U.S. Securities and Exchange Commission

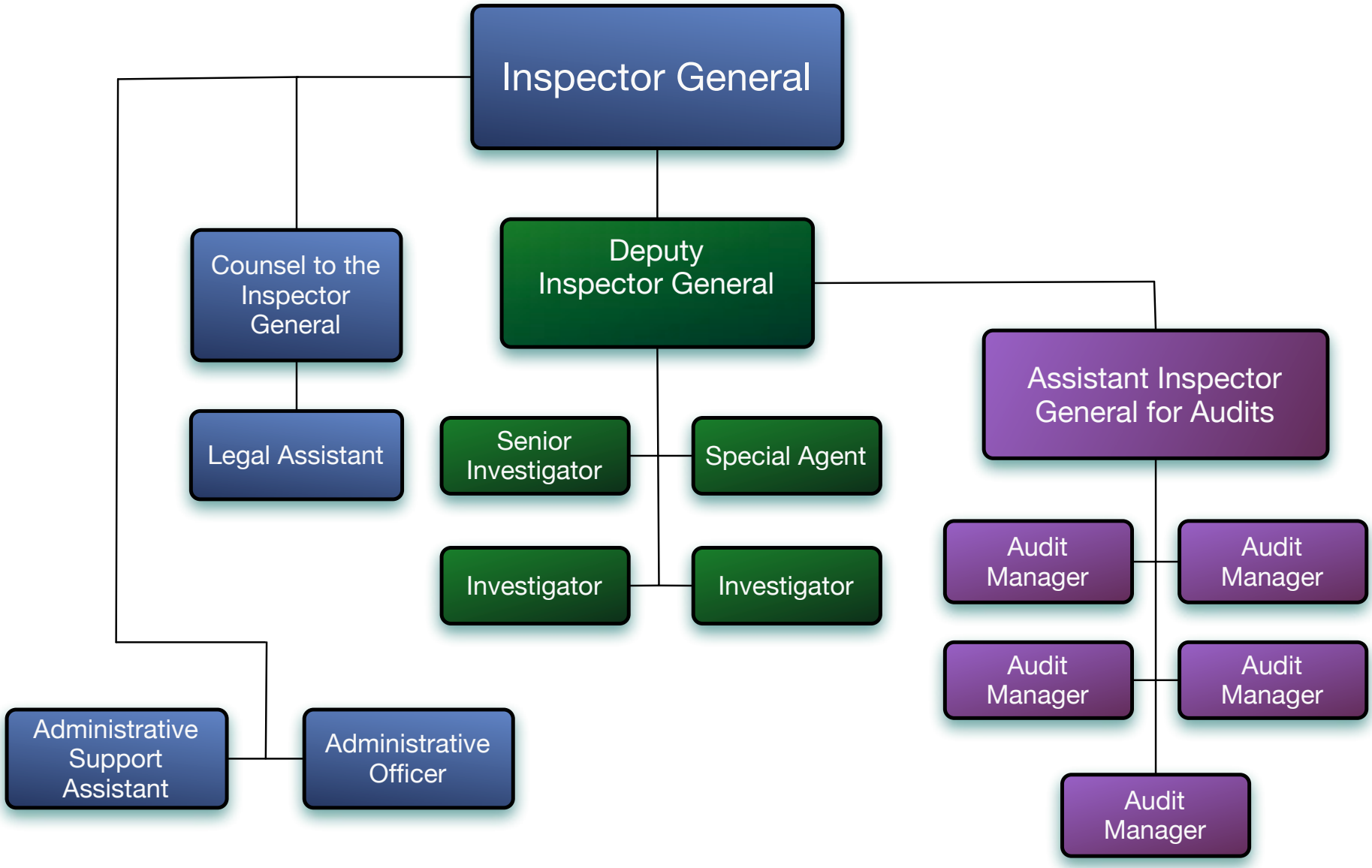
Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

April 1, 2008 - September 30, 2008

Organizational Chart

Office of Inspector General



April 1, 2008 - September 30, 2008

U.S. Securities and Exchange Commission

OFFICE OF INSPECTOR GENERAL SEMIANNUAL REPORT TO CONGRESS

Mission

The mission of the Office of Inspector General is to promote the integrity, efficiency, and effectiveness of the critical programs and operations of the Securities and Exchange Commission. This mission is best achieved by having an effective, vigorous and independent office of seasoned and talented professionals who perform the following functions:

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

U.S. Securities and Exchange Commission

Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

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Message from the

Inspector General

This is my first full reporting period since being appointed Inspector General for the Securities and Exchange Commission (SEC or Commission) on December 23, 2007. It has been a very eventful six months with numerous noteworthy accomplishments.

When I first joined the Commission, I stated my belief that a vibrant and vigorous Office of Inspector General (OIG) was critical to achieving the aims of the SEC, and pledged to ensure that the OIG fulfills its responsibilities of promoting efficiency and effectiveness within the Commission. I believe that our work over the last six months demonstrates the important role the OIG plays in increasing the quality of SEC operations and combating actual or potential occurrences of fraud, waste and abuse in Commission programs and operations.

We issued numerous important reports by both the audit and investigative sides of the OIG during this reporting period that provided valuable information to the Commission, the Congress and the public at large concerning Commission programs and operations.

On April 2, 2008, we received a request from Ranking Member Charles E. Grassley of the United States Senate Committee on Finance for an analysis of the Commission's oversight of several investment banks, most notably Bear Stearns, as well as an investigation into the facts and circumstances surrounding the Commission's decision to not pursue an Enforcement action against Bear Stearns.

In response to this Congressional request, we issued two separate audit reports during the reporting period. The first report related to the Commission's program that oversaw Consolidated Supervised Entity (CSE) firms, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers. The second report discussed the Commission's Broker-Dealer Risk Assessment Program, which tracks the filing status of 146 broker-dealers that are part of a holding company structure and have at least $20 million in capital.

We also completed an investigative report relating to the decision by a Commission Regional Office to close an Enforcement investigation brought against Bear Stearns and another entity. Our report found a failure on the part of management in the Regional Office to administer its statutory obligations and responsibilities to vigorously enforce compliance with applicable securities laws. The report also noted that the fact that two of the defense counsels in the investigation were former Enforcement attorneys created the appearance, to some, that they may have obtained favorable treatment from Enforcement staff.

During this reporting period, our auditors issued several additional reports on a variety of issues and subjects important to Commission operations. We finalized an audit of Commission premium class travel and provided several recommendations designed to strengthen management controls and

enhance policies and procedures relating to Commission travel. Through an outside contractor, we conducted an audit of the Commission's Government Purchase Card (GPC) Program, under which 96 SEC employees made purchases on behalf of the Commission. The report found that internal controls over the GPC program were not operating effectively and provided 17 recommendations, many of which Commission management has already begun to address, to increase efficiencies and controls.

OIG auditors also followed up on a Government Accountability Office (GAO) report regarding the operation of the Division of Enforcement (Enforcement) and conducted a survey of Enforcement's new case management tracking system. This survey culminated in a written report providing several recommended actions based upon user feedback in an effort to improve Enforcement's new system. Additionally, we finalized an inspection of the process by which the Division of Corporation Finance refers potential securities law violations to Enforcement for investigation, and provided recommendations to improve the referral process. We also contracted with an outside entity for the 2008 Federal Information Security Management Act Report assessing the Commission's information technology security procedures and controls.

In investigative matters, we completed a re-investigation of claims made by a former Enforcement attorney that he was improperly terminated and that Enforcement gave improper preferential treatment to a high-level investment bank executive in an investigation. I undertook this re-investigation personally and conducted it over a ten-month period. In the course of this re-investigation, I reviewed over 70 transcripts of testimony or memoranda of interviews of individuals with knowledge of matters relating to the re-investigation, and personally conducted testimony on-the-record and under oath of 20 witnesses. I prepared a nearly 200-page report of investigation, with a five-volume set of 226 appendices. The report concluded that Enforcement failed in numerous respects in how it managed the former employee and allowed inappropriate reasons to factor into its decision to terminate him. The report also raised serious questions about the appropriateness of the information provided by senior Enforcement officials to an investment bank concerning an ongoing investigation. In addition, the report concluded that the common practice in Enforcement that allows (and even encourages) outside counsel to contact those above the line attorney level on behalf of their clients when they have disagreements with the line attorneys could allow certain lawyers (of prominence or note) to have greater access to the decision makers in Enforcement than other less prominent lawyers would have, and create real inequities.

Our investigative staff also completed numerous other investigations during the reporting period. These investigations related to, among other things, conflict of interest, falsification of employment application, improper solicitation and receipt of gifts from a prohibited source, misuse of official Government position and misuse of Government resources.

I am extremely proud of the accomplishments of this office during the past six months that have been achieved with a very small staff. Throughout most of the reporting period, our staff consisted of three investigators, six auditors, a counsel and a few administrative folks. We added

a Deputy Inspector General in July and an additional investigator in September, who have greatly enhanced our team. Particularly during these turbulent financial times, I believe that the work of this Office has been critical in providing the Commission, the U.S. Congress, and the public with valuable information about the regulatory climate, and we intend to continue this important work in the future.

H. David Kotz
Inspector General

Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

MANAGEMENT AND ADMINISTRATION

AGENCY OVERVIEW

The United States Securities and Exchange Commission (SEC or Commission) aims to be the standard against which Federal agencies are measured. The SEC's vision is to strengthen the integrity and soundness of the United States securities markets for the benefit of investors and other market participants, and to conduct its work in a manner that is as sophisticated, flexible, and dynamic as the securities markets it regulates.

The SEC's mission is to protect investors, facilitate capital formation and maintain fair, orderly, and efficient markets. To achieve its mission, the SEC enforces compliance with the Federal securities laws, promotes healthy capital markets through an effective and flexible regulatory environment, fosters informed investment decision making, and maximizes the use of human capital and technological resources.

SEC staff monitor and regulate a securities industry that includes more than 37,000 investment company portfolios (including mutual funds, closed-end funds, unit investment trusts, exchange-traded funds, interval funds, and variable insurance products), almost 11,000 federally registered advisers, approximately 5,730 broker-dealers with about 677,000 registered representatives, about 700 transfer agents, 10 securities exchanges, the Financial Industry Regulatory Authority, 4 securities futures products exchanges, 10 clearing agencies, 9 credit rating agencies, and the Municipal Securities Rulemaking Board. The SEC also selectively reviews the disclosures of almost 13,000 public companies under the Securities Act of 1933 and the Securities Exchange Act of 1934. In 2007, the volume traded on U.S. equity markets amounted to nearly $44 trillion.

In order to accomplish its mission most effectively and efficiently, the SEC is organized into four main divisions (Corporation Finance, Enforcement, Investment Management, and Trading and Markets), and also has 18 functional offices. The Commission's Headquarters is located in Washington, D.C., and there are 11 Regional Offices located throughout the country. As of September 30, 2008, the SEC had 3,511 full-time equivalents,

consisting of 3,442 permanent and 69 temporary positions.

OIG STAFFING

During the reporting period, the OIG filled three critical positions, including the position of Deputy Inspector General. The new Deputy Inspector General, Noelle Frangipane, was a Senior Counsel in the Office of the General Counsel of the SEC prior to joining the OIG. In that capacity, Ms. Frangipane served as an agency subject matter expert on issues of privacy and information-sharing. Before she joined the SEC, Ms. Frangipane was the Director of Policy and Public Information for the Peace Corps. In that capacity, she supervised the audit and evaluation of existing agency policy, operating plans and programs, and the drafting of new policy, and served as the agency's Freedom of Information and Privacy Act Officer. Ms. Frangipane began her Federal career at the National Institutes of Health, where she worked in the offices of administration and management, as well as legislative and intergovernmental affairs. Ms. Frangipane is a graduate of the College of New Jersey, where she received her Bachelor's degree magna cum laude in English, and Rutgers School of Law – Camden, where she received her J.D., graduating with awards for her pro bono work and brief writing.

In addition, we added two new criminal investigators during the reporting period. In April, Sam Morris joined the OIG Office of Investigations with almost 20 years of investigative experience in the securities industry. Mr. Morris came to us from the SEC's Division of Enforcement, where he served for over 10 years as a Market Surveillance Specialist investigating violations of the Federal securities laws. In that position, Mr. Morris served on the Terrorist Attack Trading Investigative Team immediately after the September 11, 2001 attacks, and received the Law and Policy Award for that work. Additionally, Mr. Morris received a commendation from the Federal Bureau of Investigation (FBI) for outstanding assistance in an investigation conducted jointly by the SEC and FBI.

Prior to joining the Commission, Mr. Morris served as a Trading Analyst in Market Investigations/Market Surveillance for the American Stock Exchange, where he reviewed and analyzed complex listed derivative products for indications of improprieties by member firms' proprietary accounts. Mr. Morris also worked at Smith Barney Shearson in its Sales Practice and Compliance Department as an Analyst. In that capacity, Mr. Morris was responsible for reviewing client securities trading for 532 branch offices to ensure compliance with suitability guidelines as well as industry and ethical standards. Before that, Mr. Morris worked at Merrill Lynch in its Fraud Control Unit as an Assistant Investigator where he was responsible for investigating Visa card and check fraud for Merrill Lynch's cash management accounts. Mr. Morris has a Bachelor's degree in Psychology from Touro College.

In September, we added another new investigator, Ray Arp, who came to the OIG with more than 35 years of experience in criminal investigations, law enforcement operations, fraud and white collar crime, program analysis and program management. Mr. Arp served for 15 years as both a criminal investigator and supervisory criminal investigator with the U.S. Army's Criminal Investigation Command, where he specialized in white collar crime investigations and drug enforcement. After retiring from the Army with twenty years of service, Mr. Arp was employed by the Commonwealth of Virginia for 10 years, where he served in management, analysis and administrative positions before returning to the

Federal government in June 2003. From 2003 until he joined the SEC, Mr. Arp served as a Senior Criminal Investigator with the Department of Defense Office of Inspector General's Investigative Oversight Directorate, where he worked on a number of high profile investigations, including the death of Corporal Patrick Tillman and leadership failures in the investigation and reporting of sexual assaults at the U.S. Air Force Academy. Mr. Arp has a Bachelor's degree in Criminal Justice Administration from Park University and a Master's degree in Administration from Central Michigan University. Additionally, he is an accredited fraud investigator and criminal justice trainer, and currently serves on the board of directors for a national association of investigators. His awards include both the Bronze Star and the Meritorious Civilian Service Award.

NEW OIG WEBSITE

During this reporting period, the OIG enhanced its public resources by developing an upgraded and more extensive OIG website. The new website, which will become operational shortly, will feature streamlined navigational tools for access to general information about the OIG, its mission and its staff, as well as more specific information concerning the OIG's two central components, the Office of Audits and Office of Investigations. The website will also provide online visitors with direct access to expanded content, such as audit and evaluation reports and several years of OIG Semiannual Reports to Congress. Another new feature of the website is the option of subscribing to a list serve to allow visitors to receive notification of newly-issued OIG reports. Finally, the website will provide visitors with information about and access to the OIG's new telephone and web-based Hotline for making confidential complaints to the OIG, as described below.

NEW OIG COMPLAINT HOTLINE

During the previous reporting period, in order to facilitate the making of confidential complaints to the OIG, the OIG entered into a contract with an outside vendor to provide both telephone and web-based Hotline services for the reporting of suspected fraud, waste or abuse in SEC programs and operations, and SEC staff or contractor misconduct. We are pleased to report that the Hotline became operational on August 13, 2008.

Hotline complaints may be made by either calling the OIG's toll-free Hotline number, (877) 442-0854, 24 hours a day, seven days a week, where a specially-trained Hotline operator will record all important details of the complaint, or by completing an online complaint form at www.reportlineweb.com/sec_oig. While individuals submitting complaints through the Hotline may request to remain anonymous, complainants are encouraged to assist the OIG by providing their names and information on how they may be contacted for additional information. The OIG will protect the confidentiality of complainants upon request.

Between the date the Hotline became operational and the end of the reporting period, the OIG received a total of 29 Hotline complaints (19 by telephone and 10 by web-based reporting). We anticipate that the number of Hotline complaints will increase as more individuals become aware of and familiar with the Hotline. We believe that the new Hotline service will enhance the ability of Commission employees and members of the public to report matters confidentially to the OIG and will assist the OIG tremendously in carrying out its critical function of preventing and detecting fraud, waste, abuse and mismanagement in Commission programs and operations.

RESPONSES TO CONGRESSIONAL INQUIRIES

During the reporting period, the OIG responded to several inquiries and requests for information from Congressional Committees, as well as individual Members of Congress.

On April 2, 2008, we received a letter from Ranking Member Charles E. Grassley of the United States Senate Committee on Finance requesting that OIG undertake both investigatory and audit work relating to the collapse of Bear Stearns. The April 2, 2008 letter noted that according to regulatory filings and a December 2007 Wall Street Journal article, the Commission's Division of Enforcement (Enforcement) declined to bring an action against Bear Stearns. Ranking Member Grassley asked that, in light of the subsequent collapse and Federally-backed bailout of Bear Stearns, the OIG conduct a thorough investigation into the facts and circumstances surrounding the decisions by Enforcement not to pursue an action against Bear Stearns and to close the investigation.

Ranking Member Grassley also asked the OIG to conduct follow-up audit work on matters relating to the Commission's oversight of investment banks, such as Bear Stearns, through its Division of Trading and Markets (TM). Specifically, Senator Grassley asked that the OIG analyze the missions of TM's oversight programs, as well as their polices and procedures, and the adequacies of the reviews conducted of Bear Stearns.

As discussed at length in the section on Investigations and Inquiries Conducted, on September 30, 2008, the OIG issued a comprehensive report of investigation relating to the decision by a Commission Regional Office to close the Enforcement investigation of Bear Stearns and another entity, finding a failure on the part of management in the Regional Office to

administer its statutory obligations and responsibilities to vigorously enforce compliance with applicable securities laws.

In addition, as discussed at length in the section on Summary of Audits and Inspections, on September 25, 2008, the OIG issued two separate audit reports in response to the April 2, 2008 Congressional request. The first report related to the Commission's program that oversees Consolidated Supervised Entity (CSE) firms, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers. The second report discussed the Commission's Broker-Dealer Risk Assessment Program, which tracks the filing status of 146 broker-dealers that are part of a holding company structure and have at least $20 million in capital.

During the reporting period, the Inspector General also issued a progress report to Senator Grassley on the status of the SEC's implementation of the recommendations made in an August 2007 Report prepared by the Minority Staff of the Committee on Finance, United States Senate and the Committee on the Judiciary, United States Senate, as requested in a February 4, 2008 letter to the Inspector General from Senator Grassley.

By letter dated May 15, 2008, Inspector General Kotz informed Senator Grassley about the status of SEC actions relating to instituting standardized investigative procedures, establishing policies regarding the directing of appropriate resources to significant and complex cases in Enforcement, the issuance of written guidance requiring supervisors to keep complete and reliable records of all outside communications regarding any Enforcement investigations, as well as policies regarding the communicating of recusals to all SEC staff who have official contact with the recused individual, and maintaining a record of the recusals. The May 15, 2008 letter also informed Senator Grassley about an April 2, 2008 memorandum issued by SEC Chairman Christopher Cox to all SEC employees reminding them that the Commission has protections in place to safeguard them from retaliation for making protected whistleblower disclosures of wrongdoing at the Commission. The memorandum also specifically indicated that communicating with the OIG may be an alternate, confidential channel of communication that employees may use to report wrongdoing or misconduct if they fear communicating through their chain of command.

During the reporting period, the Inspector General also met, and had numerous telephone calls, with staff of Congressional Committees to discuss a variety of matters of ongoing concern with the SEC or the IG community. The OIG also replied to an inquiry from a Member of Congress about a matter of interest to an individual constituent.

ADVICE AND ASSISTANCE PROVIDED TO THE AGENCY

During this reporting period, the OIG provided advice and assistance to management on a number of serious issues that were brought to our attention through investigations conducted by the OIG and otherwise. This advice was conveyed through written communications, as well as oral briefings and meetings with agency officials. In addition to recommending improvements in existing procedures, we provided numerous comments, both oral and written, on policy and rule changes that were being implemented by management, some as a result of previous OIG recommendations.

Annual Attorney Certification of Bar Membership

Investigations conducted by the OIG during this reporting period and the prior reporting period revealed that two individuals employed as Commission attorneys had no active bar membership as required by their positions. One of these attorneys was transferred to an inactive status due to his failure to renew his bar license, while the other individual had never been admitted to any bar. The Commission requires that all individuals occupying attorney positions maintain active bar membership as a condition of their employment.

In order to ensure that Commission attorneys comply with the requirement of maintaining active bar membership, the OIG issued a memorandum recommending that management require all Commission attorneys to certify on a annual basis that they are an active member of at least one bar. We also recommended that Commission attorneys be required to acknowledge on the annual certification form that the failure on their part to maintain active bar membership at any time during their employment as a Commission attorney will result in a referral to the appropriate authorities, and may result in their pay being withheld and/or disciplinary action. Management concurred with the OIG's recommendation and agreed to implement the annual certification requirement.

Enforcement Policies and Procedures for the Selection of Receivers, Administrators and Consultants

Within the past year, the OIG received two complaints pertaining to SEC Enforcement matters alleging that the receivers who worked on these cases had improper conflicts of interest as a result of prior legal work they had performed, and is continuing to look into these matters. Additionally, during the previous reporting period, the OIG issued an inspection report (No. 432, Oversight of Receivers and Distribution Agents, dated December 12, 2007) that made recommendations for improvements in receiver and distribution agent oversight. The OIG has continued to monitor the implementation of these recommendations.

In connection with its ongoing efforts regarding receiver and distribution agent oversight, during the reporting period, the OIG reviewed the Division of Enforcement's (Enforcement's) draft policies and procedures governing the selection of receivers, fund administrators, independent distribution consultants, tax administrators and independent consultants. The OIG also reviewed the attachment to the draft policy, which was a form on which receiver and independent consultant applicants would disclose conflicts of interest and background information. Based upon its review of these documents, the OIG issued a memorandum to management making three recommendations for enhancements to the policy and attachment.

Specifically, the OIG recommended that the important issue of actual or apparent conflicts of interest on the part of receivers and independent consultants be addressed in the policy itself and not just in the attachment. The OIG also recommended that the information sought in the attachment to the policy be obtained for a broader or indefinite period of time, and that a certification that complete and truthful information was provided be included on the form. Management agreed to consider the OIG's comments as it continues to draft the revised policies and procedures.

New Performance Management System

A prior OIG audit (No. 423, Enforcement Performance Management, issued February 8, 2007) had found significant problems with the Division of Enforcement's performance management process and made numerous recommendations for improvements. Thereafter, the Commission began to implement a new agency-wide performance management program. In the previous reporting period, the OIG provided numerous substantive comments on several drafts of the Commission's new performance management policy.

During this semiannual period, the OIG continued to monitor the Commisson's implementation of the new performance management system and brought a particular problem it identified to management's attention. Specifically, the OIG discovered a loophole in the transitioning of supervisory employees who had recently joined the SEC to the new performance management system at the beginning of Fiscal Year 2009 that would result in these employees not being rated for a certain period of time. After the OIG pointed out the problem, management agreed to rectify the situation by adding another rating period for these employees.

New Enforcement Manual

During the reporting period, Enforcement worked on preparing a new Enforcement Manual in response to a recommendation made by the United States Senate Committees on Finance and the Judiciary. Various sections of the draft manual were provided to the OIG for its review and comment. OIG staff conducted a thorough review of these manual sections and provided comments thereon. The OIG's comments pertained to, among other things, information that should be entered into Enforcement's Hub case management system, the definition of material external communications, protecting witness confidentiality in investigations, and redactions from materials produced in response to subpoenas.

Revised Regulation on Use of SEC Office Equipment

As a result of prior OIG investigations into several employees' misuse of SEC resources and official time to view pornography, the OIG had recommended that the Office of the Executive Director (OED), in consultation with the Offices of General Counsel and Information Technology, update, consolidate and clarify the agency's Internet usage policies, including SEC Regulation (SECR) 24-4.3, "Use of SEC Office Equipment," which had not been updated since March 2002. The OIG also recommended that the OED, in consultation with these other offices, send reminders to all SEC employees and contractors that accessing or downloading pornographic materials from Commission computers is strictly prohibited and may result in appropriate discipline.

During this reporting period, the OIG reviewed a revised draft of SECR 24.4.3 and provided written comments on the draft. The OIG recommended that the policy be revised to include an exception to allow for situations where SEC staff and contractors, such as OIG employees, may have a legitimate reason to seek and access prohibited materials during the performance of their official duties. In its comments, the OIG also referenced the recommendation that management send appropriate reminders to SEC employees and contractors and suggested that management do so in connection with notifying them of the revised SECR 24.4.3 policy. Management agreed to add the exception language recommended by the OIG and to consider the suggestion for reminding employees of the prohibition against accessing pornography.

Office of Information Technology Policies and Procedures

During the reporting period, the OIG reviewed and provided comments to management on several draft Office of Information Technology (OIT) policies and procedures. For example, the OIG provided comments on OIT's draft Operating Directive on Privacy Incident Management (OD 24-08.04) and its draft Implementing Instruction on Privacy Incident Response Capability (II 24-08.04.01). In its comments on these documents, the OIG recommended that a provision pertaining to notification to the OIG of privacy incidents be expanded to require prompt notification to the OIG of any incident where there appears to have been an intentional breach of privacy by a Commission staff member or contractor. The OIG further recommended that the detailed procedures for investigating privacy incidents be revised to require consultation with the OIG whenever there is an indication of an intentional breach of privacy by a Commission staff member or contractor. OIT thanked the OIG for its feedback and

agreed to work on revising the draft policies and procedures.

The OIG also recommended several revisions to a draft implementing instruction establishing policies and procedures for the use of digital forensic tools. The OIG's recommended changes were designed to ensure that the forensic tools are only used under appropriate circumstances and with the proper approvals. In addition, the OIG reviewed and provided comments on the revised certificate to be issued upon an employee's or contractor's completion of the agency's required information technology (IT) security training course. Further, an OIG staff member participated in testing of the revised IT security training program and provided input on the training program to OIT.

SEMIANNUAL REPORT TO CONGRESS

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

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

CHALLENGE: PROCUREMENT AND CONTRACTING

The Office of Inspector General (OIG) has identified the Securities and Exchange Commission's (Commission or SEC) procurement and contracting function as a management challenge.

The OIG believes that while the Office of Administrative Services (OAS) has made progress in recent years to enhance service delivery through reorganizing the procurement and contracting functions, enhancing the skill level of current staff, recruiting additional skilled staff to better manage the workload, and pursuing efforts to implement an automated procurement system, significant challenges still remain.

An ongoing OIG review of the procurement and contracting function has identified the following key organizational issues:

- OAS's Office of Acquisitions (OA) is attempting to implement a new $4 million automated procurement system after two failed attempts to automate the procurement operation, costing more than $2.5 million.

- OA does not maintain a consolidated record of active, pending, completed and cancelled contracts, agreements, and purchase orders due to its manually-driven processes.

- Select individuals in the Commission's regional offices have been delegated the authority to execute contracts without adequate contracting training and experience. Additionally, contract activities in the regional offices are not reported in the Federal Procurement Data System (FPDS), which is a web-based tool used by agencies to report contract data to the President, Congress, the Government Accountability Office, Federal executive agencies and the general public.

- OA does not have direct authority and oversight over some individuals performing contract award and administrative functions at headquarters and the regional offices.

- OA still needs to develop comprehensive policies and procedures addressing key aspects of the procurement operation to ensure compliance with the Federal Acquisition Regulation and other applicable Office of Management and Budget guidance.

CHALLENGE: INFORMATION TECHNOLOGY MANAGEMENT

Information technology (IT) management continues to be a management challenge, although significant improvements have been made in recent years.

In this reporting period, the OIG evaluated three areas of IT management:

Information Security - The OIG found that while the Commission's Office of Information Technology (OIT) generally has effective security controls in place and has addressed most of the major areas for a sound information security and privacy program, the SEC has not completed the security controls and contingency plan testing for all of its systems. OIT also has not taken the necessary steps to implement the Federal Desktop Core Configuration (FDCC) requirements.

Laptop Controls - The OIG concluded in a recent audit report that OIT did not have proper controls over its laptop computers. Specifically, OIT lacked an inventory of its laptops and was unable to trace ownership of laptops to specific individuals.

Enterprise Architecture (EA) - The OIG found that OIT had made progress in developing and documenting a comprehensive EA program, but that EA has not been satisfactorily integrated into the SEC's overall IT strategy. The EA program is intended as a management tool to ensure planning is aligned with the agency's strategic goals. The OIG found that the EA program performed well in certain areas, but poorly in the Results Capability Areas.

The integration of IT into Commission work processes and interactions with the public continues to be a management challenge. In addition to the issues described above, the OIG has identified challenges in several other key IT areas:

- IT capital investment;
- Administration and oversight of IT contracts;
- IT governance; and
- IT human capital.

Currently, OIT has vacancies in two of its most senior management positions - the Chief Information Officer (CIO) and Chief Information Security Officer (CISO). These positions are essential to the SEC's IT program and should be filled expeditiously. Despite those vacancies, OIT has still made considerable progress in strengthening the SEC's IT program in several areas, including:

- Supporting a major upgrade to the agency's core financial management system;
- Developing comprehensive information security management and privacy policies and procedures;
- Initiating a project expected to employ XBRL interactive data technology, which gives investors and analysts quicker and easier access to key financial information about public companies and mutual funds; and
- Competing and awarding a new contract for Infrastructure Support Services.

The OIG plans to continue its oversight of IT management and monitor progress in the key areas denoted above.

CHALLENGE: FINANCIAL MANAGEMENT

The Government Accountability Office's (GAO) fiscal year 2007 audit of the Commission's financial statements found that they were fairly presented in all material respects. However, because of a material weakness and significant deficiencies in internal controls, the GAO found that the SEC did not maintain effective internal controls over financial reporting, and thus did not have reasonable assurance that misstatements would be prevented or detected on a timely basis.

GAO identified four significant control deficiencies in the Commission's financial reporting process, which, taken collectively, constitute a material weakness. These control deficiencies concerned the Commission's (1) period-end financial reporting process, (2) calculation of accounts receivable for disgorgements and penalties, (3) accounting for transaction fee revenue, and (4) preparation of financial statement disclosures.

In addition, GAO identified three significant (but not material) deficiencies in internal controls, which adversely affect the Commission's ability to meet financial reporting and other internal control objectives. These deficiencies concerned the Commission's (1) information security controls, (2) property and equipment, and (3) accounting for budgetary resources.

According to GAO, although certain compliance controls should be improved, the Commission maintained, in all material respects, effective internal controls over compliance with laws and regulations. This provided reasonable assurances that noncompliance with laws and regulations that could have a direct and material effect on the financial statements would be prevented or detected on a timely basis.

CHALLENGE: PERFORMANCE MANAGEMENT

In February 2007, the OIG issued an audit report on the Commission's performance management process. This audit found that the Commission did not consistently perform all parts of the

performance appraisal process. In addition, the audit report found that the Commission's performance management process did not sufficiently contain policies and procedures with regard to managing employees with performance problems and implementing all phases of the performance review cycle.

The OIG also found that the Commission did not make meaningful distinctions between employees' performance since each employee was merely rated as "pass" or "fail." Further, the performance process was not aligned with the fiscal year, and did not timely reward employees for their significant, performance-based contributions.

The Commission, has, however, taken numerous steps to remedy this challenge. Beginning in Fiscal Year 2008, Commission employees will begin transitioning to a new performance management process, which includes a five-level rating system. All employees are expected to transition to the new process by Fiscal Year 2010. The OIG reviewed several drafts of the Commission's new written guidance and provided three separate sets of substantial written comments on those drafts. The Commission incorporated the OIG's comments into its guidance.

CHALLENGE: PERSONAL SECURITIES TRADING

While conducting a comprehensive investigation of the securities trading activities of a few Commission employees, we have determined that the Commission's current system in place to report the ownership and trading of securities is insufficient to prevent and detect insider trading on the part of Commission employees or violations of the Commission's rules.

The OIG investigation has found that the reports that employees are required to file when they buy, sell or own securities are not meaningfully reviewed or sufficiently checked for conflicts of interest. Moreover, there is currently no system in place for the Commission to detect if an employee who has traded or owns a security failed to properly report such transaction.

The lack of a reliable oversight system of employee securities trading poses a significant management challenge to the Commission and may create an appearance of a conflict of interest in the matters on which Commission employees work.

The Ethics Counsel for the Commission is aware of this significant challenge and has indicated that he intends to take steps to correct the problem.

Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

AUDITS, EVALUATIONS AND INSPECTIONS

OVERVIEW

The OIG's Office of Audits (AUD) focuses its efforts on conducting and supervising independent audits, evaluations and inspections of the Commission's program and operations. AUD also hires independent contractors and subject matter experts to conduct work on its behalf. Specifically, we review the Commission's programs and operations to determine whether:

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

Audits

Audits examine operations and financial transactions to ensure that proper management practices are being followed and resources are being adequately protected in accordance with laws and regulations. Audits are systematic, independent and documented processes for obtaining evidence.

In general, audits are conducted when firm criteria or data exist, sample data is measurable, and testing internal controls is an integral component of the objectives. Our audits focus on Commission programs and operations related to areas such as the oversight and examination of regulated entities, the protection of investor interests, and the evaluation of administrative activities. AUD conducts audits in accordance with OIG policy, generally accepted government auditing standards issued by the Comptroller General of the United States (the Yellow Book), as well as guidance issued by the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE).

Evaluations and Inspections

AUD conducts evaluations and inspections when non-audit services or consulting services are rendered to the agency, or when a project's

objectives are based on specialty and highly technical areas.

Evaluations and inspections are reviews that typically cover broad areas and are designed to provide Commission management with timely and useful information associated with current or anticipated problems. Evaluations are conducted in accordance with OIG policy, the non-audit service standards of the Yellow Book, or guidance issued by the PCIE/ECIE. Inspections are conducted in accordance with OIG policy and the PCIE/ECIE Quality Standards for Inspections.

SUMMARY OF AUDITS, EVALUATIONS AND INSPECTIONS

SEC's Oversight of Bear Stearns and Related Entities: Consolidated Supervised Entity Program (Report No. 446-A)

The OIG conducted an audit of the Commission's Oversight of Bear Stearns and Related Entities: Consolidated Supervised Entity Program, during the period from April 2008 through August 2008, in accordance with generally accepted government auditing standards. The OIG initiated this audit based on a request received on April 2, 2008, from Charles E. Grassley, the Ranking Member of the United States Senate Committee on Finance. The request asked the OIG to analyze the Commission's oversight of the Consolidated Supervised Entity (CSE) firms and broker-dealers that were subject to the Commission's Risk Assessment Program.

In response to the Congressional request, the OIG actually conducted two separate audits. This section discusses the audit of the Division of Trading and Market's (TM) CSE Program. The second audit (Report No. 446-B) addresses TM's Risk Assessment Program and is discussed in detail below.

Prior to the OIG's issuance of its audit reports, senior Commission officials informed the OIG that they had determined the reports contained confidential and nonpublic information that could not be released to the public under Commission regulations. As a result, on September 25, 2008, the OIG issued both public and nonpublic versions of Report Nos. 446-A and 446-B. The redacted public versions of the reports were placed on the OIG's website, while the unredacted nonpublic versions were issued internally within the Commission.

Background of the CSE Program

In 2004, the Commission adopted rule amendments under the Securities Exchange Act of 1934, which created the voluntary CSE program. This program was established to allow the Commission to supervise certain broker-dealer holding companies on a consolidated basis. In this capacity, the Commission's supervision extended beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself.

A broker-dealer became a CSE by applying to the Commission for an exemption from the Commission's standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision, if it did not already have a principal regulator. By obtaining an exemption from the standard net capital rule, the CSE firm's broker-dealer was permitted to compute net capital using an alternative method.

The Commission designed the CSE program to be broadly consistent with the Board of Governors of the Federal Reserve System's (Federal Reserve) oversight of bank holding companies. However, the CSE program "reflects the reliance of securities firms on mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity in all market environments for holding companies that do not have access to an external liquidity provider."

At the time of the OIG's fieldwork, the Commission exercised direct oversight of five CSE firms: (1) Bear Stearns; (2) Goldman Sachs; (3) Morgan Stanley; (4) Merrill Lynch; and (5) Lehman Brothers. As discussed below, in March 2008, Bear Stearns failed and was sold with Federal financial backing. On September 15, 2008, Lehman Brothers announced that it would file for bankruptcy protection, and the Bank of America announced its agreement to acquire Merrill Lynch. Both Lehman Brothers and Merrill Lynch had experienced serious financial difficulties. On September 21, 2008, the Federal Reserve approved (pending a statutory five-day antitrust waiting period) applications from Goldman Sachs and Morgan Stanley to become bank holding companies with the Federal Reserve as their new principal regulator.

Bear Stearns' Collapse

Bear Stearns was a holding company that had two registered broker-dealers. Its main activities included investment banking, securities and derivatives sales and trading, clearance, brokerage and asset management. Bear Stearns was highly leveraged and had a large exposure (i.e., concentration of assets) in mortgage-backed securities. Bear Stearns also had less capital and was less diversified than several other CSE firms.

In June 2007, two hedge funds that Bear Stearns managed collapsed because of subprime mortgage losses. Nearly a year later, during the week of March 10, 2008, rumors began to spread about liquidity problems at Bear Stearns. Due to Bear Stearns' lenders not rolling over secured financing, Bear Stearns began to face severe liquidity problems. As a result, on March 14, 2008, JP Morgan Chase & Co. (JP Morgan) provided Bear Stearns with emergency funding. According to Congressional testimony, after the markets closed on March 14, 2008, it became apparent that the Federal Reserve Bank of New York's (FRBNY) funding could not stop Bear Stearns' downward spiral. On March 16, 2008, it was announced that Bear Stearns would be sold to JP Morgan, with financing support coming from the FRBNY. In May 2008, the Bear Stearns' sale was completed.

In testimony given before the Senate Committee on Banking, Housing, and Urban Affairs on April 3, 2008, SEC Chairman Christopher Cox stated that Bear Stearns' collapse was due to a liquidity crisis caused by a lack of confidence. Chairman Cox described Bear Stearns' collapse as a "run on the bank," which occurred exceptionally fast, in an already distressed market environment, i.e., the credit crisis.

Commission officials further stated that neither the CSE program nor any regulatory model (i.e., standards developed by the Basel Committee on Banking Supervision (Basel II)) used by commercial and investment banks considered the possibility that secured financing, even when backed by high-quality

collateral, could become completely unavailable. Instead, the CSE program only considered that a deterioration of secured financing could occur (e.g., that financing terms could become less favorable), and that unsecured funding could be unavailable for at least one year.

Audit Objectives and Work

The Congressional request the OIG received on April 2, 2008, noted that TM was responsible for regulating the largest broker-dealers and their associated holding companies and requested a review of TM's oversight of the five CSE firms it directly oversaw, with a special emphasis on Bear Stearns. The request further called for the OIG to analyze how the CSE program was run, examine the adequacy of the Commission's monitoring of Bear Stearns, and make recommendations to improve the Commission's CSE program. The audit's objectives were to evaluate the CSE program, emphasizing the Commission's oversight of Bear Stearns, and determine whether improvements were needed in the Commission's monitoring of CSE firms and its administration of the CSE program.

The audit was not intended to be a complete assessment of the multitude of events that led to Bear Stearns' collapse and, accordingly, did not purport to demonstrate any specific or direct connection between the failure of the CSE program's oversight of Bear Stearns and Bear Stearns' collapse.

Given the complexity of the subject matter, the OIG retained an expert, Albert S. (Pete) Kyle, to provide assistance with the audit. Professor Kyle, a faculty member at the University of Maryland, is a renowned expert on many aspects of capital markets and has conducted significant research on numerous finance-related maters. He served as a staff member of the Presidential Task Force on Market Mechanisms (Brady Commission) after the stock market crash of 1987 and has worked as a consultant on financial topics for several government agencies.

Audit Findings

The audit identified significant deficiencies in the CSE program that warranted improvement. The CSE program's mission provides in pertinent part:

> The regime is intended to allow the Commission to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including US and foreign-registered banks and broker-dealers, *or the broader financial system at risk.* [Emphasis added.]

The audit found that the CSE program failed to carry out its mission in its oversight of Bear Stearns because, under the Commission's and the CSE program's watch, Bear Stearns suffered significant financial weaknesses and the FRBNY needed to intervene during the week of March 10, 2008, to prevent significant harm to the broader financial system.

Overall, the audit found that there are significant questions about the adequacy of a number of CSE program requirements, as Bear Stearns was compliant with several of these requirements, but nonetheless collapsed. In addition, the audit found that TM became aware of numerous potential red flags prior to Bear Stearns' collapse regarding its concentration of mortgage securities, high leverage, shortcomings of risk management of

mortgage-backed securities and the lack of compliance with the spirit of certain Basel II standards, but did not take actions to limit these risk factors.

In addition, the audit found that procedures and processes were not strictly adhered to as, for example, the Commission issued an order that approved Bear Stearns to become a CSE prior to the completion of the inspection process. Furthermore, the Division of Corporation Finance (Corporation Finance) did not conduct Bear Stearns' latest 10-K filing review in a timely manner.

The audit also identified numerous specific concerns with the Commission's oversight of the CSE program. Some of the concerns the audit identified included:

- Bear Stearns was compliant with the CSE program's capital and liquidity requirements; however, its collapse raised questions about the adequacy of these requirements.

- Although TM was aware, prior to Bear Stearns becoming a CSE firm, that Bear Stearns' concentration of mortgage securities had been increasing for several years and was beyond its internal limits, and that a portion of its mortgage securities (e.g., adjustable rate mortgages) represented a significant concentration of market risk, TM did not make any efforts to limit Bear Stearns' mortgage securities concentration.

- Prior to the adoption of the rule amendments that created the CSE program, the broker-dealers affiliated with the CSE firms were required either to maintain a debt to-net capital ratio of less than 15 to 1 after their first year of operation, or to have net capital not less than the greater of $250,000 or two percent of aggregate debit items computed in accordance with the formula for determination of reserve requirements for broker-dealers. However, TM did not require CSE firms to have a leverage ratio limit. Furthermore, although TM was aware that Bear Stearns' leverage was high, TM made no efforts to require Bear Stearns to reduce its leverage, despite some authoritative sources describing a link between leverage and liquidity risk.

- TM was aware that the risk management of mortgages at Bear Stearns had numerous shortcomings, including the lack of expertise by risk managers in mortgage-backed securities at various times, the lack of timely formal review of mortgage models, persistent understaffing, a proximity of risk managers to traders suggesting a lack of independence, turnover of key personnel during times of crisis, and the inability or unwillingness to update models to reflect changing circumstances. Notwithstanding this knowledge, TM missed opportunities to push Bear Stearns aggressively to address these identified concerns.

- There was no documentation of discussions between TM and Bear Stearns of scenarios involving a meltdown of mortgage market liquidity, accompanied by a fundamental deterioration of the mortgages themselves. TM appeared to identify the types of risks associated with these mortgages that evolved into the subprime mortgage crisis, yet did not require Bear Stearns to reduce its exposure to subprime loans.

- Bear Stearns was not compliant with the spirit of certain Basel II standards, and we did not find sufficient

evidence that TM required Bear Stearns to comply with the same.

- TM took no actions to assess the tolerance for risk on the part of Bear Stearns' Board of Directors and senior officials (e.g., the Chief Executive Officer), although we found that this is a prudent and necessary oversight procedure.

- TM authorized (without an appropriate delegation of authority) the CSE firms' internal audit staff to perform critical audit work involving the firms' risk management systems, instead of the firms' external auditors performing this work as required by the rule that created the CSE program.

- In June 2007, two of Bear Stearns' managed hedge funds collapsed. Subsequent to this collapse, significant questions were raised about the lack of involvement by some of Bear Stearns' senior managers in handling the crisis. However, TM did not reassess the communication strategy component of Bear Stearns' Contingency Funding Plan after the collapse of the hedge funds, and very significant questions were once again raised about the handling of the crisis by some of Bear Stearns' managers during the week of March 10, 2008.

- The Commission issued four of the five orders approving firms, including Bear Stearns, to use the alternative capital method, and thus become CSEs, before the inspection process of these firms was completed.

- Corporation Finance did not conduct Bear Stearns' most recent 10-K filing review in a timely manner. The effect of this untimely review was that Corporation Finance deprived investors of material information that they could have used to make well-informed investment decisions (i.e., whether to buy or sell Bear Stearns' securities). In addition, the information (e.g., Bear Stearns' exposure to subprime mortgages) could have been potentially beneficial to dispel the rumors that led to Bear Stearns' collapse.

Recommendations

The audit identified 26 recommendations that, if implemented, would significantly improve the Commission's oversight of the CSE firms.

The recommendations included:

- A reassessment of guidelines and rules regarding the CSE firms' capital and liquidity levels;

- Taking appropriate measures to ensure that TM adequately incorporates a firm's concentration of securities into the CSE program's assessment of a firm's risk management systems and more aggressively prompts CSE firms to take appropriate actions to mitigate risks;

- A reassessment of the CSE program's policy regarding leverage ratio limits;

- Ensuring that: (1) the CSE firms have specific criteria for reviewing and approving models used for pricing and risk management, (2) the review and approval process conducted by the CSE firms is performed in an independent manner by the firms' risk management staff, (3) each CSE firm's model review and approval process takes place in a thorough and

timely manner, and (4) limits are imposed on risk taking by firms in areas where TM determines that risk management is not adequate;

- Being more skeptical of CSE firms' risk models and working with regulated firms to help them develop additional stress scenarios that have not already been contemplated as part of the prudential regulation process;

- Greater involvement on the part of TM in formulating action plans for a variety of stress or disaster scenarios, even if the plans are informal;

- Taking steps to ensure that mark disputes (i.e., disagreements between the parties to derivatives transactions over the value of the derivatives) do not provide an occasion for CSE firms to inflate the combined capital of two firms by using inconsistent marks;

- Encouraging the CSE firms to present Value at Risk or VaR (i.e., the maximum loss likely to be incurred with a given probability over a specified period of time) and other risk management data in a useful manner, which is consistent with how the CSE firms use the information internally and allows risk factors to be applied consistently to individual trading desks;

- Ensuring (in accordance with Basel II) that the CSE firms take appropriate capital deductions for illiquid assets and stressed repurchase agreements, especially ones where illiquid securities are posted as collateral;

- Greater discussion of risk tolerance with the CSE firms' Boards of Directors and senior management to understand better whether the actions of CSE firms' staff are consistent with the desires of the Boards of Directors and senior management;

- Requiring that TM comply with the existing rule that requires external auditors to review the CSE firms' risk management control systems or seek Commission approval in accordance with the Administrative Procedures Act for this deviation from the current rule's requirement;

- Ensuring that reviews of a firm's Contingency Funding Plan include an assessment of a CSE firm's internal and external communication strategies;

- Developing a formal automated process to track material issues identified by the monitoring staff to ensure they are adequately resolved;

- Ensuring that the staff complete all phases of a firm's inspection process before recommending that the Commission allow any additional CSE firms the authority to use the alternative capital method;

- Improving collaboration efforts among TM, Corporation Finance, the Office of Compliance Inspections and Examination (OCIE), and the Office of Risk Assessment (ORA);

- The development by Corporation Finance of internal guidelines for reviewing filings timely and tracking and monitoring compliance with its internal guidelines; and

- The creation of a Task Force led by ORA with staff from TM, the Division of Investment Management, and OCIE to perform an analysis of large firms that hold significant amounts of customer funds and have unregulated entities, to determine the costs and benefits of supervising these firms on a consolidated basis.

Management's Response

Overall, in response to a draft of the audit report, Commission management officials agreed with 21 of the report's 26 recommendations, some of which were addressed to more than one office. Specifically, TM concurred with 20 of 23 recommendations addressed to that office, OCIE concurred with the three recommendations addressed to that office, and Corporation Finance concurred with one of the three recommendations addressed to that office.

Chairman Cox also submitted a separate response to the audit report. Chairman Cox lauded the report, stating that it "provides an invaluable and fresh perspective for the agency to carefully review and consider."

On September 26, 2008, a day after OIG issued its final two reports on the SEC's Oversight of Bear Stearns' and Related Entities, Chairman Cox announced that TM would end the CSE program. In Chairman Cox's announcement, he noted that the OIG had released the CSE audit report and indicated that the report validated and echoed the concerns he had expressed to Congress about the CSE program.

SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program (Report No. 446-B)

The OIG initiated this audit in conjunction with the audit of the Commission's CSE Program, Report No. 446-A (discussed above), as a result of a Congressional request received on April 2, 2008, from Charles E. Grassley, the Ranking Member of the United States Senate Committee on Finance. We conducted our fieldwork between April 2008 and August 2008, in accordance with generally accepted government auditing standards.

Background

In 1990, Drexel Burnham (Drexel), the holding company of a formerly prominent broker-dealer, experienced financial difficulties. In a period of about three weeks, and without the knowledge of the Commission, approximately $220 million of capital was transferred from the broker-dealer to the holding company, in the form of short-term loans. By the time the Commission learned about the transaction, Drexel or its associated entities had amassed a significant amount of short-term liabilities that were due to mature within a month and could not meet their obligations. As a result, Drexel's broker-dealer filed for bankruptcy and was subsequently liquidated.

Section 17(h) of the Securities and Exchange Act of 1934 was amended in 1990, and temporary rules 17h-1T and 17h-2T became effective in September 1992, following and in response to Drexel's collapse. These rules require broker-dealers that are part of a holding company structure with at least $20 million in capital, to file with the Commission disaggregated, nonpublic information on the broker-dealer, the holding company, and other entities within the holding company system, and to maintain and preserve records and other information concerning entities related to the broker-dealer. Currently, 146 broker-dealers file a Risk Assessment Report for Brokers and Dealers (Form 17-H or 17(h) documents) with the Commission under the Broker-Dealer Risk Assessment Program.

The purpose of the Broker-Dealer Risk Assessment Program is for staff in TM to assess the risk to registered broker-dealers that may stem from affiliated entities, including holding companies, and to keep apprised of significant events that could adversely affect broker-dealers, customers and the financial markets.

Objectives

The audit's objectives were to follow up on the current status of recommendations that the OIG made in a prior audit of this program and to examine the Broker-Dealer Risk Assessment process to determine whether improvements were needed.

Prior OIG Audit Report

The prior 2002 OIG report on the Broker-Dealer Risk Assessment Program contained 14 recommendations designed to improve the program. TM had addressed several of the report's recommendations. However, one of the most significant recommendations in the prior OIG report stated that the Commission should update and finalize temporary rules 17h-1T and 17h-2T. As of the date of the current audit, six years later, the temporary rules still had not been updated. The result was that several aspects of these rules were not effective, mainly because they did not require the firms to file certain pertinent information with the Commission.

The prior OIG report also recommended that TM explore the feasibility of having firms electronically file 17(h) documents. In 2005, TM, in consultation with the Office of Information Technology, launched the Broker-Dealer Risk Assessment system, which enables firms to file Form 17-H electronically. As of September 2008, however, three years later, only 20 of the 146 firms filing 17(h) documents were filing electronically.

Audit Findings

The OIG found that TM was not fulfilling its obligations in accordance with the underlying purpose of the Broker-Dealer Risk Assessment Program in several respects. First, TM had not updated and finalized the rules governing the Program, which would ensure that broker-dealers file pertinent information with the Commission in a timely manner. Second, TM had not enforced the temporary rules' document retention and filing requirements that are incumbent upon broker-dealers. As a result, nearly one-third of the firms failed to file 17(h) documents as required by the rules. Third, even after the collapse of Bear Stearns in March 2008, two related broker-dealers still existed, one of which carried a significant number of customer accounts. However, the audit found that TM had not determined whether these broker-dealers were obligated to file Form 17-H. Fourth, although TM tracked the filing status of 146 broker-dealers that filed quarterly and annual reports with the Commission, TM only conducted an in-depth review of the filings for six of the 146 firms that they determined were the most significant. TM generally did not review the filings for the remaining 140 firms, but the firms were still required to file with TM under the Broker-Dealer Risk Assessment Program. Fifth, TM did not timely process and review the filings from the six firms on which the staff focused their review. Sixth and finally, TM did not maintain documentation to identify all the broker-dealers that were exempt from the filing process.

Overall, the audit found that TM's failure to carry out the purpose and goals of the Broker-Dealer Risk Assessment Program hindered the Commission's ability to foresee or respond to weaknesses in the financial markets. Moreover, this failure may have had an impact on TM's ability to protect firms' customers from financial or other problems experienced by broker-dealers.

Recommendations

The report included 10 recommendations, including the reassertion of an OIG recommendation made in 2002, that TM should update and finalize temporary rules 17h-1T and 17h-2T, which govern the Broker-Dealer Risk Assessment Program and enforce broker-dealer compliance with these rules. In addition, the report recommended that TM determine whether the broker-dealers associated with Bear Stearns were required to file Form 17-H with the Commission, in light of the significant amount of customer accounts carried by these broker-dealers. We also recommended that TM process all 17(h) filings in a timely manner, ensure that firms required to file Form 17-H actually file the form, and maintain documentation to identify all of the broker-dealers that are exempt from filing Form 17-H. We further recommended that TM aggressively encourage firms to file electronically with the Commission, and resolve the technical problems we identified with the Broker-Dealer Risk Assessment filing system.

TM concurred with eight of the report's nine recommendations directed to that office, and the Office of Information Technology concurred with the one recommendation directed to that office.

Internal Control Review of the Government Purchase Card Program (Report No. 440)

The OIG contracted the services of Kearney & Company (Kearney) to conduct an audit of the Commission's Office of Administrative Services' (OAS) Government Purchase Card (GPC) program as a follow-up to a previous OIG report, Purchase Cards, issued on November 25, 2002. Kearney conducted the audit between October 2007 and September 2008, on behalf of the OIG, in accordance with generally accepted government auditing standards.

The SEC has 96 employees located at its Headquarters and Regional Offices who are approved GPC holders and make credit card purchases on behalf of the agency. The GPC holders primarily make small purchases for goods and services up to $3,000. Cardholders are responsible for the GPCs and are directed to use them as prescribed in SEC Regulation (SECR) 10-6, Smartpay Purchasing Card Program. All cardholders receive a Letter of Delegation of Authority sanctioning their GPC authority and spending limits, as approved by the Associate Executive Director of OAS.

OAS appoints an Agency Program Coordinator (APC) to oversee the GPC program and an approving official to ensure the GPC program is administered in compliance with governing GPC regulations. The APC serves as the liaison to the vendor for the program, conducts high-level reviews of purchases and follows up on disputed charges and billing errors. Approving officials complete a detailed review of transactions prior to approving the cardholders' statements for payment.

The overall objective of the audit was to assess the design and operation of the GPC program's internal controls. Effective internal controls over the GPC program are necessary to ensure that fraudulent, improper and abusive purchases do not occur and, if such purchases do occur, the transactions are promptly detected and appropriate corrective action is taken.

The audit report found that internal controls over the GPC program were generally adequately designed, but the controls were not always operating effectively. Specifically, the audit found that the Commission was not in compliance with current documented policies and procedures, yet had not revised these policies and procedures. As a result, SEC divisions and offices had adopted unapproved and unofficial practices.

In addition, the audit found that cardholders did always not obtain required approvals or retain required documentation for GPC transactions. The contractor's testing of GPC transactions identified missing transaction approvals, lack of required competitive bids, and missing supporting documentation. Approximately 20 percent of the tested transactions did not provide support for the receipt of goods or services.

Further, the contractor identified two expenditures that were split to circumvent the approval threshold. The audit also identified deficiencies in the training and certification of users prior to the issuance of GPCs, as well as inadequate control over spending limits and untimely cancellation of GPCs. Combined, these deficiencies increased the risk of waste and misappropriation through inadequate training and monitoring of purchasing practices. Additionally, the audit identified certain instances where the implementation of additional controls was needed. For example, the OAS should establish a process to ensure completion of GPC training and receipt of a signed Letter of Delegation before a GPC is issued.

Although no occurrences of fraudulent purchases were found, the audit concluded that the current internal control environment created an increased risk of waste, fraud, and abuse in the GPC program.

The OIG issued a final audit report on September 18, 2008, providing the results of the contractor's testing and analysis. The report contained 17 recommendations that are necessary to improve the Commission's internal controls over the GPC program. The recommendations included: (a) revising SECR 10-6, Smartpay Purchasing Card Program, to reflect relevant procedures that program officials and cardholders should follow; (b) requiring cardholders to use a purchase card log each month to verify purchases; (c) periodically issuing a reminder to cardholders of various critical requirements; (d) issuing guidance to cardholders describing what constitutes a split purchase, warning of the prohibition against splitting purchases and specifying the penalty for making a split purchase; (e) requiring the APC to consult with the Office of Financial Management (OFM) to verify that open obligations at the end of a fiscal year are rolled into the next fiscal year; (f) requiring the APC and OFM to work together to identify underlying root causes of late payments; (g) developing a formal GPC training course and setting up a plan to roll out the training to all cardholders

in a timely manner; and (h) establishing procedures to ensure completion of GPC training and receipt of a signed Letter of Delegation before the GPC is issued to the cardholder.

Management concurred with all 17 recommendations and already began to implement many of the OIG's recommendations.

Audit of Premium Travel (Report No. 447)

The OIG conducted an audit of OFM's controls over premium travel between May 2008 and August 2008, in accordance with generally accepted government auditing standards. The objectives of the audit were to determine whether OFM had established effective management controls over premium travel and to determine whether Commission employees complied with the Federal Travel Regulation (FTR) and other applicable laws, rules, regulations, and policies regarding the approval, justification, and documentation of premium travel.

A primary purpose of the FTR is to interpret statutory and Executive Branch policy requirements to ensure that official travel is conducted responsibly while minimizing administrative costs. Consistent with this purpose, the FTR provides that, with limited exceptions, travelers must use coach class accommodations for both domestic and international travel. Premium class air travel (first or business class) may be used only when the traveler's agency specifically authorizes the use of such accommodations and only under specific circumstances. Likewise, the FTR requires that lodging, meals and incidentals (actual expenses) in excess of the prescribed per diem rate for a specified location be approved in advance of travel and under specific circumstances.

Under Commission policy, OFM permits first and business class travel only due to a qualifying medical necessity or in other narrow circumstances expressly provided for by the FTR. OFM does not approve travel upgrades to business class based on the necessity to review confidential documents or to perform agency work.

The Commission spent approximately $5.8 million on travel in Fiscal Year 2007 (FY 07) and $4.2 million in Fiscal Year 2008 (FY 08), as of April 30, 2008. OFM approved 42 and 14 business class air upgrades in FY 07 and FY 08, respectively. OFM reported no first class travel for these periods. OFM also approved approximately 1,095 and 564 lodging upgrades for FY 07 and FY 08, respectively.

The OIG issued its final audit report on September 29, 2008. The audit found that although the Commission had established some management controls over travel upgrades for airfare and actual expenses, significant improvements were needed to strengthen travel guidance and to track and review premium travel data.

Specifically, the audit report found that OFM's current guidance pertaining to travel upgrades was outdated and required strengthening. As a result, there is increased risk that Commission employees may not follow proper procedures for authorizing, justifying and documenting premium travel. In addition, the report found that OFM

should update its travel website to ensure that all pertinent memoranda and policy updates pertaining to premium travel are available electronically to Commission employees. This will help ensure that employees, especially new hires, can easily access applicable travel requirements, including those for premium travel, from one central location.

The audit also found that OFM does not routinely track summary data related to business class air travel and lodging, meals and incidental upgrades. Without knowing how much is spent on premium class travel, the Commission cannot effectively manage its travel budget to prudently safeguard taxpayer dollars.

Additionally, the audit found that OFM's existing management controls were generally functioning as intended and, for the most part, travel upgrades were processed in accordance with the FTR and Commission policy. Some travel practices, however, resulted in increased costs to the Commission and gave the appearance of impropriety. These practices included travel upgrade requests and travel vouchers that were self-approved, or approved by a subordinate. In addition, the audit questioned $5,604 in additional costs the Commission incurred where, in three instances, travelers departed from a location other than their official duty station, although their vouchers and supporting documentation did not show why the change in routing of their travel was "officially necessary," as was required.

To improve and strengthen internal controls over premium travel, the audit report made six recommendations. The report recommended that the Commission (1) enhance existing policies and procedures pertaining to travel upgrades, (2) update its current travel website, (3) implement procedures to obtain summary data on travel upgrades for purposes of internal monitoring, (4) prohibit subordinates from approving their supervisor's travel and require Office Heads, Division Directors, and other senior management officials to obtain travel-related approval from a peer or higher level official, (5) prohibit travel from a telework location if it results in increased cost to the Commission, and (6) enforce the Office of Management and Budget's requirement to restrict premium class travel for temporary duty when the employee is not obligated to report to duty the following day, and include this requirement in its travel policies and procedures.

Commission management generally concurred with all six OIG recommendations and indicated that it would take action to implement these recommendations.

Survey of Enforcement's Hub System (Report No. 449)

The OIG conducted a survey of the Division of Enforcement's (Enforcement) Hub system during the period May 2008 through August 2008, in accordance with the standards for non-audit services.

The Hub system is Enforcement's newly-implemented case management tracking system, through which staff plan, track and close investigations. This system was launched in October 2007, after an August 2007 report issued by the Government Accountability Office (GAO) highlighted major issues with Enforcement's case management and tracking system and made several recommendations for improvement.

The OIG survey followed up on the GAO report's recommendation pertaining to the Hub system regarding implementing written procedures that reinforce the importance of

attorneys entering investigative data into the Hub, providing guidance on how to do so in a timely and consistent way, and establishing a control process by which other division officials can independently assess the reliability of investigative data maintained in the system.

The OIG sent a web-based questionnaire to 1,261 authorized Enforcement users to obtain feedback regarding Enforcement's written Hub policies, the use of the Hub by Enforcement personnel, the adequacy of user training and the system's capabilities.

The survey received a 46 percent (577 of 1,261) response rate, as well as a significant number of written comments. Sixty-two percent of the respondents to the survey were attorneys, branch chiefs and accountants, which is significant given that Enforcement management requires attorneys, rather than support staff, to populate case data.

Overall, the survey results revealed that most Hub users were satisfied with the system and felt its features were an improvement over the previous system in place, the Case Activity Tracking System or CATS. However, even though a large number of respondents indicated that they were pleased with the Hub system, the survey determined that before the Hub can become a fully robust management tool within Enforcement, some improvements are needed.

The survey responses revealed that while approximately 62 percent of the respondents personally used the Hub system, only 47 percent indicated that they actually entered data into the system, and 23 percent of these respondents indicated that they used it occasionally. Similarly, the survey results found that just 41 percent of respondents used the Hub system to obtain information, and 25 percent of users did so only occasionally.

The survey further found that 51 percent of respondents stated that they either used a Hub system user manual or were aware such a manual was available. However, when asked whether they found the Hub user manual to be helpful, only 15 percent of respondents agreed or strongly agreed the manual was useful, and 17 percent disagreed or strongly disagreed that it was useful.

Finally, the survey found that although Enforcement developed a user manual, held training presentation sessions on the use of the Hub, and issued a Division newsletter to communicate the Hub's progress and expectations to the users, Enforcement had not developed or issued formal written guidance, such as standard operating policies and procedures, regarding the Hub, as was recommended in the GAO report. We determined that formal written policies and procedures may help ensure that Hub system users better understand how to utilize the system properly to achieve its goals.

The OIG issued its final report on September 29, 2008, and provided the results of its survey, as well as five recommended actions. The report recommended that Enforcement (1) develop written policies for entering information into the Hub system, (2) perform an assessment of the authorized users to ensure that the proper personnel are utilizing the system fully and appropriately, (3) incorporate many of the comments to the Hub survey relating to the revising of the reports feature of the system to allow for customized reports that may be exportable to

spreadsheets, (4) ensure that the Hub system users become aware of the features and advantages of the system, and (5) review the survey comments to obtain possible areas for enhancement of the Hub system.

Enforcement's management agreed with three of our five recommended actions, and partially concurred with one recommended action regarding developing formal written policies and another recommended action suggesting the assessment of authorized users to ensure that the proper personnel are utilizing the system fully and appropriately. The OIG hopes that Enforcement will reconsider and fully implement all the report's recommended actions.

2008 FISMA Executive Summary Report (Report No. 451)

In June 2008, the OIG contracted with Electronic Consulting Services, Inc. (ECS) to complete and coordinate the OIG's input to the Commission's response to the Office of Management and Budget's (OMB) Memorandum M-08-21. Memorandum M-08-21 provides instructions and templates for meeting the Fiscal Year 2008 reporting requirements that agencies must follow under the Federal Information Security Management Act of 2002 (FISMA), Title III, Pub. L. No. 107-347.

FISMA provides the framework for securing the Federal government's information technology. All agencies must implement the requirements of FISMA and annually report to OMB and Congress on the effectiveness of their Privacy Impact Assessments and information security programs. OMB uses the information to help evaluate agency-specific and government-wide privacy performance, development of its annual security report to Congress, assist in improving and maintaining adequate agency privacy performance, and inform development of the E-Government Scorecard under the President's Management Agenda.

The objectives of the evaluation were to provide background information, clarification, and recommendations regarding the OIG's response and input to Section C of the OMB reporting template. The topic areas for the FISMA reporting template included the following:

- FISMA Systems Inventory;
- Certification and Accreditation, Security Controls Testing, and Contingency Plan Testing;
- Evaluation of Agency Oversight of Contractor Systems and Quality of Agency System Inventory;
- Evaluation of Agency Plan of Action and Milestone (POA&M) Process;
- IG Assessment of the Certification and Accreditation Process;
- IG Assessment of the Agency Privacy Program;
- IG Assessment of the Agency Privacy Impact Assessment Process;
- Configuration Management;
- Incident Reporting;
- Security Awareness Training;
- Collaborative Web Technologies and Peer to Peer File Sharing; and
- E-Authentication Risk Assessments.

The Commission operates 49 various computer systems, 44 of which have undergone evaluations and have moderate system impact levels. The five remaining

system impact levels were evaluated and rated as low.

We issued ECS's comprehensive report to management on September 29, 2008. Senior Commission officials informed the OIG that they had determined that the majority of the information contained in the report was confidential and nonpublic, and could therefore not be released to the public under Commission regulations. As a result, the OIG issued both public and nonpublic versions of ECS's report. The redacted, executive summary version of the report was placed on the OIG's website, while the unredacted nonpublic version was issued internally to Commission management.

In its report, ECS found that the Commission performed oversight and evaluations of information systems used or operated by agency contractors and other organizations on behalf of the Commission in order to ensure that applicable FISMA requirements were met. ECS also found that the Commission's Privacy Office had made significant progress in its development of privacy resources and in benchmarking externally with other agencies.

The report made a total of three recommendations that required the Office of Information Technology (OIT) to complete the security controls and contingency plan testing for certain systems, to address certain requirements and make identified improvements, and to use the report, along with the completed OIG reporting template, to develop the Commission's annual consolidated FISMA Report.

OIT management concurred with the second and third recommendations, but disagreed with the first recommendation on the basis that it had provided documentation to the GAO concerning this recommendation. Although OIT agreed to the second recommendation, it suggested that responsibility for implementing part of this recommendation should be assigned to OAS's Office of Acquisitions. OIT indicated that it will take action on the remaining portion of the second recommendation, as well as the third recommendation, within the upcoming year.

Inspection of Corporation Finance Referrals (Report No. 433)

The OIG initiated an inspection of referrals from the Division of Corporation Finance (Corporation Finance) to the Division of Enforcement (Enforcement). The inspection, conducted between July 2007 and August 2008, was performed in accordance with the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency Quality Standards for Inspections. In September 2007, due to unforeseen changes in the OIG's work priorities, the former Deputy and Acting Inspector General suspended work on the inspection. In February 2008, the OIG resumed work on the inspection and concluded the previously conducted inspection work.

Corporation Finance refers potential securities law violations to Enforcement for investigation. Corporation Finance categorizes these referrals as involving either delinquent or non-delinquent filers. Delinquent filer referrals pertain to individuals or entities that are not current in their Commission filing obligations. In contrast, non-delinquent filer referrals include all other types of potential securities law violations, such as accounting misstatements and the inadequacy of issuer disclosures.

When Corporation Finance staff review registrant filings, they may identify potential securities law violations. When they do so, the staff prepare a referral memorandum for Corporation Finance's Office of Enforcement Liaison (OEL) that describes the potential securities law violation. The OEL reviews the referral memorandum and then forwards it to either the Enforcement Office of the Chief Accountant (OCA) or Enforcement staff who are actively working on matters involving the same registrant. If OCA receives the referral, it reviews the referral and in conjunction with a senior officer in Enforcement, makes an initial determination of whether Enforcement staff should investigate the referral. OCA staff forward the referral to Enforcement staff for investigation if they believe the alleged securities law violation warrants further investigation. This process determines the merits of a referral based on a variety of factors, such as the age and nature of the alleged securities law violation and the degree of potential harm to investors.

The OIG's inspection found that OEL and OCA use separate Access databases to track non-delinquent filer referrals that store similar referral information. In addition, OCA does not always receive a copy of the referral when OEL sends a referral directly to Enforcement staff. The inspection also found that OCA does not consistently record the outcome of referrals in the database. This type of information would be beneficial as it could improve the quality of future referrals by identifying shortcomings in previous referrals. Additionally, the inspection determined that OEL could enhance its current gatekeeper role and improve the quality of referrals if it is provided with additional information on the outcome of referrals.

We issued a memorandum report on September 30, 2008, which identified three recommendations that Enforcement and Corporation Finance should implement to improve the referral process. First, we recommended that the referral process could be improved by centralizing the OEL and OCA database tracking systems. Second, we recommended that Enforcement record information about the outcome of non-delinquent filer referrals in its database. Lastly, we recommended that Corporation Finance enhance the OEL's gatekeeper role once outcome information becomes more available.

Commission management agreed with all of the report's recommendations and indicated that they will explore options to implement the recommendations.

Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

INVESTIGATIONS

OVERVIEW

The OIG's Office of Investigations responds to allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. The misconduct investigated ranges from criminal wrongdoing and fraud to violations of Commission rules and policies and the Government-wide ethical standards of conduct. The Office of Investigations conducts thorough and independent investigations into allegations received in accordance with the Quality Standards for Investigations of the President's Council on Integrity and Efficiency and the Executive Council on Integrity and Efficiency. In instances where it is determined that something less than a full investigation is appropriate, the Office of Investigations conducts a preliminary inquiry into the allegation. If the information obtained during the inquiry indicates that a full investigation is warranted, the Office of Investigations will commence an investigation of the allegation.

Upon the opening of an investigation, the primary OIG investigator assigned to the case prepares a comprehensive plan of investigation that describes the focus and scope of the investigation, as well as the specific investigative steps to be performed during the investigation. In all investigations, the OIG investigator interviews the complainant first whenever feasible and conducts significant interviews under oath and on the record. Where there is any reason to believe a witness will not provide truthful testimony, the OIG investigator provides an appropriate perjury warning. In addition, the OIG investigator gives assurances of confidentiality to potential witnesses who have expressed reluctance to come forward.

Where allegations of criminal conduct are involved, the Office of Investigations notifies and works with the Department of Justice and the Federal Bureau of Investigation as appropriate. The OIG has entered into a memorandum of understanding with the Commission's Office of Information Technology to provide necessary assistance for OIG investigations, including the prompt retrieval of employee e-mail accounts as requested by the OIG investigators. The OIG investigative staff meet with the Inspector

General frequently (approximately monthly) to review the progress of ongoing investigations. The Inspector General and the OIG investigative staff also meet periodically with the Commission's Ethics Counsel to coordinate activities.

Upon completion of an investigation, the OIG investigator prepares a comprehensive report of investigation that sets forth in detail the evidence obtained during the investigation. Investigative matters are referred to the Department of Justice and Commission management as appropriate. In the investigative reports provided to Commission management, the OIG makes specific findings and recommendations, including whether the OIG believes disciplinary or other action should be taken. The OIG requests that management report back on the disciplinary action taken in response to an OIG investigative report within 45 days of the issuance of the report. The OIG follows up with management prior to and at the 45-day mark to determine the status of disciplinary action taken in the matter.

INVESTIGATIONS AND INQUIRIES CONDUCTED

Re-Investigation of Claims by Former Enforcement Employee of Improper Preferential Treatment and Retaliatory Termination

The OIG concluded its re-investigation of allegations made by a former Commission attorney that managers gave favorable treatment to a prominent individual by not taking his testimony in an insider trading investigation and then fired the attorney in retaliation for complaining about the favorable treatment.

This matter initially began in October 2005, when the OIG opened an investigation after receiving a letter, dated September, 2, 2005, from the terminated employee addressed to Chairman Christopher Cox. In that letter, the employee claimed, among other things, that his supervisors in the Division of Enforcement (Enforcement) gave improper preferential treatment to the Chairman and Chief Executive Officer (CEO) of an investment bank, whom the former employee was pursuing as a potential tipper in an insider trading investigation involving a hedge fund. On November 29, 2005, the OIG closed the initial investigation into the former employee's claims, finding that the evidence gathered did not show that the prominent individual was given preferential treatment.

In or about April 2006, under the leadership of U.S. Senators Charles Grassley and Arlen Specter, the staff of the Senate Committees on Finance and the Judiciary (Senate Committees) commenced an investigation into allegations made by the former employee. The Senate Committees held three hearings related to these matters. On June 28, 2006, the Judiciary Committee held a hearing examining short selling activities of hedge funds and independent analysts. On September 26, 2006, the Judiciary Committee held a second hearing examining enforcement of insider trading prohibitions and insider trading by hedge funds, especially trading ahead of mergers. On December 5, 2006, the Judiciary Committee held a third hearing focusing on the allegations made by the SEC former employee.

In August 2007, the Senate Committees issued a final report concluding their investigation and finding, among other things,

that the former employee said his supervisor warned him it would be difficult to obtain approval for a subpoena of the prominent individual due to his "very powerful political connections." The report also found that the Commission fired the former employee after he reported his supervisor's comments about this prominent individual, despite the fact the employee had received positive performance reviews and a merit pay raise.

On July 6, 2006, the OIG re-opened its investigation after a request was made by Chairman Cox and, in January 2008, the newly-appointed Inspector General H. David Kotz personally took over the re-investigation of the former employee's allegations. The re-investigation focused on the following issues: (a) whether the SEC gave improper preferential treatment and blocked the former employee's efforts to take an individual's testimony because of his political connections and/or prominence; (b) whether senior SEC Enforcement officials improperly provided representatives of an investment bank nonpublic information about the insider trading investigation, and specifically the Enforcement Division's intentions with respect to the prominent individual; (c) if, after the former employee was terminated, the SEC Enforcement Division took insufficient actions to investigate the case and improperly closed the investigation because of the individual's political connections and/or prominence; and (d) whether the SEC Enforcement Division improperly terminated the employee in retaliation for his complaints about preferential treatment and to block his efforts to take the prominent individual's testimony.

During the re-investigation, the IG personally took on-the-record, under oath testimony of the complainant on five occasions and reviewed thousands of pages of material written by the former employee in complaints filed with administrative agencies and communications with Congressional officials. IG Kotz also reviewed the record of the Hearing before the Committee of the Judiciary, United States Senate, 109th Congress, Second Session, December 5, 2006, Serial No. J-109-121, *Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity*, which included witness testimony, formal answers to questions submitted by Senators Grassley and Specter, and numerous written submissions. Additionally, IG Kotz reviewed the testimony of the Hearing before the Committee of the Judiciary, United States Senate, 109th Congress, Second Session, June 28, 2006, *Hedge Funds and Independent Analysts, How Independent are Their Relationships*, which included testimony from the former employee.

IG Kotz also reviewed the transcripts of testimonial interviews of 14 witnesses taken by the staff of the Senate Judiciary and Finance Committees. In addition, the IG reviewed and analyzed memoranda of OIG interviews of 28 persons with potential knowledge of the claims asserted by the former employee and on-the-record, under oath testimony of six individuals. IG Kotz personally took testimony on-the-record, under oath of 20 witnesses after he assumed responsibility for the re-investigation. In all, IG Kotz reviewed over 70 transcripts of testimony or memoranda of interviews of over 50 separate individuals with knowledge of issues relating to the former employee's allegations.

In addition to the above efforts, the OIG conducted numerous searches for documents, including searches for the former employee's e-mails for his entire tenure at the Commission and pertinent e-mails of several other SEC employees. In addition, the OIG obtained and reviewed various documents

pertaining to the underlying insider trading investigation.

In September 2008, the IG concluded the re-investigation, and prepared a nearly 200-page report of investigation with a five-volume appendix of 226 exhibits. Overall, the report concluded that Enforcement managers, particularly the former employee's first-level and second-level supervisors, failed in numerous respects in how they managed the former employee, allowed inappropriate reasons to factor into the decision to terminate him, and conducted themselves in a manner that raised serious questions about the impartiality and fairness of the insider trading investigation.

Specifically, the OIG investigation found that although the former employee's supervisors testified that they had significant concerns about his performance and conduct throughout his tenure with the Commission, they failed to provide him with timely feedback of these concerns, denying him any ability to improve his performance or change his behavior. In fact, the record demonstrates that the former employee was not given any significant negative feedback until after he advocated taking the testimony of a prominent individual in the financial industry.

The OIG investigation also found evidence that in conversations with the former employee about the taking of the prominent individual's testimony, his direct supervisor used the term "political clout" and referred to the prominent individual's counsel as having "juice," thus conveying the impression that political clout factored into the decision to deny the former employee the ability to take the testimony. In addition, the record showed that the approach adopted by the supervisors in connection with the insider trading investigation, and specifically the decision concerning the taking of the prominent individual's testimony, was different from the approach commonly utilized in other Enforcement investigations.

In testimony, the supervisor explained that the "juice" he was referring to related to the ability of counsel for the prominent individual to reach out to senior Enforcement officials. The OIG's report found that even if one accepted this explanation, however, this "juice" did, in fact, materialize, as senior Enforcement officials were contacted by representatives of the investment bank about the investigation as it pertained to this prominent individual, who was under serious consideration for the position of the bank's new CEO.

The investigation further found that shortly after the contacts were made on behalf of the investment bank, senior Enforcement officials imparted to representatives of the investment bank relevant information regarding the extent of the evidence Enforcement had against the prominent individual in connection with the insider trading investigation. The Commission's Conduct Regulation prohibits Commission officials and employees from divulging confidential and nonpublic information in circumstances where the Commission has determined to accord such information confidential treatment. See 17 C.F.R § 200.735-3(b)(7)(i). Information obtained by the Commission in the course of any investigation, unless made a matter of public record, is specifically deemed to be nonpublic. 17 C.F.R. § 203.2. According to Commission policy, the prohibition against use of nonpublic information without specific authorization or approval by the Commission does not apply to the use of such materials as necessary or appropriate by members of the staff in pursuing SEC investigations, or in the

discharge of other official responsibilities. SECR 19-1.

Although Commission regulations do not define specifically in what circumstances nonpublic information may be disclosed in the discharge of official duties, and the senior Enforcement official primarily responsible for the disclosure of the information may have legitimately believed her actions were necessary to discharge her responsibilities, the OIG investigation found there are serious questions about the appropriateness of the information conveyed to the investment bank. First, the investigation disclosed that there is clearly a disconnect within Enforcement about the procedures for the release of nonpublic information. Second, the fact that senior Enforcement officials provided the information without first conferring with the attorney who had primary responsibility for the investigation is problematic, and created an appearance that they were providing preferential treatment. Third, learning the extent of the information the Commission had against a potential target (i.e., that there was no "smoking gun" evidence in the hands of Enforcement) could prove very useful to outside counsel in preparing a defense. Fourth, the information was provided specifically because the prominent individual was being considered for a high-level position in a large investment bank, and would not be available to another potential target of lesser means or reputation.

The investigation also called into serious question the appropriateness of the current common practice in Enforcement that affords outside counsel the opportunity to communicate with officials above the line attorney level on behalf of their clients when they have issues or disagreements with the Enforcement lawyers with whom they have been dealing.

On the other hand, the OIG investigation did find that the explanation provided by the former employee's supervisors as to why they felt it was appropriate to postpone taking the prominent individual's testimony until a later point in the investigation was a plausible one. In addition, while several other individuals who worked with the former employee on the insider trading investigation concurred with his request to take the testimony in July or August of 2005, they also generally indicated that it was not necessarily improper to wait to obtain additional information before bringing in this individual for testimony. Accordingly, the OIG investigation did not find sufficient evidence to establish that the prominent individual was given improper preferential treatment regarding the taking of his testimony. Moreover, the investigation did not find that Enforcement cases are generally affected by political decisions or the prominence of the individuals under investigation.

The investigation also found that although Enforcement seems to have "gone through the motions" in ultimately taking the prominent individual's testimony, the evidence did not show the insider trading investigation was abandoned. To the contrary, while there was a shift by Enforcement away from one aspect of the investigation based upon the belief that other aspects were more promising, there is substantial evidence that the insider trading investigation continued to be aggressively pursued until it was closed in November 2006.

With respect to the former employee's termination, the OIG investigation found that there was a connection between the decision to terminate the former employee and his seeking to take the prominent individual's testimony. The record demonstrated that after the communications with the investment bank, and during the time a two-step merit

increase that had been recommended for the former employee was being processed, the former employee's supervisors prepared a supplemental evaluation that criticized him for being "resistant to supervision" and referenced complaints about him from opposing counsel. The supplemental evaluation also noted that the employee "expresses resentment at what he inaccurately perceives as attempts by his supervisors to thwart his success." The supplemental evaluation was not placed in the employee's personnel file, and the evidence suggested that the substance of the supplemental evaluation may never have been conveyed to him.

Further, several other Enforcement attorneys, some of whom had worked in the Enforcement Division for many years, testified that they had never seen or even heard of a supplemental evaluation. In addition, the timing of the supplemental evaluation evidences that complaints made about the former employee's second-level supervisor's management style also played a role in the decision to issue this unprecedented document.

The evidence also showed that within a short time period after the supplemental evaluation was prepared and while the former employee was continuing to seek approval to take the prominent individual's testimony, Enforcement management decided to terminate the former employee. In their testimony, all of the former employee's supervisors referenced his inability to work well with others as the basis for his termination and, in fact, there was substantial evidence of his conflicts with co-workers, supervisors and opposing counsel.

Nonetheless, the record also showed that the former employee's supervisors were discussing the issue of taking the prominent individual's testimony around the same time period, and perhaps even in the same meeting, in which they made the decision to terminate him. In fact, the e-mail that proposed the former employee's termination directly followed an e-mail from him in which he provided a justification for taking the prominent individual's testimony. In addition, the former employee's third-level supervisor acknowledged that the fact that the employee simply would not listen with respect to the prominent individual must have played some part in his supervisors' assessment of his conduct. For these reasons, the investigation found that it was simply not credible to find that the decision to terminate the former employee was totally unrelated to his efforts to take the prominent individual's testimony.

Furthermore, although there was evidence that Enforcement had a legitimate basis for terminating the former employee in his probationary period, the evidence also showed that few employees in Enforcement have historically been terminated, even in their probationary periods, and Enforcement management has tolerated much worse conduct on the part of other Enforcement lawyers.

During the course of the OIG re-investigation, numerous former and current subordinates of the former employee's second-level supervisor came forward, after requesting and being granted confidentiality, to describe the atmosphere of "abuse" and "unfairness" that pervaded the office under his leadership. They also described their intense fear of retaliation and provided accounts of how it was fruitless to complain about the second-level supervisor to upper-level management because they would not take appropriate action. There were also concerns expressed about the former employee's direct supervisor's management style. This

supervisor was described as a "micro-manager" who "harassed" subordinates, but gave little or no substantive feedback.

Accordingly and in light of all the evidence, the Inspector General recommended that appropriate disciplinary and/or performance-based action be taken against the former employee's first and second-level supervisors, including removal of their supervisory responsibilities, and appropriate disciplinary and/or performance-based action be taken against the senior-level Enforcement official who made the ultimate decision to terminate the former employee. The report also recommended: (a) clarification of the Commission's policies on the disclosure of nonpublic information in the context of Enforcement investigations and relevant training of Enforcement employees, particularly with respect to the appropriateness of disclosing the extent of evidence against a person of interest in an ongoing investigation; and (b) reassessment and clarification to staff of Enforcement's practice that allows outside counsel the opportunity to communicate with managers above the line attorney level on behalf of their clients when they have issues or disagreements with the Enforcement lawyers with whom they have been dealing to ensure Enforcement practices and policies do not result in favorable treatment, or the appearance thereof, for prominent individuals and their counsel.

In the report of re-investigation, which was issued on September 30, 2008, the Inspector General requested that he be informed within 45 days of the actions taken in response to the report's recommendations.

Investigation of Failure to Vigorously Enforce Action in Regional Office

The OIG conducted an investigation at the request of United States Senator Charles Grassley, Ranking Member of the Senate Finance Committee, into the reasons why a Commission investigation of a bank holding company and an investment bank was closed without any action taken by Enforcement.

In conducting the investigation, OIG investigators took sworn, on-the-record testimony of all the individuals from the Regional Office who worked on the Enforcement matter at issue, including current and former staff attorneys, two staff accountants, the Branch Chief, the Regional Trial Counsel, both a current and former Assistant Regional Director, the Associate Regional Director, and the Regional Director. OIG investigators also took sworn, on-the-record testimony of all the individuals in Headquarters who had any substantive involvement in the matter, including Enforcement's Chief Accountant, Chief Counsel and former Deputy Director. In addition, OIG investigators also took the sworn, on-the-record testimony by telephone of counsel for various entities that were the subjects of the Enforcement investigation.

The OIG concluded its investigation in late September 2008, and issued a comprehensive report of investigation that found as follows. Beginning in March 1999, a holding company began purchasing Collateralized Bond Obligations (CBOs) and Collateralized Loan Obligations (CLOs) from an investment bank through a registered representative in the investment bank's Latin American group. For eleven months in 2002, this registered representative violated the investment bank's internal policies and

procedures by calculating his own prices, as the CBOs and CLOs in the holding company's portfolio began to decline in value. When the holding company discovered the improper valuation, and that the Corporate Debt Obligations (CDOs) had been impaired, its Chief Financial Officer (CFO) took several steps to reduce the impact of the impairment charge, each of which was not in accordance with Generally Accepted Accounting Principles. Moreover, using flawed information, the holding company's CFO concluded that a smaller than appropriate impairment charge was necessary, and the holding company issued a 2003 first quarter earnings release that was grossly inadequate, giving the false impression that the securities were not impaired.

Even after the SEC's Division of Corporation Finance (Corporation Finance) questioned the holding company about its practices, its CFO continued to use inaccurate prices, resulting in an overstatement of 67 percent of its pre-tax net income. The holding company then filed a Form 10-K and amended Form 10-K that failed to disclose relevant information concerning the impairment of its CDO portfolio. Thereafter, the holding company filed misleading press releases and a registration statement that incorporated the false information. By using the materially false and misleading price information in press releases and filings, the holding company was able to paint a favorable picture of its earnings streams for its shareholders and prevent its stock price from falling.

In May 2003, Corporation Finance referred the matter involving the holding company to Enforcement. Corporation Finance had determined that, at a minimum, the holding company had used an inaccurate method of fair value to reflect its inventory, contrary to accounting principles.

Due to a backlog in Enforcement's Office of Chief Accountant, the referral stalled for seven months. In January 2004, the Assistant Chief Accountant in Enforcement authored a Referral Disposition Memorandum, recommending further investigation to determine whether information contained in the holding company's press release about its earnings and financial condition for the first quarter of 2003 was false and misleading.

In February 2004, the referral was sent to a Regional Office for review and disposition. The Regional Office opened a Matter Under Inquiry into the holding company on February 27, 2004. Between March 11, 2004 and July 28, 2004, the investigative team assigned to the case worked at an intense pace, sending document requests that culled 53,000 documents and, between October 6, 2004 and February 14, 2005, fourteen witnesses gave voluntary testimony in the matter.

On February 15, 2005, the staff requested and was granted a formal order of investigation by the Commission. In requesting the formal order, the staff represented to the Commission that it had "nearly completed" its investigation in connection with the impairment of certain of the holding company's assets, and the role that the investment bank may have played in those violations.

Once the formal order was obtained, between February 22, 2005 and June 6, 2005, the Regional Office staff took the testimony of 11 additional witnesses in the case. Sometime around June 15, 2005, the investigative team met with the Regional Trial Counsel, who, by all accounts, told the investigative team he

believed it was a strong case. His feeling was echoed by the senior staff, who all expressed to the investigative team that it was a high priority case for the office, particularly because it had been referred by Headquarters and because there were allegations of fraud involving the investment bank.

On June 15, 2005, the staff issued notices of intent to bring an Enforcement action to a variety of parties, against whom there was evidence that they provided false price information to the CFO of the holding company, with the knowledge that the holding company was going to provide such information to its auditor as support for the incorrect $2.7 million impairment charge. The staff never issued notices to the CFO and the holding company itself, however, because the staff believed both would be willing to discuss settlement.

In the fall of 2005, the staff met with counsel for the investment bank and began discussing settlement. During that same period of time, staff entered into settlement negotiations with counsel for the CFO and the holding company. The staff then drafted a memorandum that named several individuals, as well as the holding company and its CFO, as proposed defendants. Shortly thereafter, in October or November 2005, the staff reached a settlement in principle with the CFO's attorneys, whereby the CFO would agree to a non-scienter based fraud charge, a $100,000 penalty and a possible officer and director bar. At the same time, the holding company also agreed to settle in principle for an injunction with no civil monetary penalty.

In January 2006, the position of Assistant Regional Director was filled after being vacant for nearly five months. Despite expressing an immediate interest in the case, the new Assistant Regional Director took at least nine months to become familiar with the matter. The staff became frustrated with the inaction and repeatedly inquired about the status of the case.

In September or October of 2006, the new Assistant Regional Director finally completed his very belated review of the case and, in November 2006, at least fourteen months after the initial meetings with defense counsel had occurred, the staff again contacted the investment bank's counsel and advised them that the staff was finally prepared to proceed against the proposed defendants.

Thereafter, in the early months of 2007, the investment bank's counsel convinced the SEC Regional Office to drop all charges against the investment bank's senior managing directors and to reduce the charges against the investment bank itself from a fraud charge to a charge of failure to supervise.

The Regional Office then renewed settlement discussions with counsel for the holding company and its CFO, who had heard nothing from the staff for 15 or 16 months. Although the holding company and CFO had previously agreed to a $100,000 penalty, the staff offered to reduce the proposed penalty to $75,000, and reached agreement with both the holding company, and its CFO. The staff also engaged in successful settlement discussions with counsel for the investment bank, who agreed to a reduced "failure to supervise" charge and a monetary penalty of $500,000. The staff was also making progress obtaining a settlement arrangement with the final proposed defendant, when the Regional Director abruptly decided to close the case entirely.

The Regional Director then contacted counsel for the investment bank, who was a

former SEC Enforcement lawyer with whom the Regional Director had an ongoing personal relationship, and told him, "Christmas is coming early this year," and the investment bank "can keep their money." The registered representative's lawyer, also a former SEC lawyer who had worked with the Regional Director in Enforcement in the mid-to-late 1980s, was likewise informed that no case would be brought against his client. The decision to close the case also meant that the holding company and its CFO were not required to pay a penalty or agree to any charges.

The staff was stunned at the decision to close the case, and the reasons provided to them were incongruous. The staff reported that they were told the case was being dropped due to consideration of "litigation risk," even though settlements had been negotiated with essentially all the parties in the case. When the Regional Director was asked for an explanation, he replied that the case was too old, and there was pressure from Enforcement in Headquarters not to bring old cases. Several of the staff believed the case was dropped because management never truly understood the complexities of the case.

Concurrent with the SEC investigation, a U.S. Attorney's Office was investigating another employee of the same investment bank, who had also allegedly engaged in questionable pricing of CDOs. Although the U.S. Attorney's Office informed the SEC Regional Office about its investigation, and asked to be apprised of the status of the SEC investigation, the SEC Regional Office never submitted an access request for information about the U.S. Attorney Office's investigation, and failed to even notify the Assistant U.S. Attorney (AUSA) about the Regional Office's investigation. The AUSA believed that it was significant that the investment bank's traders out of two different cities were being investigated for the same conduct. Had the SEC Regional Office sought information about the AUSA's investigation, it could have uncovered potential systematic problems at the investment bank in determining the market price and assessing the value of additional CDOs issued and held.

The OIG investigation obtained evidence that the SEC Regional Office's written case closing recommendation cited "significant litigation risks" as one of the bases for the decision to close the investigation. The case closing memorandum also indicated that although the SEC Regional Office concluded that the holding company and the investment bank may have engaged in misconduct and violated the antifraud provisions of the federal securities laws, and that there was evidence of potential fraud, they did not believe there was a sufficiently compelling case to go forward. The OIG investigation also noted that the decision to close the investigation was approved by senior-level officials at Headquarters; however, their review was relatively limited in nature. Enforcement's Chief Counsel stated that she did not think she spoke with the Regional Office Director about closing the case, but simply reviewed the case closing recommendation. Enforcement's former Deputy Director stated that he recalled being informed by the Regional Office Director that there was a consensus to close the case and no one disagreed with the decision to close it.

The OIG investigation concluded that there was a failure on the part of the SEC Regional Office's management to administer its statutory obligations and responsibilities to vigorously enforce compliance with applicable securities laws. Specifically, the OIG found that the investigation was plagued by numerous unconscionable delays that

adversely affected the staff's ability to conduct the investigation. Notwithstanding all the delays in the case, the staff was able to negotiate significant settlements with essentially all the proposed defendants when the Regional Director abruptly decided to drop the case entirely. Moreover, a significant opportunity to coordinate with the U.S. Attorney's Office and uncover evidence of a systematic problem at the investment bank was also missed through neglect.

The OIG investigation also found that the fact that two of the defense counsels in the matter were former Enforcement attorneys created the appearance, to some, that they may have obtained favorable treatment from SEC Regional Office staff. While the OIG investigation did not find evidence of a direct connection between the relationship between SEC Regional Office officials and the attorneys for the defendants and the decision to close the investigation, even the appearance of a conflict was determined to be disturbing and could potentially damage the reputation of the Commission.

Accordingly, the OIG referred the investigation to the Executive Director, Chief of Staff and Chairman for disciplinary and/or performance-based action against the Regional Officer Director. The OIG issued its report on September 30, 2008, and requested that it be advised of the action taken in response to the report's recommendation within 45 days.

Investigation of Conflict of Interest, Improper Solicitation and Receipt of Gifts from a Prohibited Source, and Misuse of Official Position

The OIG investigated an allegation that a staff member in a supervisory position attended a pre-proposal conference conducted by a state office on behalf of a Commission contractor whose work the staff member oversaw. It was further alleged that the employee attended the pre-proposal conference with the president and owner of the contracting firm, that the two individuals had developed a close personal relationship over the years and that the employee had expressed a preference for working with this particular contractor.

During the investigation, the OIG issued subpoenas *duces tecum* to the president and owner of the contracting firm and the firm itself, and reviewed materials produced in response to the subpoenas. OIG investigators obtained numerous months of the staff member's e-mails and obtained and reviewed relevant records, including the sign-in sheet for the pre-proposal conference. The OIG also took the sworn, on-the-record testimony of the company president and several other witness, although the employee who was the subject of the investigation declined to testify invoking the Fifth Amendment privilege against self-incrimination.

The OIG issued a comprehensive report of investigation to management on June 5, 2008, describing the findings of its investigation. Overall, the investigation revealed that the subject employee, while exercising official responsibility over an SEC contract, developed a personal friendship with the president and owner of the contracting firm and acted in an impartial and improper manner in violation of numerous provisions of the Standards of Ethical Conduct for Employees of the Executive Branch (Standards of Conduct). Specifically, the OIG found that the employee misused official time to attend a state agency pre-proposal conference with the president and owner of the company, at which she listed herself as an attendee for the company and used her married name to disguise her actions.

The investigation also uncovered evidence that the employee solicited and accepted a favor from the company president and owner in the form of employment for her son, during a time when she was the Contracting Officer Technical Representative (COTR) on the contract for which this company was a subcontractor. In addition, while the employee was acting as the COTR for the company's direct contract with the SEC, the company president and owner a second time attempted to secure employment for the employee's son. The evidence further showed that during the period of time in which these favors were solicited and accepted, the employee ensured that all SEC tasks went to this company, which had the SEC as its only client.

In addition, the OIG investigation uncovered evidence that an SEC senior manager, at the employee's request, used his official title to assist the employee in purchasing a cooperative apartment for her son's personal use, while falsely stating in a letter that the apartment was for the employee's use in connection with her official duties. The manager admitted under oath that he knew the employee needed him to sign the letter to get a place for her son to live, rather than for use in connection with SEC duties, as he represented in the letter.

The OIG referred the staff member who violated the Standards of Conduct by misusing official time, soliciting and accepting favors, and favoring the contractor with whom she had a personal friendship for disciplinary action, up to and including dismissal. No disciplinary action had been proposed or taken against the staff member as of the end of the semiannual period, despite the fact the report was referred almost four months before the end of the period.

The OIG also referred the manager who wrote the letter containing the false statement to Commission management for disciplinary action. In response, management counseled the manager to exercise caution should similar circumstances arise in the future, rather than undertaking any disciplinary action.

Finally, we recommended that the agency institute suspension and/or debarment proceedings against the contracting firm or undertake other appropriate action. As of the end of the reporting period, the agency had taken no action regarding the contracting firm.

Investigation of Falsification of Personnel Forms and Employment Application

The OIG conducted an investigation into the falsification of two Standard Form (SF) 50s and an employment application by a recently-hired employee. OIG investigators interviewed the employee, who admitted intentionally falsifying the document in question. Specifically, the employee admitted falsifying her position and grade at her previous agency because she did not think she would qualify for the position at the SEC based upon her actual employment information. The employee further admitted making a serious error in judgment by altering the forms.

Because the employee admitted to committing serious criminal offenses, the OIG referred the matter to the Public Integrity Section of the Criminal Division of the U.S. Department of Justice for consideration of prosecution, which was pending at the end of the semiannual reporting period.

In addition, the OIG issued a report of investigation to management on June 24, 2008, recommending disciplinary action up to

and including dismissal against the employee, who had already been placed on administrative leave. Management removed the employee from her position effective July 31, 2008, relying on the employee's admissions to the OIG that she had falsified her SF50s and employment.

Investigation of Misuse of Official Government Position

After receiving two anonymous complaints, the OIG conducted an investigation into allegations of misuse of official government position, gross mismanagement and abuse of time and attendance by a senior-level Commission employee. The OIG obtained and analyzed e-mail and building access logs for this employee, and interviewed several Commission staff members, including the employee's supervisor. The OIG also subpoenaed brokerage account statements and interviewed brokers from a brokerage firm with which the employee was alleged to have had inappropriate contact. In addition, an OIG investigator took the sworn, on-the-record testimony of the senior-level employee.

On August 12, 2008, the OIG issued a detailed report to management describing the results of its investigation. The OIG investigation found significant evidence, including her own admissions, that the senior-level Commission employee clearly and purposefully identified herself as a Commission employee when dealing with brokers about a family member's account. Specifically, the senior-level employee admitted that she contacted the family member's broker to question the investment decisions and specifically pointed out that she worked at the Commission. The broker stated that the senior-level employee told him on numerous occasions that she worked at the SEC and made it a point to tell him that she had been with the Commission for 10 or more years. The broker indicated that he felt she was trying to intimidate and bully him and he considered her conduct to be unprofessional.

The OIG concluded that this conduct was in violation of Government-wide policies that specifically and strictly prohibited employees from using their public positions in a manner intended to coerce a benefit to themselves or relatives. Based upon the employee's high-level position of responsibility within the agency, the significant impact that her conduct would have on a brokerage firm and the strict prohibitions on using one's government title or position to gain personal benefits, the OIG referred the matter to management for disciplinary action, up to and including dismissal. Management had not proposed or taken action against the senior-level employee as of the end of the semiannual period.

Follow-up Investigation of Disruptive and Intimidating Behavior by a Senior Manager

During the prior semiannual period, the OIG reported on an investigation it conducted of a Senior Officer (Senior Executive Service-equivalent) who had verbally and physically assaulted a colleague in the office. That investigation further uncovered evidence that the Senior Officer had a history of intimidating and controlling behavior in the workplace. We also found that the Senior Officer lacked candor in her sworn testimony to the OIG investigator. The OIG had referred the matter to management and recommended that serious disciplinary action be taken against the Senior Officer.

In the current reporting period, the OIG learned that while management had

reassigned the Senior Officer to a position in which she was not officially supervising staff, management took no disciplinary action against the Senior Officer, instead issuing her a counseling memorandum. Also during this period, the OIG received further allegations that the Senior Officer had approached her former subordinates in an intimidating manner seeking affidavits to defend herself from possible disciplinary action arising out of the initial OIG investigation. Upon receiving this information, the OIG re-opened its investigation of the Senior Officer and interviewed five individuals, four of whom had been approached by the Senior Officer for an affidavit.

The OIG issued a supplemental report of investigation to management on June 2, 2008, providing the results of its additional investigative work. The OIG found that the Senior Officer requested affidavits directly from several former subordinates with whom she still worked, during the workday and in the workplace. The OIG further found evidence that the former subordinates were uncomfortable with the Senior Officer's request, which they found to be both inappropriate and intimidating. The OIG's supplemental investigation also determined that the Senior Officer's actions were disruptive to the workplace and uncovered additional evidence of the Senior Officer's history of intimidating and controlling behavior that continued even after she was reassigned from her official supervisory position.

The OIG reasserted its previous investigative findings and recommended that the agency take appropriate disciplinary action, up to and including dismissal against the Senior Officer, based upon conduct described in the previous report of investigation and the additional disruptive conduct outlined in the supplemental report. As of the end of the semiannual reporting period, no disciplinary action had been taken against the Senior Officer for the findings in either the initial or supplemental investigative reports.

Investigation of Failure to Maintain Active Bar Status

The OIG investigated an allegation that a Commission attorney had not maintained active bar status for several years, as was a requirement of his position. It was also alleged that the attorney failed to advise his supervisors of the change in his bar status and continued to practice law as an Enforcement attorney. The OIG contacted the state bar of which the employee had been previously been an active member to obtain pertinent information about his bar membership status. The OIG also obtained and reviewed documents pertaining to the employee's position description, as well as documents reflecting representations made by the employee in correspondence, testimony and declarations filed with courts.

While the OIG's investigation was ongoing, the staff member admitted to management that he had failed to maintain active bar status as required by his position, but claimed he had not learned of his transfer to inactive status until several years after it occurred. The employee, however, acknowledged his inattentiveness to his bar status and agreed to retire, effective August 30, 2008.

On September 11, 2008, the OIG issued a report describing the findings of its investigation. The evidence showed that the staff member had been transferred to inactive status in 1994 for his failure to renew his bar

license. The evidence further indicated that the state court disciplinary board notified the employee of his transfer to inactive status and instructed him to comply with applicable disciplinary rules, which he never did. The evidence also showed that the employee had never been admitted to the bar of any other state.

In addition, the OIG investigation found that during the time period when the staff member had no active bar membership, he submitted a declaration in Federal court, in which he stated that he was an attorney employed by the SEC. We referred the potential false statement or perjury to the applicable United States Attorney's Office, which provided an oral declination of prosecution.

While the OIG would have recommended appropriate disciplinary action, up to and including dismissal, the OIG did not recommend disciplinary action due to the employee's retirement. The OIG provided the report to the Commission's Office of Ethics Counsel for referral to the appropriate bar disciplinary board. In addition, as described in the section on Advice and Assistance Provided to the Agency, the OIG recommended that Commission attorneys be required to certify their active bar membership status on an annual basis.

Follow-up on Investigation of Misuse of Government Parking Permit

In an investigation completed during the previous semiannual period, the OIG found significant evidence that an employee had misused a government parking permit for her personal parking on numerous occasions. When interviewed during the investigation, the employee admitted taking and using a government parking permit without authorization on one occasion. However, she claimed she infrequently parked in the garage and that, when she did, she paid the daily parking rate or the attendants allowed her to park for free. The OIG found that these statements lacked credibility, given the evidence uncovered during the investigation, and recommended that management take disciplinary action against the employee, up to and including dismissal.

During the current reporting period, the employee raised allegations that several other staff at SEC Headquarters had been accused of violating parking rules in the past but had not been referred to the OIG. Specifically, the employee claimed that her supervisor had violated the parking rules and was allowed to pay back money and avoid a referral to the OIG, but named no other specific individuals. Upon learning of these allegations, the OIG performed a supplemental investigation and requested that the employee appear for testimony concerning her allegations about other employees' parking violations. Despite being given a warning requiring her to testify and immunizing her statements from criminal prosecution, the employee refused to answer any questions concerning the specific names of individuals whom she believed had violated the parking rules.

After the employee's refusal to cooperate with the OIG's supplemental investigation, an OIG investigator interviewed the supervisor identified as violating the parking rules, who denied ever taking a parking pass without permission or otherwise violating SEC parking rules. The OIG investigator also interviewed this individual's supervisor and another long-term SEC employee and found no evidence that other individuals had engaged in misconduct similar to the

employee's misconduct but were allowed to avoid referral to the OIG. The OIG issued a supplemental report of investigation on May 23, 2008, again recommending that the agency take disciplinary action against the employee, up to and including dismissal, for the conduct described in the previous report of investigation. The OIG also recommended that the agency consider adding another charge against the employee for her refusal to cooperate with an official OIG investigation. Management removed the employee based upon the results of the OIG's initial and supplemental investigations.

Investigations into Misuse of Government Resources and Official Time to Operate Private Photography Businesses

During the reporting period, the OIG conducted two simultaneous investigations into whether employees in different Commission offices misused government resources and official time to support private photography businesses. Both matters arose out of an investigation conducted during the previous reporting period that found evidence that an employee had used substantial government resources and time for a private photography business.

In one of the matters investigated during this reporting period, the OIG investigation uncovered abundant evidence that an employee repeatedly and flagrantly used Commission resources, including Commission Internet access, e-mail, telephone and printer, in support of his private photography business for several years. To obtain this evidence, the OIG reviewed the employee's e-mails for a 12-month period, and obtained images and files from the employee's computer hard drive. Further, the OIG reviewed the employee's Official Personal Folder, interviewed several Commission staff, including the employee's supervisor, and took sworn, on-the-record testimony of the employee himself.

On July 18, 2008, the OIG issued its report of investigation setting forth in detail the evidence uncovered during the investigation and recommending disciplinary action, up to and including dismissal. Based on the OIG's report of investigation, management suspended the employee from duty and pay for nine calendar days.

In the second OIG investigation conducted during the reporting period concerning an employee using Commission resources to operate a private photography business, the OIG found evidence that the employee repeatedly used Commission resources and official time in support of his photography business, and maintained over a hundred photographs on his SEC computer. There was substantial evidence that the employee used Commission resources, including Internet access, e-mail, and telephone, during work hours.

In making its findings, the OIG obtained and reviewed the employee's e-mails for a 12-month period, as well as images and files copied from the hard drive of his SEC computers. The OIG also reviewed the employee's Official Personnel Folder and conduct file, finding evidence that the employee was previously reprimanded for misusing government computer resources and official time. OIG investigators interviewed several Commission staff and took the sworn, on-the-record testimony of the subject employee. On July 28, 2008, the OIG issued its report of investigation, finding evidence of misuse of government office equipment and official time and recommending disciplinary action. Based upon the OIG's findings, management suspended the employee from duty and pay for 14 calendar days.

Investigations and Inquiries into Misuse of Computer Resources to View Pornography

During the reporting period, the OIG continued to receive from the agency's Office of Information Technology (OIT) lists of agency employees who had numerous attempts to access pornographic websites from their Commission computers that were blocked by the agency's Internet filter, as well as instances where they successfully accessed pornography or inappropriate material. Depending on the frequency of the accesses and attempted accesses and the nature of the material accessed, the OIG conducted a full investigation or a more limited inquiry, as discussed below.

The OIG completed three investigations of employees who misused their government computers to attempt to access and successfully access pornographic website. In the first of these matters, the OIG uncovered evidence that a employee who was still in his probationary period had used his SEC laptop computer to attempt to access Internet websites classified as containing pornography, resulting in hundreds of access denials. The OIG investigation also disclosed that this employee successfully bypassed the Commission's Internet filter by using a flash drive and accessed a significant number of Internet Google images containing pornography while using his SEC computer.

In his sworn, on-the record testimony, the employee admitted that he used his SEC computer to access and attempt to access websites containing pornography and other sexually explicit material during work hours. He also admitted deliberately turning off the filter in Google to circumvent SEC information technology security protocols. The OIG issued a report of investigation to management on July 9, 2008. Because of the serious nature of the misconduct and the fact it occurred during the employee's probationary period, the OIG recommended that management take disciplinary action against the employee, up to and including dismissal. Based upon the OIG's findings, management informed the employee that his employment would be terminated, and the employee resigned.

In the second investigated matter, the OIG's examination of logs of an employee's Internet activity revealed that the employee had attempted to access websites classified as containing pornography, resulting in thousands of access denials. Moreover, forensic analysis of the employee's computer hard drive showed hundreds of pornographic images stored on the drive, some of which were of a very graphic nature. The investigation also showed that the employee had succeeded in bypassing the Commission's Internet filter by accessing pornographic materials through Google images.

The employee declined to appear for sworn, on-the-record testimony before the OIG, asserting the Fifth Amendment privilege against self-incrimination. The OIG issued a detailed report of investigation to management on April 30, 2008, recommending disciplinary action against the employee, up to and including dismissal. Based upon the OIG's report of investigation, management suspended the employee for 14 days.

In the third investigation conducted during the reporting period, the OIG found that, during a one-month period, an employee had received numerous access denials for pornographic websites. The investigation also uncovered evidence that the employee had

successfully bypassed the Commission's Internet filter, thereby accessing a significant number of pornographic and sexually explicit images, many of a graphic nature.

The employee appeared for sworn, on-the record testimony before the OIG and admitted using his SEC computer to access and attempt to access Internet websites continuing pornography and other sexually explicit material during work hours. The employee further acknowledged that he knew his activities violated SEC rules and the Standards of Conduct and attributed his actions to a mistake on his part. The OIG referred the matter to management on August 12, 2008, and recommended appropriate disciplinary action. Management had not proposed or taken disciplinary action in response to the recommendation as of the end of the reporting period.

The OIG also completed two inquiries into the misuse of SEC computer resources to view pornography. In one of these matters, the OIG found evidence that a Commission contract employee received numerous access request denials for Internet websites classified as containing pornography in a five-week period, many of which occurred during normal Commission work hours. Further, information provided by OIT showed the contract employee had successfully accessed sexually explicit and sexually suggestive Internet website that contained nudity from his SEC-assigned computer. The contract employee acknowledged to an OIG investigator that no one else had access to his computer, which was password protected. The OIG issued a memorandum report on July 2, 2008, and referred the matter for consideration of disciplinary action. Based on the OIG report, at management's request, the employee was removed from the SEC contract.

In the other inquiry, the OIG found evidence that an SEC employee attempted to access Internet pornography numerous times using two different Internet Protocol (IP) addresses, resulting in hundreds of access denials, many occurring during normal Commission work hours. In addition, information provided by OIT showed the employee successfully accessed a sexually explicit website from his SEC computer. The OIG issued a memorandum report to management for consideration of disciplinary action. At the time management received the OIG report, the employee had already announced that he was resigning to pursue other employment opportunities. Prior to the employee's departure, management issued a memorandum counseling him on his misuse of government computer resources and official time.

Investigation into Misuse of Computer Resources, Appearance of a Conflict of Interest and Lack of Candor

The OIG opened an investigation after receiving a complaint from a city government office of inspector general alleging that a Commission employee misused government resources to represent witnesses in an investigation being conducted by that office, acted inappropriately in the course of representing those witnesses and had a conflict of interest because he himself was a witness in the investigation. During its investigation, the OIG obtained and reviewed the subject Commission employee's Official Personnel Folder and conduct file, as well as his leave records for the relevant time period. Further, the OIG obtained several documents from the city government inspector general's office, including correspondence with the

Commission employee and recordings of voicemail messages left by the employee. The OIG also obtained information from the city government inspector general and an office staff attorney who worked on the investigation in question. The OIG took sworn, on-the-record testimony of the Commission employee.

The investigation revealed that the employee misused SEC resources by using his SEC telephone and facsimile machine on several occasions during the workday in his representation of witnesses in the city government inspector general investigation. Further, the OIG found that the employee failed to consider the appearance of conflicts of interest in the course of his representation of witnesses in that matter, particularly when he used his SEC telephone and facsimile number in communications with a bank concerning the city government inspector general's subpoena for the bank records of one of his clients. The OIG also found the employee lacked candor during his SEC OIG testimony. While this testimony took place less than a year after the alleged wrongdoing occurred, the employee implausibly failed to recall basic facts about his representation of his clients in the city government inspector general investigation.

On August 4, 2008, the OIG issued a report of investigation to management and recommended appropriate disciplinary action of the employee, based upon his misuse of government resources, the appearance of a conflict of interest, and his lack of candor during this SEC OIG testimony. Thereafter, management met with the employee and provided him a written counseling memorandum, admonishing him to be cognizant of the prohibitions on the misuse of Commission resources, to be particularly sensitive to creating the appearance of a conflict of interest by his outside activities, and to act with full candor and avoid making any inaccurate or misleading statements in carrying out his official duties. The employee was further directed to notify management, in advance, of any instance in which he intends to represent any person or entity (other than the SEC) as an attorney during the continuing course of his employment with the SEC.

Investigation of Complaint of Order to Falsify a Government Record

The OIG investigated a complaint that a Commission supervisor had directed his subordinate to knowingly and deliberately falsify information used in an official government report in an effort to mislead or impede government officials in the course of their duties. The orders to falsify government records were allegedly given during the course of a dispute between the supervisor and the employee about how to report certain test data. The OIG took the sworn on-the-record testimony of the supervisor and the subordinate and interviewed other relevant witnesses. The OIG also reviewed numerous pertinent documents provided by the witnesses.

On July 30, 2008, the OIG issued a report of investigation to management discussing in detail the results of the investigation. The OIG found the complaint that the supervisor ordered the subordinate to falsify a government record in order to deceive government officials was without foundation or merit. The OIG investigation did disclose, however, that in large part due to the incident that precipitated the complaint, there was a high level of tension between the supervisor and subordinate, negatively impacting the office's ability to perform its functions. The OIG recommended that management take prompt and effective measure to address the

current personnel situation within this office. Thereafter, management proposed to suspend the subordinate for conduct unbecoming a Federal employee for reasons both related and unrelated to the OIG investigation, and the supervisor resigned to accept a position at another agency.

Investigation of Alleged Unethical Instructions to Close Cases and Failure to Pursue Investigations

During an investigation conducted during the period, the OIG reviewed several allegations of misconduct by management, including that (1) staff attorneys were unethically instructed to close older cases by making false certifications, (2) a manager refused to pursue particular types of investigations and many investigations languished on his desk, and (3) cases were improperly closed without the staff attorneys who worked on the investigation being informed of the reasons for the closure. In order to pursue the allegation of unethical instructions to close older cases, the OIG obtained and analyzed detailed reports concerning closed investigations, open investigations that had been pending for several years, and the staff assigned to these investigations. An OIG investigator personally interviewed eight staff attorneys and took the on-the record, sworn testimony of another staff attorney. Many of these staff attorneys expressed fear of retaliation and requested confidentiality. The OIG also took the on-the-record, sworn testimony of four supervisors and interviewed another supervisor by telephone.

The OIG issued a report summarizing the results of its investigation on April 18, 2008. The OIG found that the allegations of misconduct were not substantiated. Specifically, the OIG found that the older cases being closed were part of an agency-wide initiative to close out cases in which no action had been or would be brought and obtained no evidence that any attorneys were instructed to close cases based on false certifications.

The OIG also found no evidence to support the allegation that the manager did not actively purse Enforcement cases, but did find instances of ineffective management on his part. The OIG further found a lack of effective communication between management and staff that engendered an atmosphere of fear, frustration and confusion among the part of many staff interviewed in the investigation. The OIG recommended that management take strong and effective measures to improve communication with staff, particularly in the case decision–making process, and to alleviate staff fear of retaliation by management. Management informed us that they have taken steps to improve the way in which managers communicate with staff, particularly in connection with decisions to close cases.

Misuse of Government Resources and Time by a Contract Employee

During this reporting period, the OIG conducted an investigation into a complaint that a Commission-employed contractor was using her SEC-assigned computer and other SEC resources to obtain personal information about the complainant and to harass her. At the OIG's request, the Office of Information Technology analyzed the contract employee's computer search history for evidence concerning the complainant and provided the OIG with the results of its analysis. The OIG also interviewed the complainant several times telephonically, and took the sworn, on-the-record testimony of the contractor.

On August 14, 2008, the OIG issued its report of investigation, finding that the contractor admitted to using her SEC computer to search the Internet for personal information about the complainant, including her home address, and to send one text message to the complainant. The investigation, however, did not disclose evidence that the contractor harassed or threatened the complainant. In response to the OIG investigation, management provided the contractor with a counseling memorandum, warning her about the SEC's policy on the use of government office equipment, including the Internet, and cautioned her that a future violation of this policy could result in formal discipline.

Other Inquiries Conducted

During the period, the OIG also completed inquiries into numerous additional matters brought to its attention, the most significant of which are described below.

An OIG inquiry reviewed a complaint that the Commission's use of an identification token for remote access to the Commission's computer system violated the complainant's patent. During the inquiry, we interviewed an SEC information technology security official and learned that the Commission purchases its remote access tokens from an outside vendor, and reviewed a copy of a recent task order for tokens. Our inquiry disclosed that the SEC purchases its tokens from a commercial vendor through a General Services Administration schedule contract and that the tokens purchased by the SEC appeared to be protected by patents that predated the complainant's patent.

Another inquiry concluded in the semiannual period involved an allegation that an individual under investigation for insider trading had obtained a nonpublic list of Enforcement investigations involving a particular type of violation and contemplated selling the list. The OIG coordinated its efforts with the Division of Enforcement and the applicable United States Attorney's Office, reviewed relevant spreadsheets and databases and requested a search for pertinent e-mails. While the OIG's inquiry was pending, it was disclosed that the individual in question had obtained the case list from a reporter and there was no indication that any SEC staff members had leaked the case list.

At the request of a United States Senator, the OIG conducted an inquiry into a complaint that Commission Regional Office Enforcement staff had improperly failed to bring an action against a particular individual. The OIG interviewed a Commission attorney who was involved in the matter and reviewed relevant e-mails and other documents. The OIG's inquiry disclosed that Enforcement staff had thoroughly reviewed the materials and information provided by the complainant. We also learned that the Commission brought a securities fraud action against one individual in the matter, but that Enforcement staff made a discretionary judgment, based upon its review of all available information, not to pursue any additional Enforcement action. We provided a response to the Senator informing him of the results of our inquiry.

The OIG conducted an inquiry into allegations that a staff member had been misusing her SEC e-mail account to send personal e-mails containing sexual innuendo to the complainant's husband. We obtained one of the allegedly inappropriate e-mails from the complainant and obtained and reviewed the employee's e-mails for a four-month period. The inquiry disclosed that the

employee sent only two e-mails to the complainant's husband during the four-month period, and neither contained inappropriate sexual content. As such, we found insufficient evidence of misuse of the SEC's e-mail system to warrant further investigation of the complaint.

The OIG concluded its inquiry into a complaint that a Commission senior attorney failed to consider seriously the complainant's claim of perjury in a self-regulatory organization (SRO) arbitration proceeding that took place approximately ten years ago. The OIG contacted staff of the SRO and obtained and reviewed relevant correspondence provided by the SRO. An OIG investigator also reviewed the files of SEC staff pertinent to the matter. The OIG provided a detailed letter to the complainant describing the substantial work performed and the results of the inquiry.

The OIG inquired into a complaint that an outside individual who was being considered for a senior position within one of the Commission's divisions had a prior felony conviction that he had failed to report as a registered broker-dealer. The OIG's inquiry disclosed that while this individual's name had surfaced in the press as a possible candidate for the position, he had, in fact, not applied for the position.

The OIG also performed an inquiry into a complaint that SEC brochures were being discarded merely because they contained a prior office name, resulting in undue waste. It was further alleged that numerous brochures and publications were being redone to give them a new look, without any substantive changes to the content. The OIG interviewed several witnesses in the offices responsible for producing and publishing the brochures, including the office director who had allegedly ordered the brochures to be redone. The OIG inquiry found no evidence that brochures were being discarded and not used because they contained the prior office name. In addition, the inquiry disclosed that while there was a project underway to give all office publications a consistent and upgraded appearance, the plan was being implemented in phases and would not result in undue waste.

PENDING INVESTIGATIONS AND INQUIRIES

Possible Violations of Rules Governing Employee Securities Transactions

The OIG is continuing its investigation into an allegation that an employee had a high volume of personal securities trading, raising suspicions that the employee may have violated the Commission's rules governing employee securities transactions. During the course of its investigation, the OIG identified a second employee who may have engaged in similar behavior.

OIG investigators have completed a comprehensive review and analysis of more than two years of these employees' brokerage records, the employees' required reports on those transactions, and their case assignments. The OIG has also reviewed the employees' Commission e-mails for a substantial time period, and found and analyzed numerous e-mails discussing stocks and securities transactions sent from their SEC computers. In addition, the OIG has interviewed or taken sworn testimony of several Commission managers and staff, and will soon be taking the sworn, on-the-record testimony of the subjects in this matter.

In this investigation, the OIG is determining whether the subject employees: (1) obtained Commission clearance for each transaction; (2) reported and traded those transactions within the required time periods after obtaining clearance, (3) properly reported their assets and securities on an annual reporting form; and (4) held those securities for the required periods of time. The OIG is also focusing on whether these employees violated Commission confidentiality requirements by discussing nonpublic information with each other, or others outside the Commission.

Additionally, the OIG is reviewing the evidence obtained in the investigation to determine whether these employees may have engaged in any trades based on nonpublic information they learned during the course of their Commission work, from SEC resources, or from discussions with other employees. As part of its investigation, the OIG is also reviewing the adequacy of the Commission's procedures for reporting and monitoring employees' securities transactions and plans to make recommendations for improvements in those procedures as appropriate.

Whistleblower Allegations of Falsification of Contract Documents

The OIG is conducting a joint investigation with a Special Agent from another Federal agency Office of Inspector General and a United States Attorney's Office into allegations made by a whistleblower that a contractor manipulated data in order to increase the millions of dollars of award fees it had obtained from the SEC over a period of several years. The investigators have obtained and reviewed hundreds of documents pertaining to the contract, including audit documents, contract task orders, reports and evaluations regularly provided under the contract, and relevant procedures. In addition, the investigators have interviewed the whistleblower, several Commission staff and employees of the other Federal agency who have relevant information. The OIG has obtained and begun to review hundreds of thousands of e-mails for relevant evidence. The investigators have also requested all documentation supporting the award fees from the contractor.

Complaint of False Statement in Previous OIG Investigation

The OIG is continuing its investigation into a complaint that a Commission employee made a false statement to the OIG in the course of its initial investigation of the allegations made by a former Commission attorney. The alleged false statement concerned the disposition of the former attorney's original employee personnel folder after he was terminated and whether copies were maintained. During the reporting period, the Inspector General took additional sworn, on-the-record testimony from the complainant and one additional witness. The Inspector General plans to take the testimony of the subject of the investigation and finalize this investigation during the next reporting period.

Complaints of Unprofessional Conduct by Commission Contractor and Employee

The OIG is conducting an investigation based upon two anonymous complaints alleging that a Commission contractor and a Commission employee with oversight responsibility for the contract engaged in unprofessional and inappropriate conduct in

the workplace. Both complaints also alleged that the contractor was arrested during his non-work hours for an offense that negatively impacted his ability to carry out his Commission-related duties.

The OIG has conducted extensive investigation into the allegations in the anonymous complaints. Specifically, the OIG interviewed a Commission staff member and numerous contract employees. The OIG also took on-the-record, sworn testimony of the two subjects of the investigation. An OIG investigator obtained relevant information and documents from the United States Capitol Police and the District of Columbia Metropolitan Police Department and interviewed two police detectives. Additionally, the OIG obtained and reviewed several months of e-mails for each subject. The OIG plans to finalize the investigation during the upcoming reporting period.

Allegations of Perjury by a Commission Manager and Receiver Conflict of Interest

The OIG has a pending investigation into allegations that a Commission manager committed perjury in a letter to a Senator that discussed the issue of naked short selling in the context of a particular Enforcement matter and also lied to the Federal court in which the case was pending. The OIG is also reviewing an allegation that the court-appointed receiver in the matter had an improper conflict of interest. An OIG investigator interviewed the complainant and other individuals with knowledge of the issues and took the sworn-on the-record testimony of the manager who allegedly committed perjury. The OIG plans to complete the investigation during the next reporting period.

Allegations of Unauthorized Disclosure by Former Employee and Improper Enforcement Investigation

The OIG has a pending investigation into an allegation made in a recently-published book that a former SEC attorney may have taken confidential investigative materials with him when he left the Commission and provided those materials to a company he went to work for as a lobbyist. It was also alleged in the book that the SEC failed to conduct an adequate investigation after the author presented evidence of fraud by an affiliate of this company and instead investigated the complainant for spreading negative views about the company. The OIG has obtained and reviewed the book containing the allegations, as well as other relevant documents. The OIG plans to conduct a thorough investigation into the allegations of unauthorized disclosure and improper investigation.

Complaint of Management Retaliation Against Staff and Travel Abuse

The OIG is conducting an investigation as a result of an internal complaint alleging retaliation by management in a Regional Office for employees' objections to policy and management decisions in that office. The complaint further alleged irregularities in two trips that management authorized to be taken by staff at government expense. An OIG investigator has obtained and reviewed relevant e-mails and documents pertaining to the office in question. The OIG plans to obtain additional travel records and take testimony from or interview several staff with knowledge of the allegations.

Allegations of Misuse of Resources and Official Time to Support Private Businesses

In addition to the several completed investigations of misuse of government resources and official time to support private businesses, the OIG is continuing to investigate whether another employee violated Commission and government-wide rules and regulations by using Commission resources and time to support a private photography business. The OIG has reviewed numerous months of the employee's e-mails and has interviewed several Commission staff in connection with this investigation. The OIG has also taken the subject's sworn, on-the-record testimony. The OIG plans to make a recommendation to management in this matter shortly. Further, the OIG has several pending inquiries to determine whether other individuals identified as having private photography and other businesses have misused Commission resources and time in furtherance of those businesses.

Complaint of Perjury and Retaliation by Regional Office Managers

The OIG is investigating a complaint alleging misconduct on the part of senior and mid-level managers in a Commission Regional Office during the course of a previously-conducted OIG investigation, including an allegation that these managers may have provided perjurious testimony. The complaint also alleged retaliation by certain senior managers because the complainant provided information to the Senate Finance Committee in connection with an inquiry involving a different OIG investigation. The OIG has taken the testimony of all relevant witnesses, including the complainant, and has obtained and reviewed numerous documents. The OIG expects to issue its report of investigation to management during the next reporting period.

Allegation of Conflict of Interest on the Part of a Senior Manager

The OIG is conducting an investigation of an allegation that a Commission Senior Officer was involved in the decision to hire a contractor with whom he had a past relationship, even though the contractor was not the lowest bidder in the procurement process. An OIG investigator has obtained and reviewed relevant documents, such as the inter-agency agreement at issue and the Senior Officer's personnel documents, and has conducted Internet searches relating to the contractor and any potential connection with the Senior Officer.

OIG investigators also conducted interviews of several witnesses and individuals with knowledge and oversight of the contract, as well as the Senior Officer named in the complaint. The OIG will finalize the matter in the next reporting period.

Allegations of Conflict of Interest and Investigative Misconduct

The OIG is continuing to investigate allegations that a Commission supervisory attorney participated in an investigation notwithstanding a personal conflict of interest that required his recusal from the investigation, and that various misconduct occurred during the course of the investigation and subsequent litigation. During this reporting period, the OIG took the sworn, on-the-record testimony of the complainant and a former Commission attorney who worked on the matter. The OIG also interviewed an attorney who previously represented the complainant and obtained numerous months of e-mails of the

attorneys who worked on the matter. The OIG plans to continue to review the e-mails obtained and to take the sworn, on-the record testimony of the subjects of the investigation.

Allegation of Retaliatory Investigation

The OIG is investigating an allegation that Commission staff engaged in a retaliatory investigation of a company after it publicly complained about naked short selling. During this reporting period, the OIG took extensive sworn, on-the-record testimony of the complainant and reviewed certain relevant documents. The OIG plans to interview additional witnesses identified by the complainant and to take the sworn, on-the-record testimony of the Commission attorneys who worked on the matter.

Allegation of Leak of Confidential Document to the Press

The OIG is investigating an allegation that Commission staff committed an unauthorized disclosure of nonpublic Commission information to a national news outlet. The OIG's investigative efforts will focus on the circumstances surrounding the leak of this information to a newspaper, the nature of the information that was disclosed and the extent of the harm caused by the leak.

Complaint of Favoritism, Abuse of Position and Retaliation by a Manager

The OIG is investigating a complaint alleging lack of impartiality, abuse of position and retaliation by a Commission manager. Specifically, the OIG is investigating whether the subject was involved in a romantic relationship with a female subordinate at the time he promoted her, and whether the complainant was retaliated against for subsequently reporting the alleged misconduct to a senior manager. The OIG has obtained and reviewed numerous relevant documents, including e-mails, and is continuing to obtain and review additional documents. The OIG has communicated in detail with the complainant, and plans to take the complainant's sworn, on-the-record testimony. The OIG further plans to interview former and current co-workers who have relevant information concerning the alleged abuse of position, and take the sworn, on-the-record testimony of the subject and the female subordinate.

Allegations of Repeated Time and Attendance Abuse and Misuse of Government Resources

The OIG is conducting an investigation into allegations of long-standing and ongoing time and attendance abuse by a Commission employee, as well as the misuse of government resources. The complaint received by the OIG specifically alleges that an employee has repeatedly not taken leave for time when he has been absent from the work place and that he has also been using government equipment and resources for personal purposes to an excessive degree or for financial gain.

The OIG has obtained numerous documents in the course of its investigation, including the employee's leave slips, building access records, computer log-in and log-off records, and Internet usage records. Further, the OIG has obtained and reviewed the subject's e-mail records for the time period that is the focus of the investigation. The OIG has also reviewed a special accommodation that was granted to the employee and has interviewed his supervisors. The OIG is undertaking efforts to secure the

subject's testimony before issuing its report of investigation to management.

Other Pending Inquiries

The OIG has several other pending inquiries that it plans to continue to review during the next reporting period. These include inquiries into:

- various allegations of misconduct on the part of Commission staff and a court-appointed receiver that were made by the subject of a Commission Enforcement proceeding;
- a complaint that a Commission-issued Blackberry was sold on eBay;
- allegations that a Commission attorney continued to send inappropriate e-mails after being disciplined for that type of behavior and failed to comply with notices requiring the preservation of documents for litigation;
- a complaint that Commission staff falsely represented to a court that subpoenas had been served on a individual when they had not been served, and failed to correct the record after a state court found the subpoenas had not been served;
- whether Commission staff members improperly provided information about a claimed whistleblower to a law firm representing the investment bank that had terminated that individual; and
- allegations that Commission attorneys made multiple false representations to a court, thereby improperly obtaining a judgment.

SEMIANNUAL REPORT TO CONGRESS

REVIEW OF LEGISLATION AND REGULATIONS

During the reporting period, the OIG reviewed legislation and proposed and final rules and regulations relating to the programs and operations of the Commission, pursuant to Section 4(a)(2) of the Inspector General Act. As is discussed in detail in the Section on Advice and Assistance provided to the Agency, the OIG provided comments on several proposed internal regulations and procedures. These included, among others, the revised regulation on use of SEC office equipment (SEC Regulation (SECR) 24.4.3), a draft Operating Directive (OD) on Privacy Incident Management (OD 24-08.04), a draft Implementing Instruction (II) on Privacy Incident Response Capability (II 24-08.04.01), and the Division of Enforcement's draft policies and procedures governing the selection of receivers, fund administrators, independent distribution consultants, tax administrators and independent consultants.

In addition, the OIG reviewed statutes, rules and regulations and requirements, and their impact on Commission programs and operations, within the context of several audits conducted during the period. For example, in the audit performed of the Broker-Dealer Risk Assessment Program (Report No. 446-B, issued September 25, 2008), the OIG reviewed the temporary rules governing the program (Rules 17h-1T and 17h-2T) that had been adopted in 2002. The OIG found that these temporary rules had not been finalized or updated and recommended appropriate corrective action. In a related audit of the Consolidated Supervised Entity (CSE) Program (Report No. 446-A, issued September 25, 2008), the OIG reviewed the rule amendments that established the CSE program and recommended that the Division of Trading and Markets either comply with an existing rule requirement or seek Commission approval for a deviation from that requirement. Additionally, in audits conducted of the agency's premium travel and government purchase card programs, the OIG reviewed the requirements of pertinent federal and agency regulations and recommended that the agency's policies, procedures and internal regulations be appropriately updated and revised.

The OIG also tracked legislation that would impact the Inspector General community, in coordination with the Legislation Committee of the President's Council on Integrity and Efficiency (PCIE) and the Executive Council on Integrity and Efficiency (ECIE). In particular, the OIG reviewed and assessed the impact on the OIG and the agency of the Inspector General Reform Act of 2008 (H.R. 928) and the

Office of Inspector General

SEMIANNUAL REPORT TO CONGRESS

STATUS OF RECOMMENDATIONS WITH NO MANAGEMENT DECISIONS
Management decisions have been made on all audit reports issued before the beginning of this reporting period.

REVISED MANAGEMENT DECISIONS
No management decisions were revised during the period.

AGREEMENT WITH SIGNIFICANT MANAGEMENT DECISIONS
The Office of Inspector General agrees with all significant management decisions regarding audit recommendations.

INSTANCES WHERE INFORMATION WAS REFUSED
During this reporting period, there were no instances where information was refused.

Table 1
List of Reports: Audits, Evaluation and Inspections

Audit / Evaluation / Inspection Number	Title	Date Issued
433	Inspection of Corporation Finance Referrals, Memorandum	Sep 30, 2008
440	Internal Control Review of the Government Purchase Card Program	Sep 18, 2008
446-A	SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program	Sep 25, 2008
446-B	SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program	Sep 25, 2008
447	Audit of Premium Travel	Sep 29, 2008
449	Survey of Enforcement's Hub System	Sep 29, 2008
451	2008 FISMA Executive Summary Report	Sep 29, 2008

Table 2
Reports Issued with Costs Questioned or Funds Put to Better Use
(including disallowed costs)

	Number of Reports	Value
A. REPORTS ISSUED PRIOR TO THIS PERIOD		
For which no management decision had been made on any issue	0	0
For which some decisions had been made on some issues	2	$153,452.48
B. REPORTS ISSUED DURING THIS PERIOD		
Audit of Premium Travel (Audit No. 447)	1	$5,604.00
TOTAL OF CATEGORIES A AND B	3	$159,056.48
C. For which final management decisions were made during this period	0	$0.00
D. For which no management decisions were made during this period	1	$5,604.00
E. For which management decisions were made on some issues during this period	0	0
TOTAL OF CATEGORIES C, D AND E	1	$5,604.00

Table 3
REPORTS WITH RECOMMENDATIONS ON WHICH CORRECTIVE ACTION HAS NOT BEEN COMPLETED

RECOMMENDATIONS OPEN 180 DAYS OR MORE

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
365 - IT Capital Investment Decision-Making Follow-Up	3/29/2004	Publish a charter for the Information Officers Council.
393 - Software Management	3/24/2005	Enhance manual controls for software management.
		Implement preventive controls for software management.
		Develop written policies and procedures for software management.
		Perform periodic inventories of software and hardware.
		Develop procedures for software acquired by contractors.
395 - Integrity Program: Inspection of Field Offices	3/31/2005	Complete the development of an employee manual.
402 - Office of the Secretary	9/20/2005	Develop a regulation involving updating and posting public company forms on the Commission's website.
406 - Federal Information Security Mangement Act 2005	9/28/2005	Conduct Privacy Impact Assessments (PIAs) for all Privacy Act systems.
412 - Oversight of the PCAOB	9/28/2006	Review the Public Company Accounting Oversight Board's (PCAOB) disaster contingency plan.

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
		Develop procedures for several PCAOB oversight issues.
417 - Systems Security Evaluation – Blue Sheets	3/22/2007	Ensure analysis of security impact for system modifications.
421 - Investment Company Disclosure Initiatives	9/25/2007	Develop outcome-based performance indicators for disclosure initiatives.
422 - Backlog of FOIA Requests for Comment Letters	3/30/2007	Develop a tracking system for comment letter postings.
425 - Federal Information Security Management Act 2006	9/18/2006	Improve the identification and documentation of systems.
428 - Electronic Documents Program	7/25/2007	Issue program guidance.
		Ensure adequate data loading and quality assurance.
		Develop written procedures for loading data work from the regional offices.
		Consider a larger forensics lab.
		Research connectivity problems with Concordance system.
		Issue guidance on the preservation of electronic records.
		Decrease and track imaging turnaround times.
		Perform background investigations for thirteen identified contract employees.

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
430 - Contract Ratifications	9/25/2007	Update Commission regulations (i.e., SECR 10-2) to incorporate requirements.
		Establish procedures to review ratification requirements submitted by the Office of Administrative Services.
		Reevaluate procurement in the regional offices.
		Develop procurement procedures and provide training for the regional offices.
		Evaluate using debit cards for the regional offices.
		Finalize expert witness guidelines.
		Determine necessary training in expert witness contracts.
		Consider requiring appointment letters for Inspection and Acceptance officials and Point of Contact officials (normally trial attorneys).
		Add disciplinary language to ratification guidance.
		Develop procedures to compile contract ratification data semiannually.
432 - Oversight of Receivers and Distribution Agents	12/12/2007	Decide how often and in what format receiver/distribution agent information should be submitted.
		Request final accounting from receivers/distribution agents.
		Provide guidance and training to Enforcement staff on receiver/distribution agent oversight.
434 - Background Investigations	3/28/2008	Develop operating procedures for program by June 30, 2008.

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
		Develop or acquire a case management tracking system.
		Evaluate and restructure staff resources assigned to the Personnel Security Branch (PSB).
		Obtain secure storage for personnel security files.
		Revise current procedures to ensure interim clearances granted after acceptable review.
		Develop milestones and methodology for completing minimum background investigations for contractors and employees.
		Notify the Office of Management and Budget of any reported data that cannot be supported and develop a methodology and system for quarterly reporting.
		Review new credentialing system requirements for compliance with FIPS 201-1, Part 2.
436 - Usefulness of IM's Website	3/28/2008	Identify clear and specific objectives for Investment Management's (IM) Intranet and discuss objectives with IM's IT staff.
		Improve Intranet including develop an appropriate project plan that incorporates applicable website best practices and systems development processes.
		Provide appropriate assistance and training to IM's IT staff to ensure IM-web meets Section 508 accessibility requirements.
437 - Security Enhancements in SP Parking Garage	10/22/2007	Install cameras in Station Place parking garage.
439 - Student Loan Program	3/27/2008	Undertake actions to delegate in writing approving waivers, amend Form 2497, and issue guidance for approval requirements of Student Loan Program (SLP) award.
		Review Office of Personnel Management regulation to ensure proper individual approves SLP awards.

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
		Ensure SLP files contain appropriate documentation of repayments by employees not completing Service Agreements.
		Ensure documentation in SLP files correctly indicates who prepared/reviewed the payments.
		Implement methods to mitigate the risk of fraudulent documentation submitted by employees.
		Ensure the reliability of management records regarding former employees.
		Review the reliability of management records involving former employees.
		Take necessary steps to adequately safeguard the SLP files.
		Implement separation of duties in the review, processing and approval of SLP awards.
		Consult with the Department of Interior to ensure that monies owed to Commission is collected, documented and recorded in a timely manner.
		Conduct a thorough review of the employee clearance process to initiate improvements.
		Implement recommendations of contractor retained by the Office of Financial Management to increase the likelihood of collection of employee debts relating to the SLP or, if not feasible, prepare a report explaining why the recommendations were not implemented.
		In consultation with the Union, provide supervisors with guidance on preparing substantial justification memoranda.
		Return to supervisors justification memoranda that lack substantiation of the criteria.
		Prepare document regarding the required criteria for justification memoranda for the 2008 Open Season.

Audit/Inspection # and Title	Issue Date	Summary of Recommendation
		Implement an automated process for monitoring lifetime awards before the 2009 Open Season.
		Develop a plan to obtain data and a methodology to analyze and record data to comply with Collective Bargaining Agreement requirements.
		In consultation with the Union, develop a detailed distribution plan.
		Ensure that all vacancy announcements issued include language regarding the SLP.
443 - Internet Use Policies and Rules	2/4/2008	Update and clarify Internet usage policies.
		Clarify pornography definition and send staff reminders about prohibition on accessing or downloading pornographic materials.
M27 - NRSI Password Management	1/29/2003	Streamline and automate the user access process for IT systems.

Table 4
Summary of Investigative Activity

CASES	NUMBER
Cases Open as of 4/1/08	14
Cases Opened or Re-opened during 4/1/08 - 9/30/08	19
Cases Closed during 4/1/08 - 9/30/08	16
Total Open Cases as of 9/30/08	17
Referrals to Department of Justice for Prosecution	6
Prosecutions	0
Convictions	0
Referrals to Agency for Disciplinary Action or Performance-Based Action	17
PRELIMINARY INQUIRIES	**NUMBER**
Inquiries Open as of 4/1/08	11
Inquiries Opened during 4/1/08 - 9/30/08	32
Inquiries Closed during 4/1/08 - 9/30/08	20
Total Open Inquiries as of 9/30/08	23
Referrals to Agency for Disciplinary Action	3
Referrals to Other Agencies	2
DISCIPLINARY ACTIONS	**NUMBER**
Removals (Including Resignations)	6
Suspensions	5
Reprimands	0
Warnings/Other Actions	5

Table 5
Summary of Complaints Received

DESCRIPTION	NUMBER
Hotline Complaints Received*	29*
Other Complaints Received	108
Total Complaints Received	137
Complaints on which a Decision was Made	133
Complaints Awaiting Disposition	4
Complaints Resulting in Investigations	17
Complaints Resulting in Inquiries	32
Complaints Referred to OIG Office of Audits	6
Complaints Referred to Agency Management/Other Agency Components	32
Complaints Referred to Other Agencies	6
Complaints Included in Ongoing Investigations or Inquiries	7
Response Sent/Additional Information Requested	14
No Action Needed	24

* The OIG Hotline became operational on 8/13/08.

Table 6
References to Reporting Requirements of the Inspector General Act

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

	INSPECTOR GENERAL ACT REPORTING REQUIREMENT	PAGES
Section 4(a)(2)	Review of Legislation and Regulations	65-66
Section 5(a)(1)	Significant Problems, Abuses, and Deficiencies	11-58
Section 5(a)(2)	Recommendations for Corrective Action	11-58
Section 5(a)(3)	Prior Recommendations Not Yet Implemented	73-78
Section 5(a)(4)	Matters Referred to Prosecutive Authorities	38-58,79
Section 5(a)(5)	Summary of Instances Where Information Was Unreasonably Refused or Not Provided	67
Section 5(a)(6)	List of OIG Audit/Evaluation/Inspection Reports Issued During the Period	69
Section 5(a)(7)	Summary of Significant Reports Issued During the Period	20-35, 38-58
Section 5(a)(8)	Statistical Table on Management Decisions with Questioned Costs	71
Section 5(a)(9)	Statistical Table on Management Decisions on Recommendations That Funds Be Put To Better Use	71
Section 5(a)(10)	Summary of Each Audit Over Six Months Old for Which No Management Decision Has Been Made	67
Section 5(a)(11)	Significant Revised Management Decisions	67
Section 5(a)(12)	Significant Management Decisions with Which the Inspector General Disagreed	67

Help ensure the integrity of SEC operations by reporting to the OIG suspected fraud, waste or abuse in SEC programs or operations, and SEC staff or contractor misconduct by contacting the OIG.

Call:

Hotline	(877) 442-0854
Main Office	(202) 551-6061

Web-Based Hotline Complaint Form:
www.reportlineweb.com/sec_oig

Fax: (202) 772-9265

Write:
Office of Inspector General
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-2736

Email:
oig@sec.gov

Information received is held in confidence upon request.
While the OIG encourages complainants to provide information on how they may be contacted for additional information, anonymous complaints are also accepted.

U.S. Securities and Exchange Commission

Additional copies of this report may be obtained by contacting the Office of Inspector General at (202) 551-6061.

The report is also available on the Inspector General's website at http://www.sec.gov/about/oig.shtml.