

Securities and Exchange Commission

Office of Inspector General

Semiannual Report to Congress

Executive Summary

During this reporting period (October 1, 1999 to March 31, 2000) the Office of Inspector General (Office) issued ten audit reports. The audits focused on reviews of periodic reports; data backup procedures; oversight of the Securities Investor Protection Corporation; investor and small business town meetings; employee training; financial and administrative controls at the Midwest Regional Office; telecommunications security; benchmarking of Commission procedures; and a summary closing report for audits of computer systems for year 2000 compliance. The Audit Program section below describes these audits further.

Ten investigations were closed during the period. One case was referred to the Commission, one case was referred to the Federal Bureau of Investigation for further investigation, and one case was referred to the Federal Protective Service for further investigation. The subject of one investigation was suspended, while the subject of another investigation took three days of leave without pay pursuant to an alternative discipline agreement. In addition, one employee resigned, and another employee's period of employment ended prior to completion of the investigation. One referral to Commission management remains pending.

A previous period audit of sensitive information found that additional controls could significantly enhance the effectiveness of the system of controls. Management concurred with our recommendation to strengthen the controls and established a task force to implement corrective actions. Management has indicated that significant improvements have already been made.

During this reporting period, the Office of Inspector General completed an audit of computer systems for year 2000 compliance. Based on the audit results and the passing of the millennium date, we are dropping this issue as a significant problem.

Information resources management (IRM) continues to experience significant problems. Specifically, systems development contracting and IRM planning remain problem areas. With the completion of year 2000 compliance, Commission management has devoted more attention to strengthening these areas. Management established a senior level information technology committee to oversee information technology policies and investments two years ago. The Office of Information Technology is implementing procedures for managing these policies and investments, according to management.

Another previously reported significant problem involves controls over the collection of fees. Although statutory changes have eliminated many of the fees most at risk and the Commission has made many improvements in controls over the collection of filings fees, the overall control structure remains inadequate. This condition will remain until a new fee system, which has been in development for four years, is implemented.

Audit Program

The Office issued ten audit reports during the reporting period. The reports contained a total of 41 recommendations, which are further described below. Management concurred with most of the recommendations.

REVIEW OF PERIODIC REPORTS

AUDIT 298, FEBRUARY 23, 2000

Public companies registered with the Commission (“reporting issuers”) must file periodic reports under the Exchange Act of 1934, which include annual (10-K) and quarterly (10-Q) reports. These reports provide the securities markets with updated financial and operating information. The Division of Corporation Finance’s (CF) goal is to review all reporting issuers at least once every three years (one-third per year).

Our objective in this audit was to determine whether review coverage of reporting issuers through the review of periodic reports was effective. During our audit, Division managers indicated that they also considered reviews of repeat registration statements, certain post-effective amendments and certain proxy statements in determining reporting issuer review coverage. Consequently, we included these filings in our analysis.

The Division of Corporation Finance was reasonably effective in achieving its goal of reviewing financial and operating information for one-third of reporting issuers each year. The performance data reported in the Commission’s budget submissions did not fully reflect this success, however, because they omitted significant aspects of CF’s review activities. For example, initial public offering registrations were not included.

Also, CF used the number of annual reports filed to estimate the number of reporting issuers. We recommended that CF instead use the list of registrants it provides on the SEC Internet site.

Our other recommendations to CF included: provide more information in its tracking and budget reports related to its review goals; include a performance measure based on achieving its goals in the performance plan required by the Government Performance and Results Act; develop review goals related to filing monitors (a type of review); and provide separate performance data for quarterly reports (10-Qs) and current reports (8-Ks) in the Commission budget.

DATA BACK-UP PROCEDURES MARCH 31, 2000

AUDIT 299,

The Office of Information Technology (OIT) oversees all information systems for the Commission, participates in the investment review process for information systems, and monitors and evaluates the performance of those information systems. As part of its handling of information systems, OIT is responsible for the integrity of the Commission's data back-up procedures.

The Office of Inspector General tasked Tichenor & Associates, an independent CPA firm, to evaluate the effectiveness of the data back-up procedures. Tichenor reviewed pertinent documentation, observed relevant processes, tested back-up file restoration, and interviewed Commission staff. It performed its audit work at the Commission's headquarters, Operations Center, and field offices.

Tichenor found that back-up activities were reasonably effective to minimize data loss. It also found that that improvements were needed in the areas of: written policies and procedures for back-up activities; training of back-up operators and their alternates; disaster recovery and contingency planning; and security awareness training.

OVERSIGHT OF SECURITIES INVESTOR PROTECTION CORPORATION MARCH 31, 2000

AUDIT 301,

The Securities Investor Protection Act of 1970 (the Act) created the Securities Investor Protection Corporation (SIPC) to protect customers from losses resulting from broker-dealer failure, thereby promoting investor confidence in the securities markets.

SIPC protects customers whose securities were misappropriated, never purchased, or stolen. However, it has not covered sales practice claims against broker-dealers that do not involve misappropriation or conversion (*e.g.*, fraudulent sales practices, unsuitable investments, failure to execute sell orders).

We evaluated the efficiency and effectiveness of the Commission's oversight of SIPC, and whether its oversight was in compliance with the Act. Overall, we found that the Commission's oversight was generally efficient and in compliance with the Act. We also found that the Division of Market Regulation (MR) had a constructive working relationship with SIPC staff. SIPC trustees and officials were generally complimentary of the Commission's oversight efforts.

We recommended that MR obtain from SIPC a written statement describing the evidence necessary and the standard of proof SIPC uses in initiating and acting on claims in SIPC proceedings. We made several other recommendations, including delegating authority to the Office of General Counsel to enter appearances in SIPC cases on a one-year pilot basis; deciding on a review schedule and inspection scope for future SIPC inspections; and enhancing the Commission's internal communications regarding SIPC.

INVESTOR & SMALL BUSINESS TOWN MEETINGS AUDIT 303, NOVEMBER 18, 1999

The Commission conducts town meetings for investors and small businesses. Since 1994, 32 investor and 13 small business town meetings have been held.

The Office of Investor Education and Assistance (OIEA) organizes investor town meetings. The purpose of the meetings is to teach investors how to safely and confidently participate in the securities markets. Another purpose is to identify investor concerns and problems.

The Division of Corporation Finance organizes the small business town meetings. These meetings discuss the requirements involved when a small business raises capital through the sale of securities. The meetings also let the Commission hear about the concerns and problems facing small businesses.

We conducted an audit of compliance with the Commission's town meeting guidelines. The audit covered investor town meetings in Seattle, WA and Portland, OR, and a small business town meeting in Kansas City, MO.

During the audit, no material instances of non-compliance with the Commission's guidelines came to our attention. Also, funds spent were reasonable and allowable, and individual firms or investments products were not mentioned inappropriately.

At one investor meeting, a sponsor distributed business cards inappropriately, an unrelated mutual fund company opened a booth nearby (which could confuse investors), and certain educational materials were not approved in advance by OIEA. We made recommendations to address these issues, with which OIEA concurred.

EMPLOYEE TRAINING

AUDIT 305, MARCH 31, 2000

Commission training policy is set by the Associate Executive Director, Office of Administrative and Personnel Management (OAPM), in consultation with the Office of the Executive Director. Within OAPM, a Training Unit headed by the Training Officer administers the program. This unit is a part of the Employee Relations and Development Branch.

We sought to determine whether the employee training program was meeting the Commission's training needs effectively, and in compliance with applicable statutes and regulations. We interviewed Commission staff, reviewed available documentation, and conducted a survey of employees, supervisors and managers, and administrative contacts. Our review was limited to activities of the Training Unit, and did not include training conducted by the program offices.

We found that the Training Unit in the Office of Administrative and Personnel Management (OAPM) had taken several steps to enhance employee training, and that a majority of Commission staff we surveyed indicated that the training program was meeting their needs.

We recommended that management implement a process to improve training, with OAPM as the facilitator. Several possible training improvements include better coordination of division-sponsored training with OAPM approved training; increasing the use of technology to deliver course content and disseminate information on training opportunities; ensuring that training is aligned with organizational and Commission goals; allowing employees access to their automated training records; and improved processing of training documentation.

MIDWEST REGIONAL OFFICE

AUDIT 307, OCTOBER 29, 1999

The Office of Inspector General conducted a limited audit of the financial and administrative controls of the Midwest Regional Office (MRO). The audit procedures were limited to interviewing MRO staff, reviewing supporting documentation, and conducting limited tests of transactions. The objective of the audit was to determine whether the internal controls were adequate, implemented economically and efficiently, and in compliance with Commission policies and procedures.

The Midwest Regional Office in Chicago, Illinois, administers Commission programs in the midwestern portion of the United States. In carrying out its responsibilities, the MRO exercises a broad range of financial and administrative functions, including maintaining time and attendance records; procuring supplies and services; arranging for staff travel; maintaining an inventory of property; and recording budgeted and actual expenditures of the office.

During our limited audit, we identified one material issue. The Office of Administrative and Personnel Management (OAPM) had not issued a contracting officer's warrant to MRO's Associate Regional Director. Otherwise, our review indicated that the MRO's controls were

generally adequate, implemented economically and efficiently, and in compliance with Commission policies and procedures.

EDGAR HARDSHIP EXEMPTIONS

AUDIT 308, MARCH 30, 2000

The Commission's temporary and continuing hardship exemption rules allow registrants otherwise required to file electronically under the EDGAR system to file in paper under certain conditions. The exemptions may be either temporary or continuing, depending on the circumstances. The Divisions of Corporation Finance and Investment Management have delegated authority to approve or deny requests for hardship exemptions.

We evaluated the Commission's effectiveness in ensuring compliance with the hardship exemption rules. We reviewed applicable regulations and procedures, interviewed Commission staff, and reviewed a sample of filings submitted pursuant to the hardship exemptions.

We found that controls over the granting of continuing hardship exemptions generally appear adequate. However, we recommended that controls to ensure submission of confirming copies or resubmission of rejected filings be enhanced. We also recommended that the filing rules require the exhibit indices in electronic filings to identify all paper exhibits, not just those subject to hardship exemptions, to help investors to locate them.

TELECOMMUNICATIONS SECURITY

AUDIT 309, MARCH 31, 2000

The Office of Inspector General issued a task order to Deloitte & Touche, LLP, to evaluate the effectiveness of security controls over the Commission's telecommunications infrastructure. The scope of the review included Commission headquarters and the Operations Center in Alexandria, VA. The assessment included an evaluation of the Commission's Private Branch Exchange (PBX) and an automated and manual evaluation of all identified analog telephone lines.

Deloitte & Touche found that many effective controls and procedures exist to assist in safeguarding the PBX and analog telephone lines. It also made several recommendations to strengthen security controls and procedures to ensure the integrity of the PBX and of internal systems, including development of comprehensive telecommunications security policies and baseline standards. The policies and standards would address strong authentication, access control, security administration, auditing, and monitoring.

BENCHMARKING COMMISSION PROCEDURES AUDIT 310, MARCH 22, 2000

We conducted an audit to compare certain Commission procedures to federal agencies with similar executive, legislative, and judicial responsibilities. Our objective was to identify possible improvements to the Commission's procedures based on best practices in the federal government (benchmarking).

During the audit, we interviewed staff at selected Federal agencies (the Commodities Futures Trading Commission, the Equal Employment Opportunity Commission, the Federal Communications Commission, the Federal Deposit Insurance Corporation, the Federal Elections Commission, the Federal Maritime Commission, the Federal Reserve Board, the Federal Trade Commission, the International Trade Commission, and the National Labor Relations Board). We also reviewed supporting documentation describing these federal agencies' organizations and procedures.

We found that in many cases the Commission's procedures are similar to the other federal agencies. In part, the similarities are due to the requirements of federal law (*e.g.*, rulemaking procedures are subject to the Administrative Procedures Act). In other cases, the procedural differences between the Commission and the other federal agencies reflect deliberate policy decisions by the Commission, or differences in mission. Accordingly, we did not make any recommendations in this audit report.

YEAR 2000 AUDITS - SUMMARY CLOSING REPORT AUDIT 312, DECEMBER 21, 1999

The Office of Inspector General (OIG) engaged the services of an independent certified information systems auditor (CIS auditor) to assess the progress of the Commission in making its automated systems year 2000 (Y2K) compliant. This audit was a continuation of audit work begun by the OIG in fiscal year 1998. The OIG has issued several progress reports detailing the progress to date and making recommendations to enhance the Commission's efforts.

The CIS auditor performed agreed-upon procedures on the Commission's Y2K certification process and contingency planning for internal mission critical systems. In regards to these issues, a Commission contractor indicated to Chairman Levitt on September 2, 1999, that the SEC had completed Y2K renovation and validation of the Commission's automated systems. Also, an initial baseline set of contingency plans related to SEC mission critical systems had been completed.

Since August 1999, the Commission had made progress in certifying its systems. The judgmental sample of 53 mission critical systems used for this audit indicated that on August 28, 1999, only 7 systems were certified. As of October 22, 1999, 23 systems were certified, with 20 systems pending certification.

For the short term (by the millennium date), the report recommended completing the certification process, and completing and testing contingency plans. For the long term, OIT should build on the accomplishments of the Y2K project, by implementing policies and procedures for inventorying and certifying systems, change control, ownership of systems, and contingency plans.

Investigative Program

Ten investigations were closed during the period. One case was referred to the Commission, one case was referred to the Federal Bureau of Investigation for further investigation, and one case was referred to the Federal Protective Service for further investigation. The subject of one investigation was suspended, while the subject of another investigation took three days of leave without pay pursuant to an alternative discipline agreement. In addition, one employee resigned, and another employee's period of employment ended prior to completion of the investigation. One referral to Commission management remains pending.

At the close of the period, seven investigations were pending. The pending investigations included allegations of unauthorized disclosure, unauthorized use of assets, violation of post-employment restrictions, failure to disclose, time and attendance abuse, favoritism and theft of property. The most significant cases closed during the period are described below.

MISUSE OF COMPUTER RESOURCES

The Office developed evidence that a Commission employee had used the employee's government computer for a variety of personal purposes. These personal purposes included visiting sexually suggestive adult websites on the Internet. The employee was suspended for five days.

In another investigation involving the misuse of computer resources, we found evidence that a Commission employee had used the government computer assigned to him to access Internet websites containing adult pornography. The employee's period of employment ended prior to completion of the investigation and was not renewed.

CHILD PORNOGRAPHY

An employee had admitted that he visited websites containing child pornography from his government computer. The employee resigned before administrative action was taken. We referred the matter to the Federal Bureau of Investigation for further investigation.

UNAUTHORIZED DISCLOSURE

The Office investigated an allegation that a nonpublic Commission document had been disclosed without authorization to officials of a union that is seeking to represent Commission employees. After investigating the allegation, we were unable to determine how the union had acquired this document.

CONFLICT OF INTEREST

The Office investigated an allegation that a Commission staff member had an improper relationship with a subject of a Commission investigation. It was also alleged that the Commission staff member had provided information concerning the investigation to the subject. The evidence failed to substantiate the allegations.

Significant Problems

No new significant problems were identified during this period.

Significant Problems Identified Previously

SENSITIVE INFORMATION

During a prior period, we conducted an audit survey of management's controls for safeguarding sensitive information. The survey found that these controls required strengthening to enhance their effectiveness.

Management concurred and established a task force to implement corrective actions. According to management, significant improvements have already been made. For example, management has issued a policy to all employees on safeguarding sensitive nonpublic information and implemented new building access procedures. Management also indicated that it is working with a security consultant to make further improvements.

We intend to monitor the efforts to strengthen controls over sensitive information.

YEAR 2000

We completed an audit of the Commission's efforts to make its systems year 2000 compliant (see Audit No. 312 above). The scope of the audits included EDGAR and Commission internal systems, as well as non-information technology.

Based on the results of our audit and the passing of the millennium date without incident, we are dropping year 2000 compliance as a significant problem.

INFORMATION RESOURCES MANAGEMENT

Information resources management (IRM) remains a significant concern, particularly the areas of contracting for systems development and information resources planning.

Now that year 2000 remediation has been completed, Commission management has devoted more attention to strengthening these areas. Management has established a senior level information technology committee to oversee information technology policies and investments two years ago. OIT is implementing procedures for managing these policies and investments, according to management.

COLLECTION OF FILING FEES

A prior audit of the collection of filing fees confirmed the Commission's previous assessment that the management controls were not in material conformance with accounting standards. Although statutory changes have eliminated many of the fees most at risk and Commission management has made significant progress in correcting the most serious weaknesses, some corrective actions must await the implementation of a new computerized collection system.

Since 1996, the fee system has been in the process of being redesigned as part of EDGAR modernization. A working group of managers and users is working with the contractors and developers to ensure that the new fee system contains adequate financial controls and meets the agency's and filers' requirements. Until these corrective actions are fully implemented, the overall control structure will continue to fail to provide assurance that accountability over filing fees is adequate.

Access to Information

The Office of Inspector General has received access to all information required to carry out its activities. No reports to the Chairman, concerning refusal of such information, were made during the period.

Other Matters

EXECUTIVE COUNCIL ON INTEGRITY AND EFFICIENCY

The Office actively participates in the activities of the Executive Council on Integrity and Efficiency (ECIE). The Inspector General attends ECIE meetings, is an active member of its Financial Institutions Regulatory Committee, and serves as the ECIE member of the Integrity Committee established by Executive Order No. 12993.

The Counsel and Associate Counsel to the Inspector General are active members of the PCIE Council of Counsels. The Council considers legal issues relevant to the Inspector General community.

Questioned Costs

		DOLLAR VALUE (IN THOUSANDS)		
		<u>NUMBER</u>	<u>UNSUPPORTED COSTS</u>	<u>QUESTIONED COSTS</u>
A	For which no management decision has been made by the commencement of the reporting period	0	0	0
B	<i>Which were issued during the reporting period</i>	<u>0</u>	<u>0</u>	<u>0</u>
	Subtotals (A+B)	0	0	0
C	For which a management decision was made during the reporting period	0	0	0
(i)	Dollar value of disallowed costs	0	0	0
(ii)	Dollar value of costs not disallowed	0	0	0
D	For which no management decision has been made by the end of the period	0	0	0
	Reports for which no management decision was made within six months of issuance	0	0	0

Recommendations That Funds Be Put To Better Use

		<u>NUMBER</u>	<u>DOLLAR VALUE (IN THOUSANDS)</u>
A	For which no management decision has been made by the commencement of the reporting period	0	0
B	Which were issued during the reporting period	-	-
	Subtotals (A+B)	<u>0</u>	<u>0</u>
C	For which a management decision was made during the period	0	0
	(i) Dollar value of recommendations that were agreed to by management	0	0
	- Based on proposed management action	0	0
	- Based on proposed legislative action	0	0
	(ii) Dollar value of recommendations that were not agreed to by management	0	0
D	For which no management decision has been made by the end of the reporting period	0	0
	Reports for which no management decision was made within six months of issuance	0	0

Reports with No Management Decisions

Management decisions have been made on all audit reports issued before the beginning of this reporting period (October 1, 1999).

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, including “Funds Put to Better Use” and “Questioned Costs.”