duped into overpaying Allied for its stock." Exhibit 30. Einhorn added, "We, again, request that the SEC put a stop to Allied's fraudulent practices through forceful and timely regulatory action." *Id.*

Those letters were followed by a May 7, 2004 letter to(b)(7)(C) (b)(7)(C) referenced below, about BLX, and then three letters, dated September 20, 2004, June 5, 2007 and January 28, 2008, to(b)(7)(C) Enforcement's lead attorney investigating Allied. Exhibits 31; 32; 33 & 34. In the September 2004 letter, Einhorn raised the issue of his home telephone records being stolen. Exhibit 31. In the January 2008 letter, Einhorn alleged that the "massive fraud" at BLX came to light and a BLX executive had been indicted on charges of defrauding the government of millions of dollars of Small Business Administration ("SBA") loans. Exhibit 34. That January 2008 letter also alleged that Allied had repeatedly violated the settlement order with the Commission, discussed below. *Id.*

C. The Investigation Was Supervised by(b)(7)(C) (b)(7)(C) Who, One Year Later(b)(7)(C)

Shortly after Allied met with officials at the SEC to urge an investigation of Einhorn in June 2002, the Division of Enforcement began an investigation into whether(b)(7)(C),(b)(8) (b)(7)(C),(b)(8) Einhorn's hedge fund Greenlight Capital,(b)(7)(C),(b)(8) and (b)(7)(C),(b)(8) worked together to orchestrate(b)(5) (b)(5)

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11 On July 9, 2002, the matter was opened initially as a matter under inquiry ("MUI") entitled,(b)(5) but it was later renamed, *In Re*(b)(7)(C),(b)(8) Exhibits 35 & 36.

(b)(5)

(b)(5)

A Formal Order was issued on February 11, 2003 appointing (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) (b)(7)(C) and (b)(7)(C) as designated officers in the investigation.[12] (b)(7)(C) stated that he, (b)(7)(C) and (b)(7)(C) were the attorneys who worked on the (b)(7)(C),(b)(8) investigation. Exhibit 20.

(b)(7)(C) acted as supervisor on the (b)(7)(C),(b)(8) investigation. During that time, however, (b)(7)(C) had personal difficulties, and Enforcement was not satisfied with his job performance. In fact, as discussed further below, (b)(7)(C) was asked by then Associate Director (b)(7)(C) to leave Enforcement. Transcript of Testimony of (b)(7)(C) Tr."), August 7, 2009, attached hereto as Exhibit 39 at 25.

(b)(7)(C) began working at the Commission as a staff attorney in Enforcement (b)(7)(C) (b)(7)(C) and was promoted to Branch Chief in Enforcement in (b)(7)(C) (b)(7)(C) (b)(7)(C) worked under then (b)(7)(C) for a period of time when he was a staff attorney and then (b)(7)(C) (b)(7)(C) again reported to (b)(7)(C) until his tenure in Enforcement ended (b)(7)(C) Transcript of Testimony of (b)(7)(C) (b)(7)(C) August 11, 2009, attached hereto as Exhibit 42, at 8.

(b)(7)(C) refused to give testimony to the OIG. Exhibit 3. Instead (b)(7)(C) requested time to prepare a "written narrative" response to the allegations against him. Exhibits 2 & 3. And despite repeated promises to provide the OIG with a "written narrative," (b)(7)(C) never provided any response. Exhibit 3. During the OIG's several attempts to get (b)(7)(C) to provide testimony or a written response to the allegations, (b)(7)(C) voluntarily provided the OIG with information related to our investigation during telephone calls. *Id.*

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12 (b)(7)(C) (b)(7)(C) and (b)(7)(C) are no longer Commission employees and (b)(7)(C) is now deceased.

1. [redacted] Learned a Great Deal About Allied During Course of [redacted] Investigation

[redacted] claimed to have "zero" involvement in the SEC's investigation of Allied. *Id.* However, the record shows that during the course of the [redacted] investigation [redacted] learned a great deal about Allied. [redacted] admitted to meeting with Allied officials and to reaching out to SEC officials and staff while at the SEC, as discussed below. *Id.* [redacted] said he had no idea Allied would be his client when he joined Venable. *Id.*

a. [redacted] E-Mails Showed his Engagement in [redacted] Case

[redacted] e-mails show he was actively engaged in the [redacted] investigation, especially during the early months of 2003. This is further confirmed in testimony from [redacted] Referring to [redacted] performance problems [redacted] testified that [redacted] was on "thin ice" when the [redacted] investigation began saying, "And I think he thought this investigation could turn everything around for him." [redacted] Tr. at 47. [redacted] clarified the excitement about the case was related to proving manipulation in the credit default market, not so much the Allied/Greenlight aspect of the investigation. *Id.* She added, "So I think in [redacted] mind this had great potential for him but then he quickly tired of it. Once we sort of got into the case and realized it was not going to be a huge payoff, he quickly checked out." *Id.*

In addition [redacted] e-mails show that he reached out to several SEC officials to inquire about Allied during his investigation of [redacted] For example [redacted] contacted [redacted] to inquire about their investigation of whether Allied inappropriately valued its holdings.[13] In a January 22, 2003 e-mail [redacted] wrote [redacted] "They only briefly considered the market manipulation angle and are about to close without making an enforcement recommendation. In short, there's no overlap with what we are doing." Exhibit 43. [redacted] learned that [redacted] group had looked into Greenlight Capital's criticisms of Allied, met with Allied executives, but decided there was no case. Exhibit 44. On February 5, 2003 [redacted] e-mailed [redacted] [redacted] tossed the Allied and Greenlight productions, but [an official in] IM still has copies. I'll give her a call and see if someone can pick them up today." Exhibit 45.

When told about a scheduled March 14, 2003 meeting with Allied to "discuss the 'false statements' made in the Greenlight report [redacted] responded, "I'll attend if I can." Exhibit 46.

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[13] According to the SEC's Intranet [redacted] currently works in the SEC's New York Regional Office.

In a April 9, 2003 e-mail responding to (b)(7)(C) about Greenlight Capital's production of documents, (b)(7)(C) provided details about what he had learned about Greenlight Capital at that point. Exhibit 44. Specifically (b)(7)(C) responded in part,

> (b)(7)(C) group looked at the matter informally (I don't even believe it was a MUI) and kicked it to Philly when it didn't look like a fast hit against Allied (there's no write up). Philly did some sort of review, though it's not clear they re-visited [sic] the valuation issue.
> *Id.*

In addition (b)(7)(C) wrote (b)(7)(C) "I made contact with a colleague in [Investment Management] about three weeks ago to 'grease the skids,' so to speak, on getting some [Investment Management] help. I put a new call into him after reading your message, and he suggested some names . . . ." *Id.* That e-mail ended with (b)(7)(C) writing, "I should participate in initial contacts with other Commission offices." *Id.*

After learning via e-mail from (b)(7)(C) that Allied's counsel told her that OCIE examiner (b)(7)(C) had been contacting the company over the last few weeks to discuss valuation, (b)(7)(C) replied, ". . . let's talk with (b)(7)(C) This is news to me. I'll mention it when I speak to (b)(7)(C) (b)(7)(C) tomorrow." Exhibit 47. In May 2003, (b)(7)(C) sent (b)(7)(C) and (b)(7)(C) a lengthy e-mail outlining her thoughts about Greenlight Capital's report on Allied in preparation for their testimony of Einhorn. Exhibit 48. (b)(7)(C) sent an e-mail on May 21, 2003 to (b)(7)(C) seeking further information on OCIE's examination of Allied stating, in part:

> I understand tha (b)(7)(C) (and maybe (b)(7)(C) have been looking at Allied and its method of valuing its holdings in certain privately-held companies. (b)(7)(C) an attorney in my branch, has reported that OCIE is contemplating a referral to Enforcement on this issue. I called yesterday to find out a bit more about OCIE's review and determine, the best I could, where you stood on the issue, e.g., [sic] has a referral been contemplated by you and the OCIE front office? is a referral likely? I'd appreciate any information you can supply . . . .
> Exhibit 49.

Shortly thereafter, (b)(7)(C) e-mailed (b)(7)(C) telling her he had a lengthy conversation with (b)(7)(C) about Allied and had learned OCIE would be:

looking into two primary issues: (1) the way Allied determines 'fair value' of its holdings in private companies and (2) whether Allied must raise/borrow capital to pay out its dividend. (b)(7)(C) (b)(7)(C) said that OCIE is not contemplating a referral to Enforcement at this time. Exhibit 50.

b. (b)(7)(C) Wrote a Detailed Memorandum with Investigative Plan in the (b)(7)(C),(b)(8) Investigation

(b)(7)(C) On March 18, 2003 (b)(7)(C) prepared a 12-page detailed memorandum to his supervisor, outlining the investigative plan in the (b)(7)(C),(b)(8) investigation. Exhibit 51 (b)(5)

(b)(5)

c. (b)(7)(C) Aggressively Questioned Einhorn in Testimony

Einhorn appeared for testimony at the SEC on May 8 & 9, 2003. Exhibits 14 & 52. Einhorn was represented by Zabel, then partner at the law firm Akin Gump Strauss Hauer & Feld,[14] and (b)(7)(C) and (b)(7)(C) of the law firm O'Melveny & Myers LLP. For the SEC, (b)(7)(C) and (b)(7)(C) appeared.

It is undisputed tha (b)(7)(C) was present for part of Einhorn's two days of testimony before the SEC, and was active in asking questions. *Id.* (b)(7)(C) claimed, however, he did not take Einhorn's testimony; he explained (b)(7)(C) was responsible for that and said he only "stepped in" to ask "a series of aggressive questions." Exhibit 20. He said his goal in that testimony was to get Einhorn to admit he attempted to drive down the price of Allied stock when Einhorn gave his speech in 2002, as Allied had alleged. *Id.* (b)(7)(C) further claimed not to have reviewed any of the documents produced by (b)(7)(C),(b)(8) in response to the subpoenas they issued, saying it was standard operating procedure in Enforcement for a branch chief to rely on the staff

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[14] In October 2009, Zabel was appointed Chief of the Criminal Division of the Southern District of New York's USAO. *See* http://justice.gov/usao/nys/pressreleases/October09/criminaldivisionchiefappointmentpr.pdf.

attorney who is taking the testimony. *Id.* (b)(7)(C) did admit he probably reviewed (b)(7)(C) testimony outline. *Id.*

A review of the Einhorn testimony shows that it began at about 10 a.m. on May 8, 2003 and continued until about 5:30 p.m. that day. Exhibit 14. The transcript demonstrated (b)(7)(C) showed up on May 8, 2003 about an hour after (b)(7)(C) began the testimony, he began asking questions very quickly thereafter, and continued until the end of that day at about 5:30 p.m. *Id.* Einhorn again appeared on May 9, 2003 at about 9 a.m. Exhibit 52. Once again (b)(7)(C) began the questioning but (b)(7)(C) appeared at 10 a.m. and immediately began questioning Einhorn. (b)(7)(C) stayed until the end of that day's testimony, which concluded at around 12 p.m. *Id.*

Einhorn complained to the OIG about, and dedicated a chapter in his book to, the testimony he gave before the SEC in May 2003. Einhorn claimed (b)(7)(C) was "confrontational" and "very aggressive" in his questioning of Einhorn in that testimony. Einhorn's book at 162 & Transcript of Testimony of David Einhorn ("Einhorn Tr."), March 9, 2009, attached hereto as Exhibit 53, at 47. (b)(7)(C) agree(d) (b)(7)(C) was "a little combative" and it "seemed to me it was over the top." (b)(7)(C) Tr. at 48-49. She further testified, "I thought (b)(7)(C) was sort of putting on a show for (b)(7)(C)."[15] *Id.* at 48.

According to (b)(7)(C) she believed during Einhorn's testimony (b)(7)(C) "... tried his hardest to get David Einhorn to just 'fess up that he had manipulated the stock, but David Einhorn did not manipulate the stock." (b)(7)(C) Tr. at 47. (b)(7)(C) testified that she had a lot of problems with (b)(7)(C) role in that testimony, including that he did not assist her, had an inadequate reason for being late, and he starting quizzing her about what she had asked Einhorn already in testimony during the first break. *Id.* at 47. Einhorn noticed the tension between (b)(7)(C) and (b)(7)(C) and testified before the OIG that it almost felt like (b)(7)(C) was uncomfortable with (b)(7)(C) questioning. Einhorn Tr. at 50.

d. (b)(7)(C) Reached Out to SEC Officials and Offices to Gain Information about Allied During (b)(7)(C),(b)(8) Investigation

During the course of the (b)(7)(C),(b)(8) investigation (b)(7)(C) told the OIG he reached out to several officials and different offices to determine what findings and/or actions there were related to Allied. Exhibit 20. As a result (b)(7)(C) learned what actions had and were being taken related to Allied, and the positions different staff and officials held about

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15 (b)(7)(C) served as Associate Director in Enforcement under (b)(7)(C) and left the SEC after (b)(7)(C) years in (b)(7)(C)

whether Allied was violating the law. In addition (b)(7)(C) told the OIG of at least one meeting with Allied at which he recalled being. *Id.* According to (b)(7)(C) though, they had probably four to five meetings with Allied. (b)(7)(C) Tr. at 41.

The investigation found that (b)(7)(C) reached out to (b)(7)(C) and examiner (b)(7)(C) about Allied. Specifically, as discussed above (b)(7)(C) e-mailed (b)(7)(C) asking about OCIE's ongoing examination of Allied and whether it was likely to result in a referral to Enforcement. Exhibit 49. (b)(7)(C) reported to (b)(7)(C) that he had a lengthy conversation with (b)(7)(C) about Allied on May 21, 2003, and found out that OCIE was looking into two primary issues: (1) the way Allied determined fair value of its private holdings, and (2) whether Allied must raise/borrow capital to pay out its dividend. Exhibit 50. The e-mail continued, (b)(7)(C) said that OCIE is not contemplating a referral to Enforcement at this time, but that could change as they get a better handle on Allied's business." *Id.* In addition, he received extensive comments from (b)(7)(C) regarding the difficulties of bringing a case against Allied on valuation issues. Exhibit 48.

In the OIG's telephone conversations with (b)(7)(C) he indicated that logs he retained from his time at the SEC show that he spoke to (b)(7)(C) on January 29, 2003 and (b)(7)(C) told him Allied had been examined in November 1994 and November 1999 with routine "no cause" exams. Exhibit 20. (b)(7)(C) also recalled that he spoke to (b)(7)(C) between January and June 2003, after his testimony of Einhorn, and (b)(7)(C) told him he believed Allied was not engaged in wrongdoing. *Id.* Since Einhorn's testimony was on May 8 & 9, 2003, this conversation likely took place in May or June 2003. As discussed below, despite what (b)(7)(C) told (b)(7)(C) by May 2003 the OCIE examiners had found evidence of wrongdoing by Allied. (b)(7)(C) remembered that OCIE found that Allied was not financing their dividends. *Id.* He also recalled that (b)(7)(C) said (b)(7)(C) was satisfied Allied was not engaged in wrongdoing in late June 2003. *Id.* In addition, (b)(7)(C) told the OIG his notes showed that (b)(7)(C) called him on January 27, 2003 and (b)(7)(C) told him that they were closing their investigation of Allied because there was no evidence of improper valuation of its funds. *Id.*

(b)(7)(C) testified he did not remember (b)(7)(C) but that someone may have contacted him about Allied. (b)(7)(C) Tr. at 60-61. (b)(7)(C) admitted he may have told (b)(7)(C) in mid-2003 Allied was not engaged in wrongdoing. *Id.* at 61. According to (b)(7)(C) Commission staff should not say a company has engaged in wrongdoing until after adjudication. *Id.* at 62. But (b)(7)(C) admitted that at that point there were "issues [showing] that there could be wrongdoing" by Allied.[16] *Id.* at 63.

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16 When asked if that would have been a more accurate statement to make in response to whether it appeared Allied was engaged in wrongdoing, (b)(7)(C) claimed not to recall what he said and asked if (b)(7)(C) had notes. *Id.*

(b)(7)(C) also remembered meeting with officials, including the Senior Official in Investment Management and staff in the Division of Market Regulation, about the fair value methods related to BDC investments, including Allied. Exhibit 20. In addition (b)(7)(C) told the OIG he recalled tha (b)(7)(C) was working with Investment Management on Allied and that OCIE found that Allied was financing their dividends. *Id.*

(b)(7)(C) The record shows tha (b)(7)(C) was skeptical of Einhorn's claims about Allied and, like discussed below, did not believe the staff's findings about Allied and asked staff to investigate further. He stated that (b)(7)(C) believed Einhorn was brilliant and had convinced her and (b)(7)(C) that Allied was a Ponzi scheme. *Id.* (b)(7)(C) said he believed (b)(7)(C) and (b)(7)(C) were making judgments without digging into the facts, and that he did not think they were right and asked them to look into it further. *Id.*

e. Additional Investigative Efforts by (b)(7)(C)

1. 13 Boxes of Documents Subpoenaed from Einhorn

According t (b)(7)(C) they had gotten lots of information from Greenlight Capital and Einhorn to prepare for his testimony. (b)(7)(C) Tr. at 28-29. In fact, they received 13 boxes of documents from Einhorn, including trading records, e-mails concerning Allied and certain hedge fund managers involved in the (b)(7)(C),(b)(8) investigation. *Id.* at 29. (b)(7)(C) thought "the most significant portion of the documents produced by David Einhorn and Greenlight were his support for the allegations contained in his written report." (b)(7)(C) Tr. at 30. The written report (b)(7)(C) was referring to was the analysis Einhorn put on his website that was critical of Allied with his thesis of why it was a fraudulent company. *Id.* & Exhibit 23.

According to Einhorn, Greenlight Capital received a letter on January 24, 2003 from the SEC advising that there was an informal inquiry and asked for Greenlight Capital to produce several documents including their research on Allied, all contacts made to third parties about Allied and their research file on Allied, all their trading records, an organizational chart, contact information for all Greenlight Capital employees, all documents describing their compensation structure, a list of their bank and brokerage accounts, and their telephone records from January 1, 2002 forward. Einhorn's book at 149. Einhorn also wrote that later in Spring 2003 Greenlight Capital received a subpoena for Einhorn's testimony and more documents. *Id.* at 153. Einhorn said the second subpoena for documents requested information on other companies, information on trading credit derivatives, their client list, client redemption requests, and their correspondence with several other hedge funds. *Id.*

Einhorn stated tha (b)(7)(C) had access to numerous documents from discovery in the (b)(7)(C),(b)(8) investigation that were valuable to Allied, noting:

> They had everything, because he asked for our trading records, and you have to realize one of the things Allied desperately wanted to know at that point was how many shares were we short, when did we buy and sell and so forth. And so (b)(7)(C) had access to our trading records. He also had access to all of the e-mails that I had relating to Allied on every topic. So there are e-mails from the former employee who contacted us, there were . . . lots and lots of e-mails relating to our criticism of Allied, . . . including what other people we were talking to and getting information from and so on and so forth. And all of that would be information that I would think would be inappropriate for Allied to have any sense of. Einhorn Tr. at 33-34.

Einhorn further testified tha (b)(7)(C) and (b)(7)(C) had, "[w]hat I would consider to be confidential and proprietary information. And this was a very heated battle. And they asked for lots and lots and lots of records, and then had time to look through all of those records in the preparation for questioning me." *Id.* at 34. According to Einhorn's counsel, Zabel, (b)(7)(C) "would have had the full documentary window into what [Einhorn] was doing." *Id.* And, according to Einhorn, based on the questioning (b)(7)(C) did "it was very clear" he had reviewed the materials provided in response to the subpoenas. *Id.*

2. (b)(7)(C) Sought Einhorn's Telephone Records and Client List in (b)(7)(C),(b)(8) Investigation

(b)(7)(C) recalled tha (b)(7)(C) wanted to get the telephone records of all of the hedge fund managers, including Einhorn, to show a pattern of them calling each other prior to trades, but she did not think they ever got that information (b)(7)(C) Tr. at 29. Einhorn wrote in his book that Greenlight Capital produced several documents to the SEC in response to a subpoena they received on January 23, 2003, including Greenlight Capital's research on Allied, trading records, a list of their bank and brokerage accounts, and their telephone records from January 1, 2002. Einhorn's book at 149. However, it is unclear whether any telephone records were produced to the SEC from Greenlight Capital. (b)(7)(C) testified that she did not believe they had requested, or received, any telephone records from Greenlight Capital or Einhorn. (b)(7)(C) Tr. at 30. During Einhorn's testimony before the OIG, he testified that Greenlight Capital did not produce any telephone records. Einhorn Tr. at 35. Einhorn wrote in his book, however, that among the documents Greenlight Capital produced to the SEC in response to a subpoena they received on

January 23, 2003, were Greenlight Capital's telephone records from January 1, 2002, the OIG investigation did not substantiate this claim.[17] Einhorn's book at 149.

(b)(7)(C) testified that they did get Einhorn's client list. (b)(7)(C) Tr. at 30. (b)(7)(C) believed (b)(7)(C) wanted that list "to find some name on the list and some name in our blue sheet trading data that would be like this great moment where the whole case came together and that we would realize that they were manipulating the shares."[18] (b)(7)(C) Tr. at 37. According to (b)(7)(C) they had a lot of problems getting Einhorn's client list since he did not want to produce a written copy of the list. (b)(7)(C) Tr. at 36. (b)(7)(C) said she made (b)(7)(C) deal with the issue of getting the client list with Einhorn's counsel, testifying, "I couldn't even figure out why he wanted it to be honest." *Id.* Ultimately (b)(7)(C) said she and (b)(7)(C) had Einhorn read his list of clients to them over the phone. *Id.* at 37.

(b)(7)(C) claimed in our telephone interviews that he only learned three things about Allied from his work on the (b)(7)(C),(b)(8) investigation, and that he only disclosed one of those things - who Einhorn's counsel was - to Allied. Exhibit 20. (b)(7)(C) indicated the second thing he learned was that Einhorn had a celebrity client. *Id.* (b)(7)(C) did not disclose to the OIG the third thing he supposedly learned about Allied while at the SEC.

2. (b)(7)(C) Shifted Attention from Allied Matter, and (b)(7)(C) Unaware of Other SEC Actions Related to Allied During Investigation

a. (b)(7)(C) Learned About Two Prior Enforcement Matters Involving Allied Where No Action was Taken

During the (b)(7)(C),(b)(8) investigation (b)(7)(C) found out that there had been two other investigations involving Allied. (b)(7)(C) Tr. at 31-32. Specifically, (b)(7)(C) learned that about a year before, (b)(7)(C) group at headquarters looked into Allied but did not pursue it because the difficult accounting issues prevented a "quick hit" for his group, which at the time was operating under a "real time Enforcement" mandate. *Id.* at 31. The other investigation was conducted by (b)(7)(C) group at the PRO that looked into Allied but ultimately decided to do nothing because it involved a "very notoriously gray area" of accounting. *Id.* at 32. (b)(7)(C) testified that she did not know what prompted those groups to look at Allied. *Id.* at 31.

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17 The OIG was unable to obtain the January 2003 subpoena from Enforcement. The April 2003 subpoena, however, did not seek telephone records. Exhibit 54.

18 Blue sheet trading data shows customer trading information. *See* "SEC Systems" on SEC Intranet.

b. (b)(7)(C) Unaware that OCIE was Conducting a Simultaneous Examination of Allied Until Allied's Counsel Informed Her

During the investigation, (b)(7)(C) testified that she was unaware that OCIE was conducting an examination of Allied. (b)(7)(C) Tr. at 53-54. (b)(7)(C) only learned about this examination when Allied's counsel, (b)(7)(C) called to inform her about this. *Id.* According to (b)(7)(C) (b)(7)(C) told her, "I'm just telling you this because I used to work at the SEC and I know that one hand doesn't always know what the other hand is doing." *Id.*; *see also* Exhibit 47. (b)(7)(C) testified after hearing this from (b)(7)(C) ". . . I did not want to say that we had no idea, but we had no idea." (b)(7)(C) Tr. at 53-54. Similarly (b)(7)(C) testified that she was unaware that OCIE conducted examinations of Allied in 1994 and 1999. *Id.* at 32. When asked about those examinations in testimony she stated, "No. I think that's the first time I'm hearing that actually." *Id.*

c. (b)(7)(C) Also Unaware Einhorn had Submitted Letters to the SEC Because (b)(7)(C) Did Not Allow (b)(7)(C) to Contact SEC Official About Allied

(b)(7)(C) was also unaware that Einhorn had submitted several letters to the SEC when she was conducting the investigation. *Id.* at 31. (b)(7)(C) testified that she knew (b)(7)(C) had contacts with the Senior Official but was unaware the Senior Official had received letters from Einhorn. *Id.* at 33. In fact, (b)(7)(C) testified she wanted to speak to the Senior Official before Einhorn's testimony, but that (b)(7)(C) was adamant she not speak to the Senior Official. *Id.* at 55. According to (b)(7)(C) (b)(7)(C) told her that the Senior Official was very embarrassed by being quoted by Einhorn in his report on Allied, since he should not have been quoted in accordance with Commission policy.[19] *Id.*

3. There is No Evidence (b)(7)(C) Physically Took Non-Public SEC Documents

(b)(7)(C) did tell the OIG that he took with him a "memo pad of notes," "personal logs" and calendars from his time at the SEC. Exhibit 20. During telephone interviews with (b)(7)(C) he referred to these notes and calendars which he said reflect telephone calls he made and received related to the (b)(7)(C),(b)(8) investigation. *Id.* As discussed above, for example, (b)(7)(C) told the OIG that his personal logs show that on January 27, 2003, he got a telephone

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[19] The Senior Official testified he knew who (b)(7)(C) was, but was not sure he had ever spoken to him. Senior Official Tr. at 68. He testified Einhorn quoted him accurately, he did not need Commission approval to be quoted, and the quotes did not cause him a problem. *Id.* at 62.

call from (b)(7)(C) telling him that (b)(7)(C) was closing the Allied investigation because there was no evidence of improper valuation of its funds. *Id.* The OIG uncovered no evidence that (b)(7)(C) took any non-public or case-related documents with him when he left the SEC. Nor did we obtain evidence that (b)(7)(C) received any non-public information from any SEC employee after leaving the SEC.

When we asked Einhorn if he was concerned that (b)(7)(C) had taken Greenlight Capital documents when he left the SEC, Einhorn testified that if (b)(7)(C) had simply walked away knowing how many shares Greenlight Capital was short in Allied "at this price at that date," or did not trade after the speech, "I think that would have been information I very much did not want Allied Capital to have." Einhorn Tr. at 36. Einhorn continued, "Just the knowledge of the size of the position . . . . Allied so desperately wanted to know the size of the position . . . ." *Id.* at 36-37.

4. Enforcement Quickly Found Einhorn Engaged in No Wrongdoing

Enforcement concluded by mid-2003 there was no credible evidence to demonstrate that the activities of the hedge funds violated the federal securities laws. Exhibit 37. But the (b)(7)(C),(b)(8) investigation was not formally closed until December 18, 2006. Exhibit 36. The investigation remained open, but inactive after mid-2003, because the New York Attorney General's office was conducting a parallel investigation, which ultimately resulted in no charges. Exhibit 37. According to (b)(7)(C)

> In my mind and in my opinion, as soon as I finished David Einhorn's testimony, I was convinced that he had done nothing wrong . . . , at the end of his testimony I was convinced that he had not manipulated any stock or engaged in any schemes to drive the price of the stock down.
>
> (b)(7)(C) Tr. at 46.

(b)(7)(C) testified that no one disagreed with her on this point. *Id.*

5. Einhorn Was Not Informed He Was No Longer Subject of Investigation, Despite Requesting Such Notice

At the end of Einhorn's testimony in the (b)(7)(C),(b)(8) investigation, he requested that he be told if the SEC determined Greenlight Capital was no longer under investigation. Einhorn testified, ". . . it would be an enormous benefit to us if you could let us know . . . ." when the investigation was complete. Exhibit 52. (b)(7)(C) responded directly to Einhorn's request, saying Enforcement's procedure was to,

> . . . provide a written termination letter at the end of an investigation to entities or people who we have decided not to take action against and who were named in the formal order of investigation. Any other notification is at the discretion of the senior management in the Enforcement Division. (b)(7)(C),(b)(8) (b)(7)(C),(b)(8) as you know from looking at the formal order, is in the caption and is named in the formal order. Greenlight Capital is not named, David Einhorn is not named . . . .
> *Id.*

Therefore, according to (b)(7)(C) articulation of Enforcement's policy and procedures at that time, Einhorn would only receive notification he was no longer being investigated if senior management in Enforcement decided to do so.

(b)(7)(C) could not tell the OIG what Enforcement's policy was then or is now as to sending termination letters after an investigation has ended. (b)(7)(C) Tr. at 17-19. The Enforcement Manual issued in October 2008, however, has a section on termination letters and is clear about when and to whom they should be sent. It states, "The Division's policy is to notify individuals and entities at the earliest opportunity when the staff has determined not to recommend an enforcement action against them to the Commission." Exhibit 55. In addition, the policy states that a termination letter must be sent to, among others, anyone who "asks for such a notice (assuming the staff has decided that no enforcement recommendation will be recommended against that person or entity)." *Id.*

According to Einhorn, he gave testimony in May 2003 and "never heard another word" and was not notified the case was over. Einhorn Tr. at 67-68. In fact, Einhorn testified that (b)(7)(C),(b)(8) the named subject of the investigation, only got a termination letter after writing directly to former Chairman Christopher Cox. *Id.* at 69. It is unclear whether the Enforcement Manual articulated the policy in effect prior to October 2008, since the OIG was unable to find any earlier policy on sending termination letters. Therefore, if this policy had been in effect at the time of Einhorn's testimony, Enforcement would have been required to send him a termination notice shortly after his testimony when, according to the closing memorandum, they had determined he had not engaged in wrongdoing. Exhibit 55.

6. (b)(7)(C) Left the SEC After Significant Performance Problems

a. (b)(7)(C) Was on a Performance Improvement Plan

By at least the beginning of 2003, Enforcement officials had major concerns about (b)(7)(C) work performance. (b)(7)(C) testified that (b)(7)(C)

(b)(7)(C) was placed on a performance improvement plan ("PIP"), which is given to an employee when they have been determined to be unacceptable in one or more elements of their job requirements. (b)(7)(C) Tr. at 11. A PIP is a written plan aimed at raising an employee's job performance to an acceptable level, with assistance such as closer supervision. Exhibit 56. (b)(7)(C)
(b)(7)(C)

(b)(7)(C) served as both Deputy Assistant Director, essentially a higher-level Branch Chief, and Acting Assistant Director (b)(7)(C) (b)(7)(C) Tr. at 7, 14-15. During that time, (b)(7)(C) testified that he supervised (b)(7)(C) as well as other (b)(7)(C) who reported to (b)(7)(C) *Id.* at 17. (b)(7)(C) knew (b)(7)(C) from when he and (b)(7)(C) worked as branch chiefs under (b)(7)(C)
Id. at 16. According to (b)(7)(C) (b)(7)(C) promoted (b)(7)(C) to Branch Chief. *Id.*

(b)(7)(C) testified that (b)(7)(C) the attorneys who reported to (b)(7)(C) came to him to complain abou (b)(7)(C) *Id.* at 18. A confidential document about (b)(7)(C) 's poor performance indicates tha (b)(7)(C) of the four attorneys working under (b)(7)(C) visited (b)(7)(C) to complain about (b)(7)(C) after (b)(7)(C) was out (b)(7)(C) (b)(7)(C) and tha (b)(7)(C) of them asked to be reassigned. (b)(7)(C) At some point (b)(7)(C) said, he spoke to them (b)(7)(C) about the situation. (b)(7)(C) Tr. at 18-19. (b)(7)(C) testified that he thought there had already been complaints abou (b)(7)(C) which (b)(7)(C) and (b)(7)(C) were aware of, and had begun looking into (b)(7)(C)
(b)(7)(C) *Id.* at 19. (b)(7)(C) however, seemed unaware, or perhaps did not remember, that (b)(7)(C) was on a (b)(7)(C) before (b)(7)(C) (b)(7)(C) *Id.*

(b)(7)(C) testified that the complaints about (b)(7)(C) were that he was not responsive and not following through to complete projects. (b)(7)(C) Tr. at 20. (b)(7)(C) similarly testified that the staff attorneys working under (b)(7)(C) complained about his failure to timely review action memoranda and other documents. (b)(7)(C) Tr. at 10. (b)(7)(C) testified that (b)(7)(C) was difficult to work with. (b)(7)(C) Tr. at 11. According to (b)(7)(C) staff had "personality clashes" with him, and some moved to another group or asked to be moved to another group.

(b)(7)(C) told the OIG that during (b)(7)(C) 's (b)(7)(C) leave (b)(7)(C)
(b)(7)(C) (b)(7)(C) didn't have anybody watching him closely and so he really just started coming in hours late and not really doing his work." (b)(7)(C) According to (b)(7)(C) during this time (b)(7)(C) was also experiencing "significant personal problems," (b)(7)(C)
(b)(7)(C) (b)(7)(C) Tr. at 11-12. (b)(7)(C) notes show tha (b)(7)(C) took leave during the week of April 25, 2003 (b)(7)(C) Exhibit 58. In addition, (b)(7)(C) testified that (b)(7)(C) spent much of his time dealing with buying homes

and fixing them up. (b)(7)(C) (b)(7)(C) added, "We used to joke that his real job was real estate." *Id.*

After (b)(7)(C) told (b)(7)(C) about the staff attorneys coming to complain to him about (b)(7)(C) (b)(7)(C) asked him to "look into the concerns." (b)(7)(C) Tr. at 21. (b)(7)(C) testified that he then spoke to two trial unit lawyers who had worked with (b)(7)(C) and probably spoke to each person who worked under (b)(7)(C) but did not recall for certain. *Id.* (b)(7)(C) believes he then prepared a confidential document to brief (b)(7)(C) and "perhaps, in preparation for (b)(7)(C) meeting with (b)(7)(C) to address these issues." Exhibit 57. According to (b)(7)(C) (b)(7)(C) had individual meetings with each person in (b)(7)(C) 's group. (b)(7)(C) Tr. at 16.

According to that confidential document, there were "two major problems" with (b)(7)(C) 's work: (1) failing to follow through on assignments, and (2) leaving things to the last minute resulting in a poor work product. *Id.* According to that document, those issues had been discussed with (b)(7)(C) before, but the situation had not improved. *Id.* It then identified specific examples of (b)(7)(C) 's failure to complete assignments and its consequences, including that three of the four members of (b)(7)(C) 's branch voiced concerns about (b)(7)(C) two asked to be reassigned, and (b)(7)(C) was taken off of a trial team because of his delays in completing work assignments. *Id.*

b. (b)(7)(C) Was Asked to Leave Enforcement

According to (b)(7)(C) the initial meetings with (b)(7)(C) about his work performance were more exploratory, including "possibilities for (b)(7)(C) moving on." (b)(7)(C) Tr. at 25. (b)(7)(C) testified, "I do know that there was one point where the last meeting I recall . . . (b)(7)(C) basically asked (b)(7)(C) to leave and, you know, the desire was to have that happen as quickly as it could." *Id.* (b)(7)(C) believed that (b)(7)(C) left Enforcement at the end of July, and then used leave he had accumulated. *Id.* (b)(7)(C) thought he went to (b)(7)(C) 's going away party at the end of July 2003. (b)(7)(C) Tr. at 26.

According to (b)(7)(C) there was an effort to arrange for (b)(7)(C) to go to work in OCIE for a while. (b)(7)(C) Tr. at 26. (b)(7)(C) handwritten notes from that time period also appear to show that (b)(7)(C) contacted (b)(7)(C) about a position for (b)(7)(C) *See* Exhibit 59. For a very short period of time, before (b)(7)(C) formerly separated from the agency on September 11, 2003, he worked in OCIE.[20] (b)(7)(C) thought (b)(7)(C) went to work for

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[20] (b)(7)(C) official personnel file (OPF), however, shows that he was still assigned to the Division of Enforcement after July 2003. (b)(7)(C) Moreover, his OPF shows that he was (b)(7)(C) an SK-15, Step 27 (with a salary of $131,911) (b)(7)(C) SK-14-Step 27 (with a salary of $124,442) (b)(7)(C)

OCIE for about two to three weeks. (b)(7)(C) Tr. at 8 (b)(7)(C) testified that everyone assumed that this was the solution (b)(7)(C) had come up with for (b)(7)(C) even though (b)(7)(C) told them that he was moving to OCIE and had been thinking about a change for a while. *Id.* at 16-17. (b)(7)(C) also said there was gossip that (b)(7)(C) had problems in OCIE as well. *Id.* at 9.

According t (b)(7)(C)

> My understanding is that (b)(7)(C) was moved to OCIE because he was not working out any longer in Enforcement and that (b)(7)(C) (b)(7)(C) in particular, had for several months been sort of trying to come up with a solution to the problem that (b)(7)(C) had become in Enforcement. And specifically pretty much anyone who reported to (b)(7)(C) ever, or during the time that he was branch chief even before I got here, supposedly asked to be moved out of his group.
> *Id.* at 10.

When asked, "Did you?" (b)(7)(C) responded, "Yes." *Id.*

Directly after leaving the SEC (b)(7)(C) joined the law firm Venable (b)(7)(C) *Id.* at 18-19. (b)(7)(C) told the OIG that he went to work for Venable because he followed (b)(7)(C) and (b)(7)(C) in Enforcement, with whom he had worked at the SEC. (b)(7)(C) joined (b)(7)(C) from the SEC in (b)(7)(C) (b)(7)(C) (b)(7)(C) said that he had interviewed with Venable and OCIE, that he went to work for OCIE for one week in (b)(7)(C) after having returned from a leave of absence (b)(7)(C) when Venable offered him the job and he accepted.[21] Exhibit 20.

(b)(7)(C) never told the OIG that he was having employment problems, was on a PIP, or was asked to leave Enforcement, but instead told the OIG that he had to take a "massive" amount of time off from work (b)(7)(C) *Id.* According to (b)(7)(C) he basically turned over the supervision of the (b)(7)(C) case to (b)(7)(C) who started in (b)(7)(C) 's group as a staff attorney, because he had essentially "lost control" of his branch. *Id.*

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[21] At the time of our telephone interviews with (b)(7)(C) in February 2009, he indicated he had not worked for Allied for a couple of years. Exhibit 20. Since that time, (b)(7)(C) joined another law firm and is now a solo practitioner. *Id.*

7. (b)(7)(C) Registered as a (b)(7)(C) for Allied One Year Later

Effective October 1, 2004 (b)(7)(C) became a registered (b)(7)(C) for Allied on behalf of Venable. Exhibit 15. According to (b)(7)(C) his (b)(7)(C) with Allied was on the short sale transparency bill, and Allied had (b)(7)(C) go to the Senate Banking Committee to say, "let them [the SEC] do their job." *Id.* (b)(7)(C) said that SEC Chairman William Donaldson at the time was pushing for a hedge fund rule. Exhibit 20.

In 2005, Greenlight Capital and Einhorn's counsel sent the OIG a letter of complaint about possible legal and ethical violations by (b)(7)(C) becoming a (b)(7)(C) for Allied after "obtaining confidential material from [Greenlight], including e-mails, trading records and testimony about Allied." Exhibit 61. Einhorn and his counsel pointed out that (b)(7)(C) had no (b)(7)(C) experience prior to becoming a (b)(7)(C) for Allied. *Id.* & Einhorn's book at 258. In addition, Einhorn noted that according to Venable's press release issued when it hired (b)(7)(C) he was to "concentrate on corporate investigations, white collar & securities litigation and compliance."[22] *Id.*

a. Ethics Office Cleared (b)(7)(C) to Register as (b)(7)(C) Based on Incomplete Information from (b)(7)(C)

During the 2005 inquiry into this matter, the OIG interviewed the Assistant Ethics Counsel (b)(7)(C) of the Office of the Ethics Counsel within the SEC's Office of the General Counsel, who gave (b)(7)(C) advice about his (b)(7)(C) for Allied. Exhibit 62. During that 2005 inquiry, the OIG learned that (b)(7)(C) recalled (b)(7)(C) contacting her before registering as a (b)(7)(C) for Allied and told her his (b)(7)(C) would have nothing to do with what he worked on at the Commission. *Id.* He also told (b)(7)(C) he had not worked on the investigation of Allied while he was at the SEC. *Id.*

There is no evidence tha (b)(7)(C) s (b)(7)(C) for Allied violated any specific rule, regulation or statute. For example, (b)(7)(C) does not violate any criminal statute such as 18 U.S.C. § 207, which prohibits former government employees from knowingly making any communication to, or appearance before, any department or agency with the intent to influence. Nevertheless, the OIG investigation found that (b)(7)(C) received clearance (b)(7)(C) for Allied based upon incomplete information, including the fact that while he did not specifically work on

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[22] As noted above, the OIG conducted an inquiry in 2005 and found no violation of any law, SEC rule or regulation, or ethics rule.

the Allied investigation he had learned a great deal about Allied during his work and supervision of the (b)(7)(C),(b)(8) investigation just before his departure from the SEC.[23]

The Ethics Counsel told the OIG that even though there may be an appearance of impropriety i(b)(7)(C) for Allied one year after leaving the SEC, after he learned much about Greenlight Capital's trading position in Allied, among other things, the Ethics Office could not preven(b)(7)(C) from registering as a(b)(7)(C) since he was no longer an SEC employee. Exhibit 63.

b. (b)(7)(C) (b)(7)(C) Contacted Ethics Office About Concern for Potential Conflict of Interest

(b)(7)(C) testified that(b)(7) learned(b)(7)(C) had registered as a(b)(7)(C) for Allied from(b)(7)(C) (b)(7)(C) Tr. at 52.(b)(7)(C) said that it concerned(b)(7)(C) when(b)(7) learned of it because there might be a conflict of interest due t(b)(7)(C) s work on the(b)(7)(C),(b)(8) investigation; therefore,(b)(7) called the Ethics Office. *Id.*(b)(7)(C) did not recall who(b)(7) spoke to in the Ethics Office. *Id.* But(b) remembered that the Ethics Office was aware of the issue and told(b)(7)(C) had contacted them prior to registering as a(b)(7)(C) for Allied. *Id.* at 53.

(b)(7)(C) testified that the Ethics Office either said or implied that they had given (b)(7)(C) approval to register as a(b)(7)(C) *Id.*(b)(7)(C) said(b)(7) shared with the Ethics Office the facts as(b)(7)(C) understood them, specifically that(b)(7)(C) knew "some things" about Allied, and that they seemed aware of those facts. *Id.* at 53-54.(b)(7)(C) further testified that the Ethics Office informe(b)(7)(C) told them the work he would be doing as(b)(7)(C) did not relate to Allied's dealings with the Commission. *Id.* According t(b)(7)(C) the Ethics Office did not ask(b)(7)(C) any more questions and(b) took it to mean that it had been cleared with them. *Id.* at 54. Other than telling(b)(7)(C) boss,(b)(7)(C) did not take any other action related to this matter. *Id.* at 53.

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[23] (b)(7)(C) told the OIG in 2005 that even if(b)(7)(C) had worked on Allied during his tenure at the SEC there would not be a problem with(b)(7)(C) for Allied. Exhibit 62. This is true,(b)(7)(C) told the OIG, because(b)(7)(C) typically involves some prospective action that the company wants Congress to take and Congress is prohibited from influencing the outcome of Commission investigations. *Id.*

C. Allied's Counsel Informed the SEC, and Criminal Authorities, that (b)(7)(C) Engaged in Pretexting of Einhorn's Telephone Records After He Left the SEC, But No One Ever Informed Einhorn of This Matter

1. The Pretexting

According to Einhorn, he and others critical of Allied, were the victims of pretexting. Einhorn's book at 213-215; *see also* Exhibit 64. Pretexting is impersonating someone to obtain their telephone records, and because it is identity theft, it is a considered a crime.[24] Exhibit 66.

In his book, Einhorn noted that he discovered that his wife's (Cheryl Einhorn's) telephone records were taken on December 7, 2003, when he was told a woman called AT&T and identified herself as "Cheryl Einhorn" and used her social security number to open an online billing account for his home telephone.[25] Einhorn's book at 215. According to Einhorn, the caller directed the phone company to send copies of Einhorn's home telephone bills to an AOL account. Einhorn's book at 215.

2. Allied's Admission and SEC Disclosure of Pretexting

Einhorn first raised concerns that Allied illegally gained assess to his phone records in a March 2005 letter to Allied's Board. Exhibit 67. Einhorn wrote, ". . . my home phone records were among the records that were illegally accessed. . . . Like me, at least four additional individuals have been the victims of this identity theft and access device fraud. The only thing that connects the victims is that they have all been critics of Allied." *Id.* Allied responded a week later, asking Einhorn for specific information related to his allegations. Exhibit 68.

Einhorn reiterated his allegation and concerns about the pretexting in a letter to Allied in September 2006, seeking to have the Board conduct an investigation into the matter. Exhibit 69. Eleven days later, Allied responded to Einhorn and stated, "We have looked into your allegations

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[24] Pretexting became widely known in a high-profile matter in September 2006 when it was revealed that Hewlett Packard Co. ("HP") General Counsel, at the behest of HP Chairwoman Patricia Dunn, used security experts who in turn hired private investigators to obtain HP Board members and reporters' telephone records by impersonating them in order to identify the source of an information leak. Exhibit 65. Dunn and the Board members were charged with violating several laws restricting unauthorized access to data, and the SEC also investigated the matter. *Id.*

[25] We note this was a short time afte (b)(7)(C) left the Commission and began work at Venable representing Allied.

that Allied's management played a role in an attempt to access your phone records and have found no evidence to support your claim." Exhibit 70. Allied also noted that they were skeptical of Einhorn's motives and were, therefore, not disposed to credit his claims without "corroborating evidence." *Id.*

After denying for some time that it had any involvement in illegally obtaining Einhorn's telephone records, Allied filed an SEC Form "10-Q" with the SEC in March 2007, and disclosed the following regarding the pretexting:

> In late December 2006, we received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by us or our agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, we became aware that an agent of Allied Capital obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while we were gathering documents responsive to the subpoena, allegations were made that our management had authorized the acquisition of these records and that management subsequently advised that these records had been obtained. Our management has stated that these allegations are not true. We are cooperating fully with the inquiry by the United States Attorney's office [sic].[26]
> Exhibit 71.

In a February 7, 2007, *Washington Post* article entitled, "Allied Capital Says Its 'Agent' Got Phone Data," it quoted the statement outlined above in Allied's SEC Form "10-Q." Exhibit 72. The article also obtained a quote and statement from Einhorn reacting to Allied's disclosure. Einhorn was quoted as saying, "After five years, Allied Capital has acknowledged a tiny piece of its rampant misconduct." *Id.* He noted that Allied left unanswered, however, questions about

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[26] It is unclear from Allied's disclosure whether they discovered personal home telephone records of David Einhorn as well as telephone records of Greenlight Capital during a period of time in 2005 or whether it was just Greenlight Capital's telephone records. That time period (2005), however, is inconsistent with what Einhorn says he learned about the pretexting of his home telephone records – *i.e.*, that his home telephone records were taken in December 2003.

who at the firm knew about the pretexting, who hired the agent responsible for obtaining the records and how widespread the activity was. *Id.*

To date, Allied has issued no other statement or disclosure regarding the pretexting.

3. Allied's Lawyers Told the SEC that (b)(7)(C) was Responsible for the Pretexting

The Enforcement Division learned in early 2007, just before the final settlement of the Enforcement investigation of Allied discussed below, from outside counsel for Allied that (b)(7)(C) was the agent responsible for obtaining Einhorn's phone records. (b)(7)(C) Tr. at 110. According to (b)(7)(C) during the settlement discussions between Enforcement and Allied discussed below, counsel for Allied (from the law firm WilmerHale as well (b)(7)(C) from the law firm DLA Piper) came to the SEC to say, "There is something you should know" -- and they informed (b)(7)(C) (b)(7)(C) and (b)(7)(C) that (b)(7)(C) was responsible for obtaining Einhorn's phone records. *Id.* at 109-110. (b)(7)(C) testified that (b)(7)(C) and (b)(7)(C) were the partners from WilmerHale who were present at that meeting, and that (b)(7)(C) was the one who imparted the information. *Id.* at 112. Moreover, (b)(7)(C) testified that counsel for Allied also informed the USAO about this. *Id.* at 115.

(b)(7)(C) testified that everyone was "really, really surprised" and "shocked" to learn this. *Id.* at 111. (b)(7)(C) believed that (b)(7)(C) s former supervisor, seemed shocked from the look on (b)(7)(C) face. *Id.* at 112. After the meeting, (b)(7)(C) testified he, (b)(7)(C) and (b)(7)(C) had a debriefing about the pretexting issue and whether Enforcement had jurisdiction over the issue. *Id.* at 112. According to (b)(7)(C) they checked with the Enforcement group who handled the action and settlement against Hewlett-Packard for a similar type of act, but concluded Enforcement did not have jurisdiction over the matter because they did not see a potential securities law violation.[27] *Id.* at 109. In addition, Enforcement instructed the USAO to inform them if they believed there was a potential securities law violation by Allied regarding the pretexting. *Id.* at 114. The USAO was "actively looking at the pretexting

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[27] The OIG found that Enforcement opened an investigation into Hewlett Packard ("HP") in October 2006 into potentially false or misleading disclosures made in SEC forms filed with the SEC earlier that year. Exhibit 65. The disclosures related to the resignation of one of its directors. *Id.* In May 2007, the Commission filed settled administrative charges against HP "for failing to disclose the reasons for a director's abrupt resignation in the midst of HP's controversial investigation into boardroom leaks." *Id.* HP was found to have violated the public reporting requirements of the Securities Exchange Act of 1934. *Id.*

issue.[redacted] learned, and a grand jury was convened. *Id.* at 115. [redacted] assumed [redacted] was either a subject, target or witness of that grand jury. *Id.*

[redacted] had a less definitive recollection from that meeting of whether Allied's counsel was certain [redacted] was responsible for the pretexting. Specifically, [redacted] testified that [redacted] and [redacted] had a meeting with [redacted] from WilmerHale, in which he brought to Enforcement's attention that "there was a possibility that [redacted] had been involved in some way" in the pretexting of Einhorn's phone records. [redacted] Tr. at 46 & 48. [redacted] further testified [redacted] remembered learning from Allied's counsel,

> [redacted] had possibly hired someone, an investigator. And I don't remember specifically, but that the investigator may have gotten access to these records and that there was a question as to whether [redacted] had asked or authorized that particular action and whether the company had been aware of it.
> *Id.* at 47.

[redacted] continued, "I vaguely recall there being some issues about figuring out some more of the details." *Id.* In addition, [redacted] told the OIG they learned that the USAO started an investigation although [redacted] did not know the status of the investigation. *Id.* at 49.

The OIG discovered handwritten notes from a telephone call to the OIG from [redacted] about [redacted] dated February 5, 2007, that appear consistent with [redacted] testimony about what [redacted] learned about [redacted] possible role in the pretexting. Exhibit 73. It appears [redacted] contacted the OIG about a meeting [redacted] had with Allied where [redacted] learned that [redacted] may have engaged in the pretexting of Einhorn's records. *Id.* When asked during testimony, however, whether [redacted] had contacted the Ethics Office, OIG or a state bar after learning [redacted] may have been responsible for the pretexting, [redacted] did not recall contacting anyone about this. [redacted] Tr. at 50.

The notes show that [redacted] was contacted by WilmerHale, who represented Allied, and appear to state in short hand, among other things, "allegation: [redacted] authorized private investigator that engaged in pretexting." Exhibit 73. The notes also appear to state, "[redacted] . represented Allied . . . hired PR firm authorized firm to hire private investigator to get phone records of hedge fund." *Id.* [redacted] notes also state there was a criminal investigation relating to the pretexting.[28] *Id.*

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[28] The OIG contacted the USAO to inquire about its investigation into Allied, and learned that it had investigated [redacted] and formed a grand jury. The OIG made a request to the USAO to review their files related to [redacted] The USAO was unable to locate their

4. Einhorn and his Counsel Responded to the Failure of SEC to Take Action Against Allied's Admitted Pretexting

On May 1, 2007, Zabel, Greenlight Capital's and Einhorn's counsel, wrote to Allied about its public disclosure and admission that it had become aware "an agent of [Allied] obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005." Exhibit 74. Zabel then wrote, "Despite this public admission, Allied has thus far apparently kept the information its agents illegally accessed and given no information to Mr. Einhorn to allow him to evaluate the incursion into his privacy and the misappropriation of his personal information." *Id.*

Zabel requested to be immediately provided with: (1) copies of the phone records which purport to be Greenlight Capital's or Einhorn's; (2) a description of the methods used to obtain such records, including the information used to misappropriate them; (3) the identity of the persons involved in obtaining the records; and (4) the names of anyone to whom Einhorn's personal information or misappropriated information was provided. *Id.* To date, Einhorn and his counsel indicated that they received no additional information related to the pretexting. Einhorn Tr. at 116-117.

During the OIG's testimony of Einhorn, Zabel expressed his extreme disappointment and frustration with the SEC related to the pretexting saying, "And I don't understand why the SEC doesn't force them to reveal what happened in their internal investigation into this." Einhorn Tr. at 117. Zabel continued,

> One of our big complaints, there are a number of them, but the SEC, among others, seemed to not care at all that the company came out and admitted – after denying and lying about it . . . denigrating [Einhorn] as this being a figment of a paranoid imagination is the way they put it, they made false, or at a minimum incorrect statements about the actions of their own agents. And the SEC didn't seem to care about a public company having agents do something like that, which in our view is a crime. And [this] is not the conduct that the SEC should want public companies engaging in, because it's very chilling to the free kind of debate and criticism that the SEC, I think, wants in the marketplace.

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files, which had been archived. We note, however, even if they had located those archived files many of the documents were likely grand jury materials and could not have been shared with the OIG.

Id. at 37-38.

Zabel said, ". . . nobody has even called us to tell us this is what we found, or here's why we can't bring a case." *Id.* Ironically, given that it appears a former Enforcement attorney engaged in the pretexting of Einhorn's records, Zabel said, "I can guarantee you that if an SEC person who had been involved in investigating a company . . . was pretexted, that there would have been some pretty swift action." *Id.* at 40. Furthermore, Zabel continued,

> That is just amazing to me that no one is making [Allied] do anything about it. There's no reason that you can't have a company you now know, they have admitted they did something wrong, at least address some of those issues. Even if it's an ongoing investigation, where are the records, who got them, who are these people so we can know who they are and we can watch out for them and what they might be doing with the records. . . . It's really an outrage. The whole thing is. That part is particularly reckless on the part of the government.
> *Id.* at 118-119.

In comparing this to the Hewlett-Packard matter, Zabel stated,

> This is not just pretexting. I viewed this as more important that the Hewlett-Packard one. Hewlett-Packard was an internal dispute which wasn't good. But it was really just people getting on each other within their own company being stupid and paranoid. These were market participants engaged in a real debate of real importance, and one side employed dirty tactics to try to shut the critics down. And I thought it was far more significant than Hewlett-Packard, although HP got all the press because there were some big names.
> *Id.* at 89-90.

III. The 2002-2004 SEC Examination of Allied

An OCIE examination of Allied began from a referral from the Senior Official in Investment Management. Senior Official Tr. at 46-47. Investment Management is responsible for assisting the Commission in investor protection and promoting capital formation through oversight and regulation of the investment management industry. *See* http://www.sec.gov/about/whatwedo. Investment Management also reviews investment

company and investment advisor filings and assists the Commission in Enforcement matters involving investment companies and advisors. *Id.* The Senior Official testified that he spoke to OCIE about doing an examination of Allied because he thought it was more appropriate than Enforcement since OCIE was familiar with the valuation issues related to BDCs such as Allied. *Id.* at 52-53 & 59.

OCIE commenced a review of Allied in July 2002 based on Einhorn's first letter to the Senior Official, discussed in section II.B. above. Exhibit 75. Einhorn, in his phone calls and letters to the Senior Official, had outlined Allied's position related to not following SEC guidance on valuation of illiquid securities which are not traded in the markets. Exhibits 24; 26 & 27. Allied wrote a white paper on its view that the SEC guidance in this area should not apply to them. Exhibit 13. The Senior Official testified that he did not agree with Allied that it was difficult, if not impossible, to apply SEC guidance on valuation to BDCs. Senior Official Tr. at 57. He further testified that he was worried that Allied was valuing its assets consistent with its white paper, which would not have been appropriate. *Id.* at 58. According to the Senior Official, this made it worthy and appropriate for the Commission to look into Allied's valuation. *Id.* The Senior Official recalled that he had expressed his disagreement with the white paper at a meeting with (b)(7)(C) and Enforcement. *Id.* After that meeting, the Senior Official said, Allied took down the white paper from its website. *Id.*

The OCIE examination was conducted at headquarters beginning July 23, 2002 and was completed on March 19, 2004. Exhibit 75. According to the examination report, the last examination of Allied was conducted in 1999. *Id.* During the period of the examination, the examination team received the additional letters from Einhorn as well as from another critic of Allied, Jim Brickman ("Brickman").[29] During this same time period, staff members of Investment Management and Enforcement conducted their own review of Allied, and joint divisional meetings were held. *Id.* The examination report was issued on April 26, 2004, and it was formally referred to Enforcement for action. *Id.* Enforcement had already opened a matter under inquiry ("MUI") on March 9, 2004. Exhibit 76. On May 9, 2004, Enforcement opened a formal investigation, discussed below, into Allied based on that examination. Exhibit 77. Despite finding problems that merited a referral to Enforcement, OCIE did not send Allied a deficiency letter, "which meant the people [at Allied] just kept on doing what they were doing,

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[29] Brickman, a retired real estate developer from Dallas with a background in SBA lending, was a vocal critic of Allied who also sent letters of complaint to the SEC about Allied. Exhibit 6; Einhorn's book at 137. According to Einhorn, Brickman contacted him about Allied and they began a long dialogue about issues related to Allied. Einhorn's book at 138. Einhorn described Brickman as "one of the best forensic detectives I have ever met," and claimed although he had spent many hours analyzing Allied, Brickman has spent many more. *Id.*

unless they got the hint that we kept asking all those questions regarding certain issues." Transcript of Testimony of (b)(7)(C) Tr."), July 20, 2009, attached hereto as Exhibit 78 at 29.

A. Deficiencies and Unusual Circumstances with the Examination of Allied

Both (b)(7)(C) and (b)(7)(C) testified that this examination was unusual in several ways. (b)(7)(C) Tr. at 12 & 20. First, (b)(7)(C) was the primary examiner assigned to this examination, and she was supervised directly by (b)(7)(C) Second, there was no visit to Allied's offices located just blocks from OCIE's office at the time. (b)(7)(C) testified that "this whole exam was unusual" because generally examiners go out to the firm for a week or so, interview management and review documents, then come back to the SEC to write a report and then send a deficiency letter. (b)(7)(C) Tr. at 12 & 20. But in this case, there was no visit to Allied's office whatsoever and no deficiency letter was sent (although it was referred to Enforcement). This examination of Allied was also prolonged by delays and took eighteen months to complete. Moreover, as discussed below, the evidence shows that the (b)(7)(C) knew (b)(7)(C) and that (b)(7)(C) had worked at the SEC, and he believes anyone who had worked at the SEC is less likely to engage in wrongdoing.

1. The Examination Was Conducted Primarily by One Examiner and Supervised by (b)(7)(C)

(b)(7)(C) currently a senior staff accountant, was the primary examiner assigned to the Allied examination in 2002. Transcript of Testimony of (b)(7)(C) Tr."), February 11, 2009, attached hereto as Exhibit 79, at 8 & 15. According to (b)(7)(C) usually there are three or four examiners conducting an examination. *Id.* at 17. At some point later, after (b)(7)(C) had requested assistance on the examination (b)(7)(C) worked on the examination as well for about six to nine months. *Id.* at 16. (b)(7)(C) began at the SEC (b)(7)(C) as a (b)(7)(C) securities compliance examiner. *Id.* at 8 & 13. Prior to her work at the SEC, (b)(7)(C) worked as an accountant in private industry for a year. *Id.* at 6. Before that (b)(7)(C) had a career unrelated to accounting and finance. *Id.* at 6.

(b)(7)(C) worked at the SEC from (b)(7)(C) until (b)(7)(C) as an examiner, (b)(7)(C) (b)(7)(C) Tr. at 6. Before joining the SEC (b)(7)(C) worked at the Internal Revenue Service. (b)(7)(C) Tr. at 17. (b)(7)(C) has been in retirement since (b)(7)(C) [30] (b)(7)(C) Tr. at 5 & 48. (b)(7)(C)

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30 (b)(7)(C) told the OIG that one reason she retired from the SEC was her frustration with how "the exams had turned into a kind of . . . checklist, and a review of risk." (b)(7)(C) Tr. at 49. (b)(7)(C) testified that at the time OCIE would send investment companies an

(b)(7)(C)

As an examiner at SEC's headquarters, (b)(7)(C) testified that she spent 40-50% of her time on exams, and the remainder on special projects. (b)(7)(C) Tr. at 11. According to (b)(7)(C) the 2002 Allied examination was assigned as a special project, not a routine examination. (b)(7)(C) Tr. at 14; (b)(7)(C) Tr. at 14-15. (b)(7)(C) reported to (b)(7)(C) who reported to (b)(7)(C) who reported to (b)(7)(C) Tr. at 6-7. (b)(7)(C) began at the SEC in (b)(7) and became (b)(7)(C) in (b)(7)(C) Tr. at 6-7. (b)(7)(C) testified that (b)(7)(C) was "pretty much my direct supervisor for this special project," and that it was unusual to have an Associate Director supervise an examination. (b)(7)(C) Tr. at 70. (b)(7)(C) admitted he "probably supervised this exam more than most." (b)(7)(C) Tr. at 19-20.

According to (b)(7)(C) Allied was the largest BDC and "every retirement fund out there owns Allied." (b)(7)(C) Tr. at 17. She thought it was strange that she, as a fairly new examiner, was assigned to examine one of the largest BDCs testifying, "It's almost like they didn't want to find something." *Id.* at 15. (b)(7)(C) however, said this was the reason she did everything she could to find something, saying ". . . this was my project to prove myself." *Id.* (b)(7)(C) testified that (b)(7)(C) attended many of the 18-20 meetings she had with Allied, and would take the lead in questioning. *Id.* at 21. (b)(7)(C) told the OIG she was happy to have (b)(7)(C) attend the meetings since she needed some guidance. *Id.* at 21.

(b)(7)(C) told the OIG that by the time she was brought in to evaluate what (b)(7)(C) had done, (b)(7)(C) had already "spent quite a lot of time" and done a fair amount of work.

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eight-question letter, which they ultimately realized "allowed them to lie to us." *Id.* at 51. She further testified that examiners were not encouraged to find wrongdoing stating, "In fact, if I came back from an exam and I'd found something really bad, I used to say I felt like I had to hide under my desk, because I knew they did not want to hear that I'd found something wrong." *Id.* at 44. In addition, (b)(7)(C) told the OIG the exam program was much more focused on how many examinations can be completed in the fastest time rather than the quality of the examination work. *Id.* at 54-55. (b)(7)(C) also said that she found that the SEC did not consider it a "hot" case when companies were lying to investors, only when they were stealing money from investors. (b)(7)(C) Tr. at 42. We note that these complaints are consistent with some of the findings in the OIG report on Madoff. *See Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, August 2009, available at http://sec-oig.gov/news/studies/2009/oig-509.pdf.

(b)(7)(C) Tr. at 10 (b)(7)(C) testified after she was assigned to this exam, ". . . I went in to see her and I sat down and she just showed me records, and records, and records of what she had requested and analysis she had done." *Id.* at 8. (b)(7)(C) testified that (b)(7)(C) had a good accounting background so she used her to help with the accounting. *Id.* at 16. (b)(7)(C) testified she was brought in to evaluate what (b)(7)(C) had done to date because she had a good reputation of ferreting out information. (b)(7)(C) Tr. at 8. According to (b)(7)(C) (b)(7)(C) had done a very thorough job and was "absolutely on track and understood the issues." *Id.* at 8-9. (b)(7)(C) said she worked specifically on the valuation issues, while (b)(7)(C) focused on the issue of investor dividends. *Id.* at 10.

2. There Was No Visit to Allied's Office Located Blocks from the SEC

During the 18 month examination of Allied no one from the SEC ever visited Allied. (b)(7)(C) Tr. at 18. (b)(7)(C) Tr. at 15. (b)(7)(C) Tr. at 21. (b)(7)(C) testified that ordinarily an examination is conducted at least in part at the firm's office. (b)(7)(C) Tr. at 27. (b)(7)(C) testified, "I never got out to the firm, which I always thought was kind of wrong that we were just sort of restricted." (b)(7)(C) Tr. at 15. (b)(7)(C) also testified they did this examination through letter correspondence and never physically went to Allied's offices. (b)(7)(C) Tr. at 18. (b)(7)(C) testified he did not see the difference either way - visiting the firm or not to conduct an examination. (b)(7)(C) Tr. at 27.

(b)(7)(C) testified he did not remember why headquarters was conducting the 2002 examination of Allied, and not the usual the Philadelphia Regional Office ("PRO") which has jurisdiction over D.C. firms such as Allied. (b)(7)(C) Tr. at 19. (b)(7)(C) testified that this examination was probably not conducted at the firm site because it had a "narrow focus" on valuation issues. *Id.* at 19-20. In addition (b)(7)(C) initially claimed Allied was a few miles away from the SEC and that it would be more efficient to conduct the examination at the SEC. *Id.* at 21-22. But then (b)(7)(C) admitted, "it was fairly close." *Id.* at 22. In fact, Allied was just ten blocks from OCIE's office at the time. *Id.*

3. The Examination Took 18 Months to Complete

(b)(7)(C) testified that this examination was also unusual because it lasted a year and a half and "dragged out a very long time." (b)(7)(C) Tr. at 15. It appears that Allied contributed to the delays. (b)(7)(C) testified that "Allied was not overly cooperative." *Id.* at 16. While (b)(7)(C) recalled only two to three meetings with Allied representatives during this examination, (b)(7)(C) testified they probably had 18-20 meetings with Allied because Allied would say to them, "we need to come in and explain what we were doing." (b)(7)(C) Tr. at 22. (b)(7)(C) Tr. at 20.

Moreover, (b)(7)(C) testified that she and (b)(7)(C) had several meetings with (b)(7)(C) about why they wanted to continue their examination work. (b)(7)(C) Tr. at 18-19. According to (b)(7)(C) there was an overall feeling they got from (b)(7)(C) that she and (b)(7)(C) were overdoing it and "then we'd get another letter from Einhorn which was helpful to us." *Id.* at 19. In addition, (b)(7)(C) continued to have additional duties. (b)(7)(C) Tr. at 17. During one part of the examination, the OIG determined that (b)(7)(C) got pulled off the Allied examination for a period of time to work on mutual fund investigations.[31] *See* Exhibit 80 at 3.

4. (b)(7)(C) Knew (b)(7)(C) Had Worked at the SEC and it May Have Colored His View of Allied

The evidence shows that (b)(7)(C) knew (b)(7)(C) who formerly worked at the SEC from (b)(7)(C)[32] According to (b)(7)(C) it was clear that (b)(7)(C) knew (b)(7)(C) who would represent Allied at these meetings because (b)(7)(C) would walk in and say, "Hi, (b)(7)(C) How are you doing?" *Id.* at 19-20. (b)(7)(C) testified that during her involvement in the Allied examination they met with (b)(7)(C) on several occasions. (b)(7)(C) Tr. at 18. When asked if the branch chief was involved in the examination, she testified, no, "Whatever this was higher, sort of, than a normal audit. I mean it really was something that (b)(7)(C) was involved in. Which itself was unusual." *Id.* When asked, "And so what was your impression of why that was happening in this case," (b)(7)(C) testified, "Well, he knew the (b)(7)(C) at Allied." *Id.* According to (b)(7)(C) (b)(7)(C) told her something to the effect of, "(b)(7)(C) is a nice person (b)(7)(C) used to work here. I know (b)(7)(C) not going to be doing anything illegal." *Id.* (b)(7)(C) believed that (b)(7)(C) was personally involved in the Allied examination, not because of the size of Allied, but because he knew and trusted (b)(7)(C) *Id.* at 21-22.

(b)(7)(C) testified he did not recall knowing (b)(7)(C) *Id.* at 28. He further testified he may have know (b)(7)(C) worked at the SEC but just did not remember. *Id.* When asked if it would surprise him tha (b)(7)(C) and (b)(7)(C) were very clear that he knew (b)(7)(C) he testified "I don't remember if I knew (b)(7)(C) *Id.* at 28. When asked, "So I take it then you don't remember saying to (b)(7)(C) that (b)(7)(C) used to work here, (b)(7)(C) a nice person and

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31 As noted in the OIG's August 2009 *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme*, examiners in that matter were also stopped from working on the Madoff examination during early 2004 to focus on the mutual fund project. *See* http://sec-oig.gov/news/studies/2009/oig-509.pdf.

32 (b)(7)(C) s OPF shows that (b)(7)(C) was employed at the SEC as a (b)(7)(C) staff attorney in the Division of Enforcemen (b)(7)(C) unti (b)(7)(C) resignation (b)(7)(C) (b)(7)(C)

(b)(7)(C) not going to be doing anything illegal?," (b)(7)(C) replied, "I may have said that. I just don't remember it." *Id.*

(b)(7)(C) then admitted he believes that someone in the industry who used to work at the SEC is more likely to be fair and honest. *Id.* at 30. (b)(7)(C) explained, "It's just that people from here have hopefully acquired a certain attitude, a certain acculturation, and you would hope that they're not [doing something illegal]." *Id.* We then asked (b)(7)(C) "Do you think then that colors your view if there's somebody who's working at a firm who worked at the SEC that you're sort of giving them the benefit of the doubt as opposed to being more suspicious?" (b)(7)(C) answered, "Given the benefit of the doubt, probably, yes. If you've known somebody or even if they didn't really know them but you knew they worked here. . . . Well, they should hopefully be doing the right thing. . . ." *Id.* at 30-31. (b)(7)(C) testified that she believes a good examiner needs to be "properly suspicious." (b)(7)(C) Tr. at 43. While she found (b)(7)(C) to be such an examiner, she testified she did not believe (b)(7)(C) was "properly suspicious." *Id.* at 43 & 46.

5. Findings and Referral to Enforcement

As discussed above, the examination report on Allied was issued on April 26, 2004, and it was formally referred to Enforcement for action. *Id.* As a result of the 18-month examination of Allied, the examiners found the following three issues that warranted referral to Enforcement:

(1) (b)(5)

(2)

(3)

(b)(5)

(b)(5)

(b)(5)

On May 9, 2004, Enforcement opened a formal investigation into Allied based on that examination, as discussed below. (b)(5)

C. Disagreement About Referral to Enforcement and Whether Allied May Have Been a Ponzi Scheme

The OIG found that despite both (b)(7)(C) and (b)(7)(C) believing strongly that Allied had major problems, (b)(7)(C) gave them a lot of "push back" about referring it to Enforcement. (b)(7)(C) Tr. at 39-40; (b)(7)(C) Tr. at 18-19. (b)(7)(C) testified there were delays in the examination as well because (b)(7)(C) was reluctant to have them continue the examination but did not tell them to stop. (b)(7)(C) Tr. at 19. (b)(7)(C) added, ". . . in fact, there were probably periods in there where we probably didn't do anything for three months or more, there'd be delays." *Id.*

(b)(7)(C) testified that she did not feel (b)(7)(C) supported her and (b)(7)(C) s desire to refer the Allied examination to Enforcement saying, "no, I don't ever feel like he supported us on that." (b)(7)(C) Tr. at 31. (b)(7)(C) added that she recalled her and (b)(7)(C) meeting with (b)(7)(C) saying they were so convinced there was a problem with Allied, but (b)(7)(C) directed them to go back and do additional work. *Id.* According to (b)(7)(C) this additional work "didn't undo what we found." *Id.* (b)(7)(C) recalled that (b)(7)(C) felt like she was taking on (b)(7)(C) and was somewhat intimidated by him. *Id.* at 32. She testified that (b)(7)(C) would tell

(b)(7)(C) "You don't know what you're talking about," related to the dividend issue. *Id.* at 32-33.

(b)(7)(C) testified that (b)(7)(C) in referring to the dividend issue would tell her, "There's nothing there. There's nothing there." (b)(7)(C) Tr. at 40. (b)(7)(C) prepared a cash analysis of Allied's investments. Exhibit 81. According to (b)(7)(C) (b)(7)(C) prepared his own cash analysis. (b)(7)(C) Tr. at 40. (b)(7)(C) testified that as to the dividend issue, "I agreed with (b)(7)(C) completely." (b)(7)(C) Tr. at 10. According to (b)(7)(C) the pattern was very clear that every time Allied had raised money, they needed it to pay the dividend. *Id.* She said that she and (b)(7)(C) were "very concerned" with what they found and that "our conclusions meshed together." *Id.* at 11.

(b)(7)(C) admitted he had more problems with referring the dividend issue than the valuation issues since he believed Allied was properly financing its dividend, but testified the bottom line was the issue was referred to Enforcement. (b)(7)(C) Tr. at 50. According to (b)(7)(C) to get an examination report referred to Enforcement, the Branch Chief had to concur, then the Assistant Director, and ultimately (b)(7)(C) would concur or not. (b)(7)(C) Tr. at 31. According to (b)(7)(C) however, after the referral to Enforcement, (b)(7)(C) stopped speaking to her for months. (b)(7)(C) Tr. at 45. (b)(7)(C) testified he did not recall a time he was not speaking to (b)(7)(C) Tr. at 49-50. In addition, (b)(7)(C) testified that her branch chief essentially told her she was putting her career on the line going against (b)(7)(C) who has been at the SEC for about (b)(7)(C) Tr. at 41.

Einhorn referenced the dividend issue in his May 2002 speech, talking about how Allied needed to generate their dividends. Einhorn said in order for Allied to fund their shortfall they had to eventually sell equity to raise capital to pay the dividend, in effect taking money from new investors to satisfy income requirements of existing investors. Einhorn remarked to the conference attendees, "There's a name for that. [laughter]" Einhorn was referencing a Ponzi scheme. *See* http://www.foolingsomepeople.com (the videotaped speech).

The OIG found that on May 29, 2003, (b)(7)(C) prepared an e-mail about Allied which he sent to the Senior Official and others in Investment Management, copying (b)(7)(C) and (b)(7)(C) Exhibit 82. In that e-mail (b)(7)(C) wrote, "The bottom line of our analysis shows that Allied more than covered its total dividend payments during the period 1995 to 2002 with cash derived from its investment activities." (b)(7)(C) continued:

> Our analysis of dispositions during the period 7/1/02 to 3/31/03 shows that about 39% of disposition proceeds represents monitization of non-cash factors recognized as income in earlier periods . . . . Using this 39% to calculate what portion of the

> proceeds from dispositions during the period 1995 to 2002 represents the monitization of non-cash income recognized in another year, and adding this cash to the cash flows generated by annual 'operations' shows that cash derived from investment activities over the period more than covered the dividends paid during the period. ***There is no Ponzi scheme that I can see.***
> *Id.* (italics added)

(b)(7)(C) testified he did not remember this e-mail nor did he recall being satisfied about the dividend issue. (b)(7)(C) Tr. at 44. The examination report contained the same language used in (b)(7)(C) e-mail above, but added: "However, this is assuming that every year at least 39% of the proceeds from dispositions should be recognized as cash which may be higher or lower than actual." Exhibit 75.

(b)(7)(C) prepared notes about Allied related to her work on the (b)(7)(C),(b)(8) investigation. Exhibit 80. As noted above, during that investigation (b)(7)(C) learned that OCIE was conducting an examination of Allied. (b)(7)(C) Tr. at 53-54. (b)(7)(C) spoke to (b)(7)(C) and (b)(7)(C) about the examination and was told that they had uncovered several issues of concern regarding Allied's valuation of investments. *Id.* As a result, according to her notes, (b)(7)(C) believed a referral would be made to Enforcement. (b)(7)(C) notes also stated:

> On June 24, 2003 (b)(7)(C) contacted me with an update on OCIE's review. (b)(7)(C) said that representatives from Allied Capital came in and met with (b)(7)(C) at OCIE (b)(7)(C) was not present). According to (b)(7)(C) Allied convinced (b)(7)(C) that Allied is not financing its dividend, even though it looks that way and that, according to the company, Allied is issuing new shares to make new investments in its portfolio and not raising money to pay the dividend. Allied conceded that, due to necessary accounting treatment, it could appear that the company are [sic] financing the dividend, but that is not what is happening. (b)(7)(C) said that (b)(7)(C) was satisfied with Allied's explanation of this issue and, while they are still looking at a few minor areas, OCIE will likely back off from Allied.
> *Id.*

(b)(7)(C) testified he did not remember meeting with Allied alone although he conceded they likely met with Allied about the dividend issue during the examination. (b)(7)(C) Tr. at 46. He further testified that he believed there was a basis for saying Allied was borrowing money to pay for their dividends as part of their business model, which would not make it a Ponzi scheme.

Id. at 43. (b)(7)(C) added "But, you know, it wasn't entirely clear, so why not refer it to Enforcement?" *Id.* (b)(7)(C) explained it was included in the examination report,

> Because (b)(7)(C) felt strongly about it, so I thought why not. Let Enforcement look into it as part of their review. You know, perhaps there may be something that would come out in testimony, something buried in e-mail someplace or some other document, something that might show their intention of having some sort of a Ponzi-like scheme.
> *Id.* at 37.

(b)(7)(C) claimed the examination staff across the nation should be "willing to dig in and think about all sides of an issue," and that there should be a debate about the issues as part of the examination process and concluded that this scenario "ideally illustrates that point." *Id.* at 43. As discussed below, while this issue was referred to Enforcement, no investigation was ever conducted of the possibility it was a Ponzi scheme.

D. The Allied Work Papers Were Deleted from Shared Computer Drive

(b)(7)(C) contacted the Inspector General on February 11, 2009, and agreed to give testimony under oath that same day. (b)(7)(C) informed the OIG that all of her Allied files were gone from the shared "J:" drive where OCIE examiners kept their examination work papers and reports. (b)(7)(C) Tr. at 24-25. According to (b)(7)(C) she discovered the files were missing in January 2009 when another letter of complaint about Allied came in from Jim Brickman. *Id.* at 32-34. The Senior Official forwarded this letter to OCIE and (b)(7)(C) requested that (b)(7)(C) convert the letter to electronic form to send to the PRO. *Id.* at 33. While doing this, (b)(7)(C) decided to also send the PRO other documents from her examination and found them missing. *Id.* (b)(7)(C) said that the last time she had checked the Allied documents on the "J:" drive was around 2004, the year she completed the Allied examination. *Id.* at 31-32. According to (b)(7)(C) her Allied file included spreadsheets she created, the examination report, copies of relevant interoffice memos, information from (b)(7)(C) and relevant e-mails. *Id.* at 26.

Surprisingly, (b)(7)(C) had made a copy of the contents of the Allied file from the "J:" drive to the "C:" drive when she transferred the case to Enforcement, and then transferred that file to a CD to take home for safe keeping because staff's hard drives had been crashing and documents were lost. *Id.* at 27. (b)(7)(C) also said her hard drive files had been totally deleted. *Id.* at 39. (b)(7)(C) brought the OIG a copy of the list of documents she believed were in the Allied file on the "J:" drive. Exhibit 83. In addition, (b)(7)(C) testified that several times SEC

staff had been unable to find the Allied report on OCIE's internal website. (b)(7)(C) Tr. at 35 & 47.

After (b)(7)(C) realized her Allied file was gone from the "J:" drive, she told her (b)(7)(C) *Id.* at 61. Upon hearing that the files were missing, (b)(7)(C) testified (b)(7)(C) responded, "Oh my God, you're kidding me. How many files?" *Id.* (b)(7)(C) provided (b)(7)(C) with the list and (b)(7)(C) was surprised at how many files had been deleted, according to (b)(7)(C) *Id.* (b)(7)(C) then told (b)(7)(C) they had to tell (b)(7)(C) and perhaps (b)(7)(C) *Id.* at 61-62. In addition (b)(7)(C) said (b)(7)(C) suggested they may also want to go to the OIG since she had read that the OIG was reviewing Einhorn's book. *Id.* at 62.

(b)(7)(C) testified she and (b)(7)(C) met with (b)(7)(C) to tell him that the Allied file was missing from the "J:" drive. (b)(7)(C) Tr. at 62. According to (b)(7)(C) (b)(7)(C) did not seem very surprised or even concerned and responded,

> Oh. Your files were deleted? Well, the first thing we need to do is talk to [OIT] to see what they can do about it. Let's talk to them, see if they can get them back, and let's talk to them to see who has access to it, and then we'll figure out what we're going to do.
> *Id.*

(b)(7)(C) did not think (b)(7)(C) reaction to the news was normal. *Id.* at 65-66. Two days later (b)(7)(C) came to the OIG. *Id.* at 63. At that time, she had not heard back from (b)(7)(C) *Id.* But (b)(7)(C) had learned that OIT could only go back 30 days to recover documents, which (b)(7)(C) found amazing.[33] *Id.* at 46.

(b)(7)(C) testified, "Deep down I do think somebody purposely deleted [the Allied file]. I don't think it was an accident . . . ." (b)(7)(C) said it could have happened anytime between 2004 and 2009. *Id.* at 46. She further testified that someone in OCIE deleted the files because they are the only ones with access to it. *Id.* at 45. (b)(7)(C) testified she had a gut feeling that (b)(7)(C) was responsible for the deleted files and that he either directed the files be deleted or he deleted them himself. *Id.* at 68-69.

(b)(7)(C) testified he may have heard recently that the Allied work papers had been deleted from the "J:" drive. (b)(7)(C) Tr. at 55. He admitted it was unusual for work papers to be

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[33] After taking (b)(7)(C) testimony, the OIG tried to determine if OIT could find when and who deleted those files. The OIG learned, however, that there is no way for anyone at the SEC to determine who deleted files from a shared drive.

missing. *Id.* He understood that OCIE talked to their IT Specialist to determine if the file could be retrieved, as well as determine how it happened, and whether controls could be put in place to prevent it from happening again. *Id.* When asked what the result of that inquiry was as to whether the files could be retrieved, (b)(7)(C) testified, "I don't believe so." *Id.* at 56. (b)(7)(C) further testified, "I just haven't followed up on that particular issue." *Id.*

(b)(7)(C) testified anyone in OCIE on the "40 Act side could have deleted those files since they have access, and that he did not have any idea who deleted the file. *Id.* at 56-57. When asked whether he deleted them from the "J:" drive, (b)(7)(C) responded, "I don't even go on the J drive." *Id.* at 57.

IV. The Enforcement Investigation of Allied Began Almost Two Years After Einhorn Provided Detailed Evidence of Allied Fraud

As noted above, Enforcement opened a formal investigation into Allied on May 9, 2004 based on the OCIE examination after having opened a MUI on March 9, 2004. Exhibits 76 & 77. (b)(7)(C) was the lead attorney on this investigation.[34] (b)(7)(C) began working at the SEC in (b)(7)(C) after being (b)(7)(C), and was (b)(7)(C) assigned the Allied matter. (b)(7)(C)

During the three-year investigation of Allied by Enforcement, the USAO for the District of Columbia became involved early on and conducted a parallel criminal investigation. Exhibit 84. The USAO was investigating the same issues as Enforcement, including the 15 to 20 investments Allied held which Einhorn had identified as problematic. (b)(7)(C) Tr. at 25 & 44; Exhibit 84. In addition, the OIG for the SBA conducted its own investigation into Allied. Specifically, the SBA OIG investigated BLX, a private finance investment company Allied owned and controlled, to determine whether BLX fraudulently originated loans to small businesses. *Id.* The USAO did not bring securities-related fraud charges against Allied or any related entity or person as a result of that investigation. *Id.* Separately, the USAO also

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[34] According to the Senior Official, (b)(7)(C) did a great job on the investigation. Senior Official Tr. at 109. The Senior Official testified,

> He was thoroughly prepared for these meetings [with Enforcement and Investment Management]. He knew the facts. He was diligent, enthusiastic. He was exactly the kind of guy that was appropriate to investigate this case as far as I could tell.
> *Id.*

investigated whether Allied illegally obtained the telephone records of certain third parties that were critical of Allied. *Id.*

According to (b)(7)(C) Enforcement received approximately 120 boxes of documents related to Allied and reviewed six to ten million e-mails during their investigation.[35] (b)(7)(C) Tr. at 58-59. In addition, Enforcement got six boxes of documents related to Allied from OCIE. *Id.* at 16-17.

(b)(7)(C) told the OIG that he had worked for Coopers & Lybrand for a few years in the 1980s and had some experience on valuation issues related to securities. *Id.* at 20. During the Allied investigation, (b)(7)(C) said there were three different accountants assigned to work on it with him - initially (b)(7)(C) was assigned, then another accountant for a brief period of time, and finally (b)(7)(C) from Fall 2004 until the end of the investigation. *Id.* at 14. (b)(7)(C) testified that (b)(7)(C) was very impressive, but they lost him to work on another investigation. *Id.*

Enforcement did not work directly with (b)(7)(C) on the investigation, although (b)(7)(C) testified he talked to her at the beginning of the referral and would get regular updates from her.[36] *Id.* at 16. According to (b)(7)(C) Enforcement "pretty much agreed with (b)(7)(C) assessment of the valuation," as discussed further below. *Id.* at 22. As to the Ponzi-like scheme and dividend issue, (b)(7)(C) testified that Enforcement did not look at that issue specifically during the investigation. *Id.* at 54.

Several days after starting at the SEC, (b)(7)(C) and others at the SEC met with Einhorn, along with Einhorn's counsel and colleague, as well as Brickman on April 27, 2004. *Id.* at 11 & 100-101. The following SEC staff were at that meeting with Einhorn: (b)(7)(C) (b)(7)(C), (b)(7)(C) and (b)(7)(C) *Id.* at 100-101. According to Einhorn, he found the SEC staff to be "engaged, polite and inquisitive," although they had no knowledge of the 2003 meeting Einhorn had with (b)(7)(C) and (b)(7)(C) Einhorn's book at 184 & 204. (b)(7)(C) says that was

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35 According to (b)(7)(C) who testified he gleaned insights into Allied through his review of their e-mails, Allied acted "kind of paranoid" by having their office swept for bugs; and he learned from (b)(7)(C) that Allied made special arrangements to deliver documents to a separate entrance at the SEC. (b)(7)(C) Tr. at 44-45.

36 When the OIG asked (b)(7)(C) about whether OCIE examiners who have conducted examinations of firms that are then referred to Enforcement work on the investigations, he replied there was no standard practice. (b)(7)(C) Tr. at 52-53. According to (b)(7)(C) Enforcement would ask for an examiner to assist them and then the examiner would see if it fit into their schedule before determining whether to assist Enforcement. *Id.* at 53.

the one and only time he met with Einhorn, and he found Einhorn to be credible. (b)(7)(C) Tr. at 11-12. After meeting with Einhorn in April 2004, Enforcement's first subpoena for documents was to BLX. *Id.* at 103. (b)(7)(C) testified they had a lot of letters from Einhorn about Allied, and that he especially "relied on one more than others in framing what the investigation would look like." *Id.* at 13.

(b)(5)

(b)(5)

B. The Commission's Valuation Guidance

As discussed above, the Commission has not updated guidance in the area of valuation of illiquid securities since 1970. Some agency officials believe this is a "notoriously gray area" and one that needs updating by the Commission. Exhibit 80; Senior Official Tr. at 83-84. The reason for the need to update the guidance, according to the Senior Official in Investment Management, is that a lot has happened in the industry since 1970 and the industry may not believe the SEC is standing behind guidance issued that long ago. *Id.* at 89.

(b)(5)

(b)(5) The Senior Official, however, testified that while updated guidance would help clarify issues in this area to some extent, he believed (b)(5) (b)(5) [37] Senior Official Tr. at 103.

(b)(5)

C. The Issue of Whether Allied Was a Ponzi Scheme, Because of How it Financed its Dividends, Was Not Investigated

As discussed above, despite being referred from OCIE as a matter that required further work, Enforcement did not investigate the Ponzi-like scheme dividend issue. (b)(7)(C) Tr. at 54 & Exhibit 86. According to (b)(7)(C) it was a resource issue. (b)(7)(C) Tr. at 54.

[37] We pointed out to the Senior Official that it appeared that most of the Enforcement investigations related to fair value had settled, but he stated he was not sure the number settled was so great relative to other areas of wrongdoing. *Id.* at 104; *see also* Exhibit 9.

(b)(7)(C) testified, "I told my supervisor, (b)(7)(C) that I didn't have the experience, I'd have to rely on the accountant." *Id.* (b)(7)(C) testified that (b)(7)(C) the first accountant assigned to the investigation, had the expertise to look at the issue. *Id.* He wasn't sure, however, whether the other accountants assigned to the investigation were capable of making a determination on that issue. *Id.*

(b)(7)(C) testified he did not try to recreate the cash analysis (b)(7)(C) had done. *Id.* (b)(7)(C) recalled that he learned through (b)(7)(C) that (b)(7)(C) did not agree with her cash analysis related to the dividend issue. *Id.* at 50. (b)(7)(C) was not sure whether the USAO looked at the issue of Allied's dividends. *Id.* at 55. But (b)(7)(C) noted that the dividend issue was tied to the issue of valuation because it appeared Allied timed their sales to show their best finances. *Id.* at 24. Similarly, the Senior Official in Investment Management testified the dividend issue was interrelated to the valuation issues. Senior Official Tr. at 99. (b)(7)(C) testified he did not necessarily agree Allied was a Ponzi-like scheme; he thought Allied took much riskier positions in later years and that the BDC business model made it inherently risky. *Id.* at 51-53.

(b)(7)(C) testified (b)(7)(C) did not recall whether the dividend issue referred from OCIE had been pursued during the Enforcement investigation. (b)(7)(C) Tr. at 25. (b)(7)(C) further testified, "I remember the dividend issue being something that was discussed, but if you're asking me whether that's [sic] the [Action] memo, obviously it's not, but I don't recall exactly what was done to look into the dividend issue and when that was not the focus anymore." *Id.* at 25-26.

The Senior Official testified the he recalled the primary focus of the OCIE examination of Allied was their valuation, but that there was an issue of Allied not generating enough revenue for companies to maintain their dividend payment. Senior Official Tr. at 77. The Senior Official did not recall how he learned about the dividend issue, but said there were several issues associated with it. *Id.* at 78-79. Those issues included representations in Allied's registration statements when they raised money from investors about what they intended to use the proceeds for and if Allied said they were raising money to invest more when they were really doing something else. *Id.* According to the Senior Official, one concern was that they were doing the offering to pay the dividend when their investments were not generating enough revenue to maintain the dividend. *Id.* at 79.

D. Enforcement Agreed to Settle with Allied with No Penalty or Action Against Allied Officers

In June 2007, the Commission entered into a settlement with Allied. The settlement resulted in Allied agreeing to continue to employ: (1) a Chief Valuation Officer ("CVO") to oversee its quarterly valuation process; and (2) third-party valuation consultants to assist in its

quarterly valuation process for private finance investments in a manner consistent with Allied's current practices. Exhibit 84. Allied was required under the settlement order to undertake this for two years. *Id.* In addition, Allied agreed to cease and desist from committing violations of the sections of the Exchange Act of 1934 which require public companies to maintain accurate financial controls and books and records. *Id.* There was no penalty against Allied nor was any action taken against an officer or director.

1. Allied's High-Powered Counsel Requested and Obtained Meeting with Enforcement to Argue for Settlement

According to (b)(7)(C) WilmerHale requested a so-called "pre-Wells" meeting to discuss the Allied investigation.[38] Exhibit 88 & (b)(7)(C) Tr. at 90. (b)(7)(C) testified there was likely a phone call first to discuss this and WilmerHale requested to meet with Enforcement. (b)(7)(C) Tr. at 64. (b)(7)(C) e-mailed (b)(7)(C) and (b)(7)(C) to inform them of the meeting and attached a draft of the Action Memo for their review.[39] Exhibit 88.

As requested, on October 25, 2006, Enforcement met with Allied's counsel from WilmerHale.[40] (b)(7)(C) Tr. at 35. This meeting was attended by (b)(7)(C) (b)(7)(C)

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38 We note that the Enforcement Manual does not reference "pre-Wells" meetings, only Wells meetings. Exhibit 87. Moreover, the Enforcement Manual states, "A Wells notice should be in writing when possible. If a Wells notice is given orally, it should be promptly followed by written confirmation." *Id.* It appears no written notice was given to Allied.

39 When (b)(7)(C) was asked if there were Wells meetings in the Allied investigation (b)(7)(C) testified,

> I cannot divide this up and figure it out anymore. I can't recall. There were settlement meetings and there were Wells meetings. There were meetings about production of documents, a host of meetings in the course of the investigation. I can't separate them all out in my head.
>
> (b)(7)(C) Tr. at 27.

40 The "Wells submission" process represents a critical phase in Enforcement investigations. Pursuant to the Securities Act Release No. 5310, Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations

(b)(7)(C) and (b)(7)(C) from the SEC. Exhibit 89. (b)(7)(C) (b)(7)(C) and another partner from WilmerHale represented Allied. *See* Exhibits 88 & 89.

As (b)(7)(C) noted, Allied was "heavily, heavily armed." (b)(7)(C) Tr. at 43. (b)(7)(C) who had never met (b)(7)(C) noted that he "gets brought down from on high for certain events. And this was one of them." *Id.* at 43. (b)(7)(C) took the lead for Enforcement and (b)(7)(C) and (b)(7)(C) took the lead for Allied in the meeting. *Id.* at 43. At that meeting, according to (b)(7)(C) outlined the fraud charges and said, "Look, fraud's on the table, as against the company, as against this one person," referring to the (b)(7)(C) (b)(7)(C) Tr. at 61.

The OIG obtained a copy of the presentation Allied's counsel gave to Enforcement that resulted in the settlement. Exhibit 90. During that presentation, counsel for Allied made three principal arguments: (1) Allied had not overvalued its portfolio; (2) it had accurately disclosed its valuation process; and (3) based on SEC precedent, Allied's valuation practice did not justify an Enforcement action. *Id.*

2. (b)(7)(C) and (b)(7)(C) Decided Not to Bring Fraud Charges Shortly After Meeting with Allied's Counsel

According to (b)(7)(C) who we found to be credible, shortly after the "pre-Wells" meeting with Allied representatives, he was told all possible fraud charges against Allied were going to be dropped. (b)(7)(C) Tr. at 61-62 & 72. Specifically, (b)(7)(C) testified:

> About a week or so went by, and (b)(7)(C) and (b)(7)(C) came to me, and indicated they thought that based upon Wilmer's presentation, that they were going to remove the fraud charge

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(September 27, 1972), at the conclusion of an Enforcement investigation where staff has decided to seek authority from the Commission to bring a public administrative proceeding or civil injunctive action against an individual or entity, Enforcement staff may advise prospective defendants of the proposed charges against them and provide them the opportunity to file a written statement "setting forth their interests and position" in accordance with Rule 5(c) of the Commission's Rules on Informal and Other Procedures, 17 C.F.R. § 202.5(c). Prospective defendants use these responding statements - known by the SEC and the securities bar as "Wells submissions" - as an opportunity to set forth the reasons why the staff should not pursue such action before the Commission brings formal charges.

> from consideration, and did I have a problem with that, they asked me.
> *Id.*

(b)(7)(C) on the other hand, claimed that (b)(7)(C) together made the decision not to bring a fraud charge against Allied (b)(7)(C) Tr. at 31. (b)(7)(C) told the OIG that (b)(7)(C) provided input into the decision to drop the fraud charge. *Id.* at 36. When asked how it was decided that Enforcement would not pursue fraud charges against Allied (b)(7)(C) testified:

> After considering all of the facts of the case and the arguments that counsel made and all of the facts and circumstances including litigation risks. The company provided us with a settlement offer that we thought encompassed what was a reasonable settlement in this matter and that was the end of it.
> *Id.*

When asked, "If there is testimony that a week after these pre-Wells meetings with Allied's counsel that you and (b)(7)(C) told (b)(7)(C) that fraud charges were not going to be brought, does that sound wrong?" (b)(7)(C) replied, "I don't remember." *Id.* at 36.

(b)(7)(C) said it was fair to say that (b)(7)(C) and (b)(7)(C) were likely swayed by WilmerHale's presentation. *Id.* at 64. Moreover, he added that he did not know if they were influenced by (b)(7)(C) or the four to five other law firm partners in the room. *Id.* In reviewing relevant e-mails for this case, we found an e-mail string between (b)(7)(C) and (b)(7)(C) (b)(7)(C) about another investigation in which (b)(7)(C) was outside counsel. This e-mail string was dated October 31, 2006 – the same time period in which (b)(7)(C) and other partners at WilmerHale presented their argument that Allied should not face fraud charges but would accept a books and records charge. *See* Exhibit 90. In that string (b)(7)(C) was asking (b)(7)(C) colleague for a copy of the relevant Action Memo:

(b)(7)(C) wrote,

> And it doesn't look like there's a recommendation as to the company. Originally the company had offered to pay a substantial penalty. Wonder what happened with that.

(b)(7)(C) replied,

> I actually heard this was a (b)(7)(C) special, where he made an offer and simultaneously wanted to submit something saying that a penalty was inappropriate.

(b)(7)(C) responded,

> Good old (b)(7)(C) specials! Gotta love them. . . .
> Exhibit 91.[41]

While there is no evidence here that Allied agreed to pay a penalty, a very similar thing happened here at the same time -- WilmerHale partners, including (b)(7)(C) offered to have Allied submit to a books and records charge while simultaneously stating that a fraud charge was inappropriate. *See* (b)(7)(C) Tr. at 39-40 & 91.

(b)(7)(C) told the OIG he did not have a problem with that decision, but that he did feel if there was not going to be a fraud charge they at least needed to send a message to the BDC community. *Id.* at 62. To (b)(7)(C) that message was sent, by outlining with specificity Enforcement's findings as to the lesser books and records charge. *Id.* at 62 & 67.

(b)(7)(C) alleged that the driving factor in dropping the fraud charge was the,

> [l]ack of evidence, litigation risk, a determination as to whether this merited the significant resources it would require to continue in this investigation to investigate the valuations of the other approximately 100 investments Allied had made that we had not delved into, engaging in a battle of experts over valuations and a process that had been significantly changed by Allied in the meantime.
> *Id.* at 36-37.

(b)(7)(C) claimed there was no other way to establish materiality and intent for a fraud charge than to look more closely at all of Allied's investments, not just the couple dozen Enforcement found to be overvalued. *Id.* at 37-38. (b)(7)(C) stated, "If you want to establish materiality, a pattern, intent, you certainly would have to go beyond where we were able to go." *Id.* at 38.

(b)(7)(C) testified that if Allied only held the sixteen investments Enforcement found to be substantially overvalued, Enforcement would have brought a case that they were

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[41] We note that the OIG has previously investigated whether former Division Directors, (b)(7)(C) have greater access to, and influence on, Enforcement investigations. *See, e.g.*, September 30, 2008 Report of Investigation: Case No. OIG-431, Reinvestigation of Claims by Gary Aguirre of Preferential Treatment and Improper Termination; *see also* September 30, 2009 Report of Investigation: Case No. OIG-502, Allegations of Improper Disclosures and Assurances Given.

materially overvalued. (b)(7)(C) Tr. at 85. Both (b)(7)(C) and (b)(7)(C) also testified that a couple of Allied's investments were well undervalued which would have helped their case. (b)(7)(C) Tr. at 38; (b)(7)(C) Tr. at 86. In fact, (b)(7)(C) told the OIG that Allied argued Enforcement needed to look at Allied's whole family of investments to show fraud and that he found this argument convincing. (b)(7)(C) Tr. at 41.

3. The Terms of the Settlement Order

(b)(5)

Einhorn wrote about his view of the SEC settlement with Allied saying, "The consequence of Allied's illegal action was the lightest tap on the wrist with the softest of feathers." Einhorn book at 316. He also believed there was a "gaping disconnect" between the findings and the order. *Id.* Einhorn's counsel told the OIG about his frustration with the settlement testifying, "It was like all this happened but no one was responsible for it." Einhorn Tr. at 109. Einhorn's counsel said it was "quite unusual to me that those [orders] were potentially not extracting any real penalty at all in any way from anybody." *Id.* at 111. Einhorn's counsel also complained there was no reference to BLX[42] or to the pretexting. *Id.* at 109. According to Einhorn, the philosophy at the SEC at the time was not to do any harm to shareholders, and that the belief was if you punish the company you punish the shareholders. *Id.* at 112.

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42 As noted above, Einhorn's letters to the SEC often referenced problems with BLX, Allied's largest investment. Einhorn also discussed BLX at length throughout his book, including indicating that there were convictions against at least one BLX official. *See, e.g.*, Einhorn's book at 331-350. In the January 2008 letter to the SEC, Einhorn noted that the problems with BLX were finally coming to light and wrote, "We have said for years that this Allied-run entity has engaged in a systematic fraud directed at the [SBA]." Exhibit 34.

The Senior Official testified that Investment Management had input into and commented on the settlement order before it was finalized. Senior Official Tr. at 105. According to the Senior Official, "We were less than enthused when the net result was less, the ultimate order did not include those violations [of improper valuation]." *Id.* at 107-108. He also said that (b)(7)(C) had been supportive of Investment Management's views throughout the process, and would be surprised if (b)(7)(C) himself were not disappointed in the result. *Id.* at 109. Investment Management did not object to Allied having a CVO and third party valuation consultant, according to the Senior Official. *Id.* at 107. (b)(5)

(b)(5)

(b)(5) to the Director of Investment Management, told the OIG he thinks Enforcement wanted to bring a stronger case but that they were not going to get approval from the Commission at that time. (b)(7)(C) Tr. at 13-14. (b)(5)

(b)(7)(C) testified "the settlement order is so broad, really, I think it is sort of useless." (b)(7)(C) Int. Tr. at 9. (b)(7)(C) further testified, "it was a slap on the wrist," but added that Enforcement was dealt a bad hand because of the pressure Allied can exert given their political connections as well as the Commission at that time being "very hands-off." *Id.* at 44-45.

E. The Settlement Agreement Had Deficiencies

1. (b)(5)

As noted above, one of the only two elements contained in the settlement order with Allied was that it continued to employ a CVO to oversee its quarterly valuation process. Exhibit 92. (b)(5)

(b)(5)

(b)(5) Exhibit 85. In addition, (b)(7)(C) testified that in the so-called "pre-Wells" meeting, Enforcement presented to Allied's counsel that fraud was a serious consideration, not only for the company but for (b)(7)(C) Tr. at 35. (b)(5)

(b)(5)

(b)(7)(C) testified that they did not ask (b)(7)(C) to be removed and replaced. *Id.* at 35. (b)(7)(C) testified that a bigger piece of the agreement was to have a third party consultant involved. *Id.* at 33. He added that (b)(7)(C) seemed to be stricter with others' investments than with (b)(7)(C) own. *Id.*

(b)(7)(C) testified (b)(7)(C) did not recall who the (b)(7)(C) was, but that (b)(7)(C) remembered the name (b)(7)(C) (b)(7)(C) Tr. at 34. (b)(7)(C) seemed to recall that they had found that (b)(7)(C) overvalued some investments held by Allied, but claimed under the agreement (b)(7)(C) would only have one role (b)(7)(C) . *Id.* at 34. When asked, "So was there a concern that (b)(7)(had overvalued some of the investments but ye (b)(7)(was going to be one of the main parts of the settlement?" (b)(7)(C) responded:

> Number one, I don't recall that. Number two, I don't believe that if we had had evidence that (b)(7)(had intentionally overvalued that we would have brought that case. I don't want you to be too much into the memo that you have there. We clearly didn't charge (b)(7)(C) and there was a reason for that. . . . Because we didn't have any evidence to prove that (b)(7)(had committed any securities laws violations.
> *Id.* at 35.

The Senior Official testified that he recalled Enforcement found one person was more problematic than others related to Allied's valuation of its investments. Senior Official Tr. at 98. He added, "We thought there was an adequate basis for at least seriously considering charging that person and/or the company or anybody else with anti-fraud violations." *Id.* at 98-99. The Senior Official testified that the name (b)(7)(C) sounded familiar and was likely that person. *Id.* at 98.

2. Failure to Monitor Compliance with Settlement Agreement

There were no provisions in the settlement agreement with Allied for ensuring their compliance with its terms. Exhibit 92. Moreover, Enforcement did not monitor Allied for compliance with the agreement. (b)(7)(C) Tr. at 127-129 & (b)(7)(C) Tr. at 40-41. Similarly, there are no provisions regarding monitoring of settlements in the Enforcement Manual, which is intended to be a reference for Enforcement staff in the investigation of potential federal securities law violations.

(b)(7)(C) testified he likely received a January 28, 2008 letter from Einhorn about Allied violating the settlement order with the Commission. (b)(7)(C) Tr. at 122. That letter stated, in part, ". . . I believe that Allied continues to be a troubled company with a management that refuses to comply with the letter and spirit of the securities laws." Exhibit 34. Einhorn gave specific examples of Allied continuing to overvalue its investments, including that of BLX. *Id.* (b)(7)(C) testified that other than look at some financials from Allied to see if certain representations were being made by Allied, he did not do anything further with the allegations in the letter which he gave to (b)(7)(C) Tr. at 122 & 127.

(b)(7)(C) testified that he did not know how the process of monitoring a settlement agreement worked. *Id.* at 127. When asked if someone was monitoring Allied to be sure it was doing what they had agreed to do, (b)(7)(C) testified, "That's a fair question." *Id.* He told the OIG he did not know of any specific Enforcement Manual policy that indicated what steps to take when there was a settlement. *Id.* He suggested that Enforcement could have a policy to outline what steps should be taken in any instance of undertakings [valuation]. *Id.* (b)(7)(C) further noted that Enforcement could have asked Allied for reports on a quarterly basis under the agreement. *Id.* at 129.

(b)(7)(C) did not recall receiving that Einhorn letter. (b)(7)(C) Tr. at 42. As to monitoring whether Allied complied with the settlement agreement (b)(7)(C) testified, "There is no provision in [the settlement order] for us monitoring." *Id.* at 40. (b)(7)(C) added,

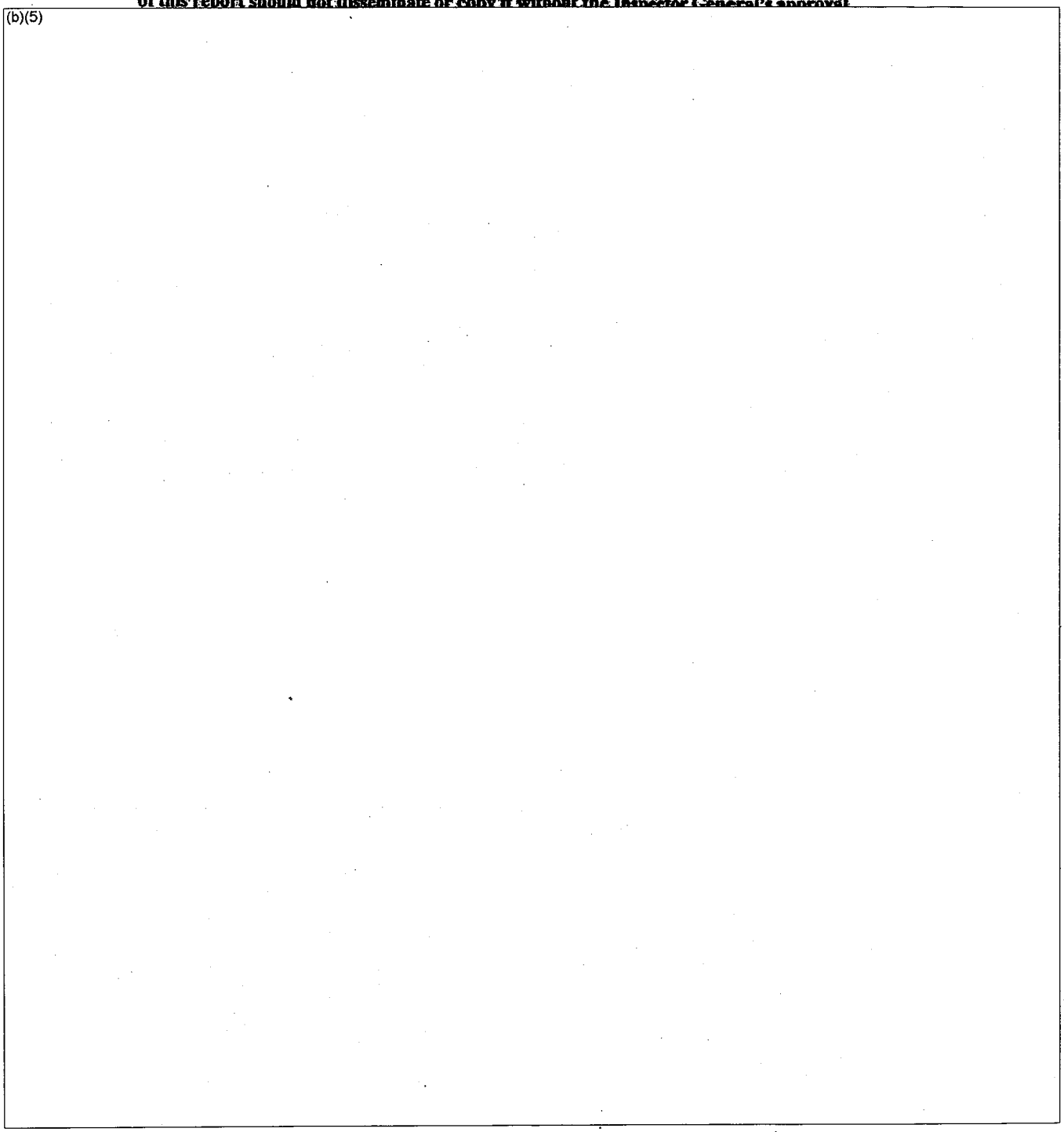
> There is typically not language in settlements that provides the details that you are, I think, asking, no. There are independent consultants or monitors that are put in place in cases where we believe that's necessary and it is their job to monitor the conduct and perhaps recommend certain changes. But that's not what was put here, what was required here, for the settlement. And that is not common.
>
> If you're asking if it's common for us to have language in our settlement documents in which the Commission undertakes to examine a company to determine whether it is doing what it said it was going to do, it is not typical for our settlements. In fact I don't believe they ever do say that the Commission will be conducting regular examinations to look at that.
> *Id.* at 41.

(b)(5)

[redacted]

[43] Recently Allied announced that it is being acquired by another BDC, Ares Capital Corporation and that a merger is currently taking place. *See* http://www.businesswire.com (October 28, 2009).

(b)(5)



(b)(5)

Conclusion

In all, the OIG's findings during this investigation raise concerns about how decisions were made within the SEC with regard to the initiating and concluding of the examination and investigations. While we did not find any evidence of specific wrongdoing on the part of current SEC employees, we found that serious and credible allegations against Allied were

not initially investigated, and instead Allied was able to successfully lobby the SEC to look into allegations against its rival Einhorn without any specific evidence of wrongdoing.

We also found that there was a lack of communication between OCIE and Enforcement with respect to pending examinations and investigations. Moreover, a former Enforcement manager (who had such significant performance problems he was asked to leave Enforcement) was able to obtain a significant amount of sensitive information he may have disclosed to Allied when he became a registered (b)(7)(C) for Allied a year after leaving the SEC. Further, we found concerns with both the OCIE examination of Allied and the resulting Enforcement investigation, and believe there are questions about the extent to which Allied's SEC connections and aggressive tactics may have influenced Enforcement's and OCIE's decisions in these matters.

We are recommending that the Directors of OCIE and Enforcement carefully review this report of investigation and the history of the examination and investigations that are described in this report and give consideration to promulgating and/or clarifying procedures with regard to:

(1) how examinations and investigations are initiated where there are requests from outside persons or entities, including whether specific allegations of wrongdoing have been provided, in determining whether to commence an examination or investigation;

(2) informing individuals and entities under investigation that they are no longer subjects of an investigation in a timely manner, as required by the Enforcement Manual;

(3) ensuring that other than traditional Wells meetings are not utilized by aggressive counsel to influence decisions in Enforcement actions;

(4) incorporating provisions in Enforcement settlement agreements that ensure requirements are adequately monitored for compliance;

(5) limiting the ability of OCIE personnel to delete examination work papers from OCIE computer systems;

(6) ensuring that OCIE management is not unduly influenced by the presence of former SEC employees in examinations and that all issues identified as potential federal securities laws violations be carefully considered for referral to Enforcement; and

(7) documenting the reasons specific issues referred to Enforcement from OCIE are not investigated.

In addition, we recommend that the Ethics Office consider methods to ensure that there is no appearance of impropriety where former SEC staff attorneys represent a company shortly after their work at the SEC provided them with specific and sensitive information related to that company. This report is being provided to the Director of Enforcement, the Acting Director of the Office of Compliance Inspections and Examinations, the Ethics Counsel, and the Deputy Chief of Staff, Office of the Chairman.

Submitted: Kelly J. Andrews Date: January 8, 2010
Kelly J. Andrews

Concur: Noelle Frangipane Date: Jan 8, 2010
Noelle Frangipane

Approved: H. David Kotz Date: January 8, 2010
H. David Kotz