



U.S. Securities and Exchange Commission
Office of Inspector General
Office of Audits

Audit of the Office of the Ethics Counsel's
Oversight of Employee Securities Holdings



December 10, 2014
Report No. 527



OFFICE OF
INSPECTOR GENERAL

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

MEMORANDUM

December 10, 2014

TO: Shira Pavis Minton, Ethics Counsel and Designated Agency Ethics Official, Office of the Ethics Counsel
Jeffery Heslop, Chief Operating Officer, Office of the Chief Operating Officer
Andrew Ceresney, Director, Division of Enforcement

FROM: Carl W. Hoecker, Inspector General, Office of Inspector General

SUBJECT: *Audit of the Office of the Ethics Counsel's Oversight of Employee Securities Holdings, Report No. 527*

Attached is the Office of Inspector General's (OIG) final report detailing the results of our audit of the Office of the Ethics Counsel's oversight of employee securities holdings. The report contains nine recommendations for corrective action that, if fully implemented, should help the U.S. Securities and Exchange Commission improve its efforts to review employee securities holdings, the functionality of the Personal Trading Clearance System, and the Office of the Ethics Counsel's annual compliance testing.

On November 19, 2014, we provided management with a draft of our report for review and comment. In its December 4, 2014, response, management concurred with our recommendations. We have included the response as Appendix II in the final report.

Management took immediate action to address Recommendations 1 and 2, which we verified prior to issuance of the final report. Therefore, those recommendations are closed for reporting purposes. The remaining seven recommendations remain open and will be closed upon completion and verification of the appropriate corrective action. Within the next 45 days, please provide the OIG with a written corrective action plan that addresses the open recommendations. The corrective action plan should include information such as the responsible official/point of contact, timeframe for completing required actions, and milestones identifying how your offices will address the recommendations.

We appreciate the courtesies and cooperation extended to us during the audit. If you have questions, please contact me or Rebecca L. Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects.

Attachment

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Executive Summary

Audit of the Office of the Ethics Counsel's Oversight of Employee Securities Holdings Report No. 527 December 10, 2014

Why We Did This Audit

The U.S. Securities and Exchange Commission (SEC) has responsibility for oversight of the securities industry and the protection of investors. To protect the public interest, it is essential that SEC employees maintain high standards of conduct. In August 2010, the SEC adopted a regulation that supplemented government-wide ethics standards. The supplemental ethics regulation addresses what investments SEC employees are allowed to make and when and how they conduct such transactions. Within the SEC, the Office of the Ethics Counsel (OEC) is responsible for advising and counseling employees and members on personal and financial conflicts of interest, financial disclosure, and securities holdings. We initiated this audit to evaluate OEC's effectiveness in ensuring employees comply with ethics regulations pertaining to prohibited holdings and temporarily-restricted trades.

What We Recommended

To improve the SEC's oversight of employee securities holdings, we made nine recommendations. The recommendations address improvements in the review of employment candidates' securities holdings, the functionality of the Personal Trading Clearance System, and OEC's annual compliance testing. Management concurred with the recommendations.

What We Found

To evaluate OEC's oversight of employee securities holdings, we reviewed SEC policies and procedures, assessed the operating effectiveness of OEC's internal controls, and evaluated OEC's annual compliance testing plan. OEC has developed and implemented policies and procedures in accordance with Federal laws and regulations, and has voluntarily implemented additional compliance processes. However, we identified areas for improvement in its oversight of employee securities holdings and transactions.

First, we identified improvements that are needed in OEC's review of Form 682, *Employee Filing Form* (Form 682). Specifically we noted instances of individuals commencing employment without OEC first reviewing their Form 682 for prohibited holdings. In instances when OEC identified prohibited holdings, OEC did not always follow up timely with new employees to confirm they divested prohibited holdings. Moreover, we found that OEC did not require employees to submit proof of divestiture and instead relied solely on employees' verbal or written confirmations.

Second, we found that the SEC's clearance system lacked certain functionality to help employees comply with the supplemental ethics regulation. For example, the system does not have a mechanism to identify and alert all employees who hold a certain security in the event that security becomes prohibited. Moreover, the system relies on incomplete information from the Division of Enforcement to process pre-trade requests. This increases the risk that the clearance system may erroneously approve a pre-trade request.

Third, we determined improvements are needed in OEC's annual compliance testing. Specifically, OEC's chosen sampling methodology for its 2014 annual compliance review will not allow OEC to gauge the compliance of all employees because the methodology will not allow the results to be projected.

During the course of our audit, we also identified other matters of interest, such as the need for OEC to update the March 2011 Ethics Handbook to reflect the new securities clearance system. We discussed these matters with OEC. These matters are further discussed in the report.

For additional information, contact the Office of Inspector General at (202) 551-6061 or http://www.sec.gov/about/offices/inspector_general.shtml.

TABLE OF CONTENTS

Executive Summaryi

Background and Objectives1
 Background1
 Objectives6

Results8
 Finding 1: Further Improvements Are Needed in OEC’s Review of
 Form 682, *Employee Filing Form*.....8
 Recommendations, Management’s Response, and Evaluation of Management’s
 Response11
 Finding 2: The Personal Trading Clearance System Lacks Certain Functionality to
 Help Employees Comply with the Supplemental Ethics Regulation13
 Recommendations, Management’s Response, and Evaluation of Management’s
 Response18
 Finding 3: Improvements Are Needed in Annual Compliance Testing20
 Recommendations, Management’s Response, and Evaluation of Management’s
 Response22

Other Matters of Interest23

Figures, Tables, and Charts
 Figure 1: OEC’s Process for Receiving and Reviewing Forms 682.....3
 Figure 2: Process for Pre-clearing, Confirming, and Reporting Securities Holdings5
 Table 1: Timeframe of OEC’s Follow-up with Employees10

Appendices
 Appendix I: Scope and Methodology24
 Appendix II: Management Comments.....30
 Appendix III: OIG Response to Management Comments.....33

ABBREVIATIONS

CFR	Code of Federal Regulations
DAEO	Designated Agency Ethics Official
Enforcement	Division of Enforcement
EPS	Ethics Program System
IRA	Individual Retirement Account
OEC	Office of the Ethics Counsel
OGE	Office of Government Ethics
OHR	Office of Human Resources

OIG	Office of Inspector General
PTCS	Personal Trading Compliance System
SEC	U.S. Securities and Exchange Commission

Background and Objectives

Background

Because the U.S. Securities and Exchange Commission (SEC) is responsible for investor protection and securities industry oversight, SEC members and employees¹ (collectively, employees) are prohibited from certain securities holdings and transactions. For example, employees cannot own interests in entities that are directly regulated by the SEC (prohibited holdings) or transact in securities of entities that are under SEC investigation (restricted securities). In addition, SEC employees are required to comply with Title 5 of the *Code of Federal Regulations* (CFR), Part 2635 - *Standards of Ethical Conduct for Employees of the Executive Branch*.

Within the SEC, the Office of the Ethics Counsel (OEC)² is responsible for advising and counseling employees on personal and financial conflicts of interest, financial disclosure, and securities holdings and transactions of employees. The Ethics Counsel, also known as the Designated Agency Ethics Official (DAEO), is responsible for, among other things: (1) maintaining and updating a record of securities that employees may not purchase or sell, or otherwise hold; and (2) administering the SEC's employee securities clearance system.³

In recent years, the SEC Office of Inspector General (OIG) has investigated several employees for conducting securities transactions that violate personal trading rules and regulations. In one instance, an SEC employee was charged with making false statements to the SEC regarding his ownership of various securities. Specifically, the employee failed to divest prohibited holdings and instead transferred the securities into a new joint brokerage account he shared with a family member and over which he had complete control. In another instance, the SEC OIG found that a staff accountant purchased shares of a prohibited holding, failed to pre-clear those transactions as required, and did not report the prohibited holding on the necessary government financial disclosure forms even though the value of the holding exceeded the reporting threshold. During the course of these and other investigations related to employees' ownership of prohibited holdings, the SEC OIG's Office of Investigations identified potential issues related to the manner in which OEC oversees employee securities holdings.

¹ The term "members" refers to the five SEC Commissioners. For the purpose of this report, the term "employee" also encompasses the holdings and transactions of an employee's spouse and unemancipated minor children.

² OEC was established in 2011 as an independent office reporting directly to the SEC Chair. Prior to that, OEC was part of the Office of the General Counsel.

³ The employee securities clearance system is the SEC's tool for clearing and tracking employee security transactions and holdings.

Federal Laws and Regulations. The U.S. Office of Government Ethics (OGE) established a comprehensive set of executive branch standards of ethical conduct (codified at 5 CFR Part 2635). OGE also required each U.S. government agency to have a DAEO to coordinate and manage the agency's ethics program and to provide a liaison to the OGE regarding all aspects of the program (5 CFR § 2638.201). On August 19, 2010, the SEC, with concurrence of OGE, adopted *Supplemental Standards of Ethical Conduct for Members and Employees of the Securities and Exchange Commission*, codified at 5 CFR Part 4401 (supplemental ethics regulation). The supplemental ethics regulation prohibits SEC employees from, among other things: (1) knowingly purchasing or holding a security or other financial interest in an entity directly regulated by the SEC; and (2) purchasing or selling any security issued by an entity that is under investigation by the SEC, a party to a proceeding before the SEC, or a party to a proceeding to which the SEC is a party.

In addition, the supplemental ethics regulation established employees' responsibilities for their security transactions and holdings. Generally, employees are required to:

- pre-clear all securities or related financial transactions and carry out transactions within 5 business days after clearance;
- report all securities purchases and sales within 5 days of receipt of confirmation of the transactions;
- hold a security (equity or fixed income instrument) for a minimum of 6 months from the trade date;
- report and certify all securities holdings according to the schedule established by the DAEO; and
- submit to the DAEO duplicate statements for every account containing reportable securities.

Appendix I summarizes other applicable Federal laws and regulations.

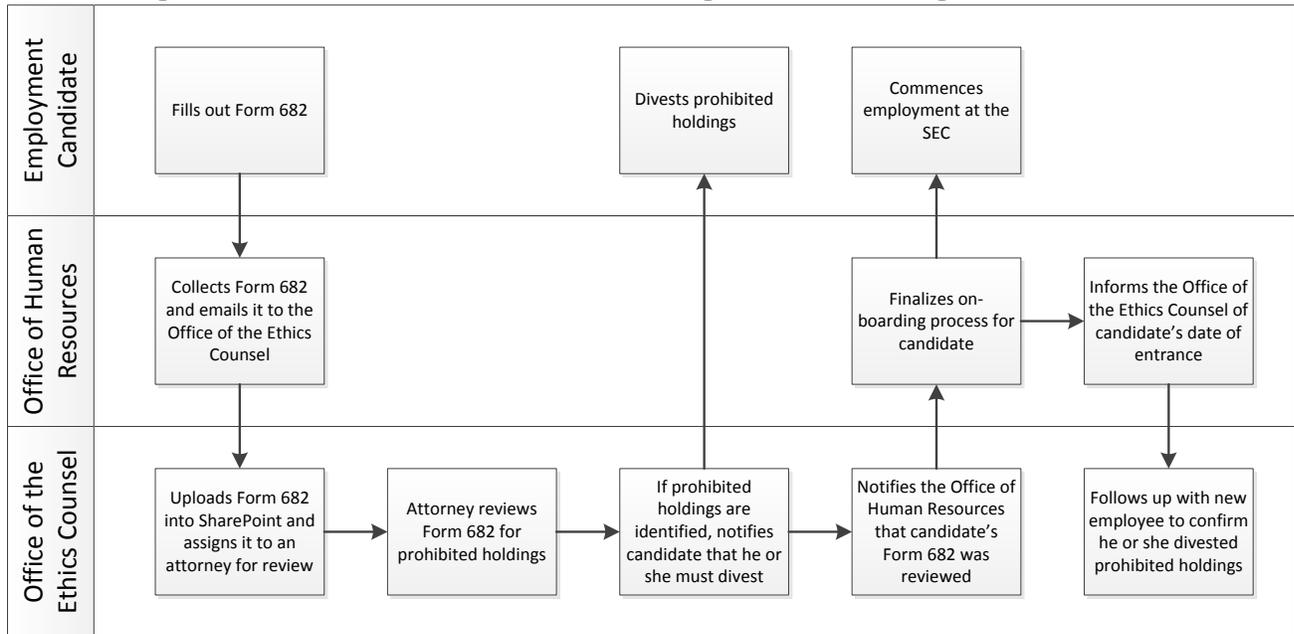
SEC Administrative Regulations, Policies, and Procedures. Following the adoption of the supplemental ethics regulation, OEC issued to employees a series of ethics bulletins that provided guidance on the new supplemental ethics regulation, advice on divesting securities that became prohibited under the supplemental ethics regulation, and resources available to employees facing the payment of taxes on potential capital gains resulting from the required sales of prohibited holdings. In March 2011, the DAEO issued an updated Ethics Handbook to reflect, among other things, the new policies under the supplemental ethics regulation. The Ethics Handbook included a chapter on the rules pertaining to securities holdings and transactions. Specifically, it

described prohibited holdings and transactions,⁴ pre-clearance and reporting requirements, holding periods, exceptions to the supplemental ethics regulation, waiver requests, and the process for divesting prohibited holdings.

Employment Candidates. The supplemental ethics regulation requires any person who receives a conditional offer of employment from the SEC to report all securities holdings on the form prescribed by the SEC. The SEC April 2011 Administrative Notice *I Have to File What? – A Guide to the Financial Disclosure Obligations of SEC Employees* further requires that all new employees of all grades and all positions list their securities holdings using SEC Form 682, *Employee Filing Form* (Form 682).

In 2011, the responsibility for reviewing Forms 682 transitioned from the Office of Human Resources (OHR) to OEC. The following figure details the process by which OEC receives and reviews Forms 682, per OEC’s standard operating procedures.⁵

Figure 1. OEC’s Process for Receiving and Reviewing Forms 682



Source: OIG-generated based on interviews of OEC personnel and reviews of standard operating procedures.

⁴ While the supplemental ethics regulation states that employees are prohibited from knowingly purchasing or holding a security or other financial transaction in an entity directly regulated by the SEC, it does not define what constitutes “an entity directly regulated by the [SEC].” The SEC March 2011 Ethics Handbook defines that phrase to include entities such as national securities exchanges; registered securities associations; broker-dealers, including banks and insurance companies that have subsidiaries that are registered broker-dealers; credit rating agencies; clearing agents; transfer agents; municipal advisors; securities information processors; and registered investment advisers.

⁵ U.S. Securities and Exchange Commission Standard Operating Procedure: Form 682, as of July 2014.

As shown in Figure 1 above, once new employees commence employment at the SEC, OEC follows up with them to confirm that they divested all prohibited holdings. OEC self-imposed a 10-business day timeframe from the date the employee commenced employment in which to follow up.

The SEC Securities Clearance System. In February 2012, the SEC issued Administrative Notice *Introducing the New Personal Trading Compliance System*, which requires employees to use the new securities clearance system, Personal Trading Compliance System (PTCS), to fulfill their obligations to pre-clear and report securities transactions. To assist employees in navigating PTCS, the SEC maintains an updated user manual that explains how to access PTCS, submit pre-trade requests, search for securities, and confirm transactions.⁶

Annual Certification. Generally, all employees are required to certify in PTCS each year their securities holdings. Also, employees are required to upload year-end brokerage statements containing reportable holdings.⁷ For 2013, the certification language was as follows: “I certify that I held securities as of December 31, 2013, and that I have not traded in securities using any confidential or material non-public information during calendar year 2013. I also certify that I have complied with the SEC Ethics Supplemental Regulation (5 CFR part 4401) including all pre-clearance, reporting and holding requirements and the rules regarding prohibited holdings. I have uploaded a complete record of my reportable holdings.”

Financial Disclosure Forms. Employees in certain positions are required to file either an OGE Form 450, *Confidential Financial Disclosure Report (Form 450)*,⁸ or an

⁶ Prior to PTCS, the SEC used a securities clearance system called the Ethics Program System (EPS). Similar to PTCS, EPS allowed employees to pre-clear and report transactions. On September 16, 2011, the SEC discontinued the use of EPS due to a potential data breach. Between September 2011 and February 2012, employees submitted pre-trade requests to OEC via e-mail.

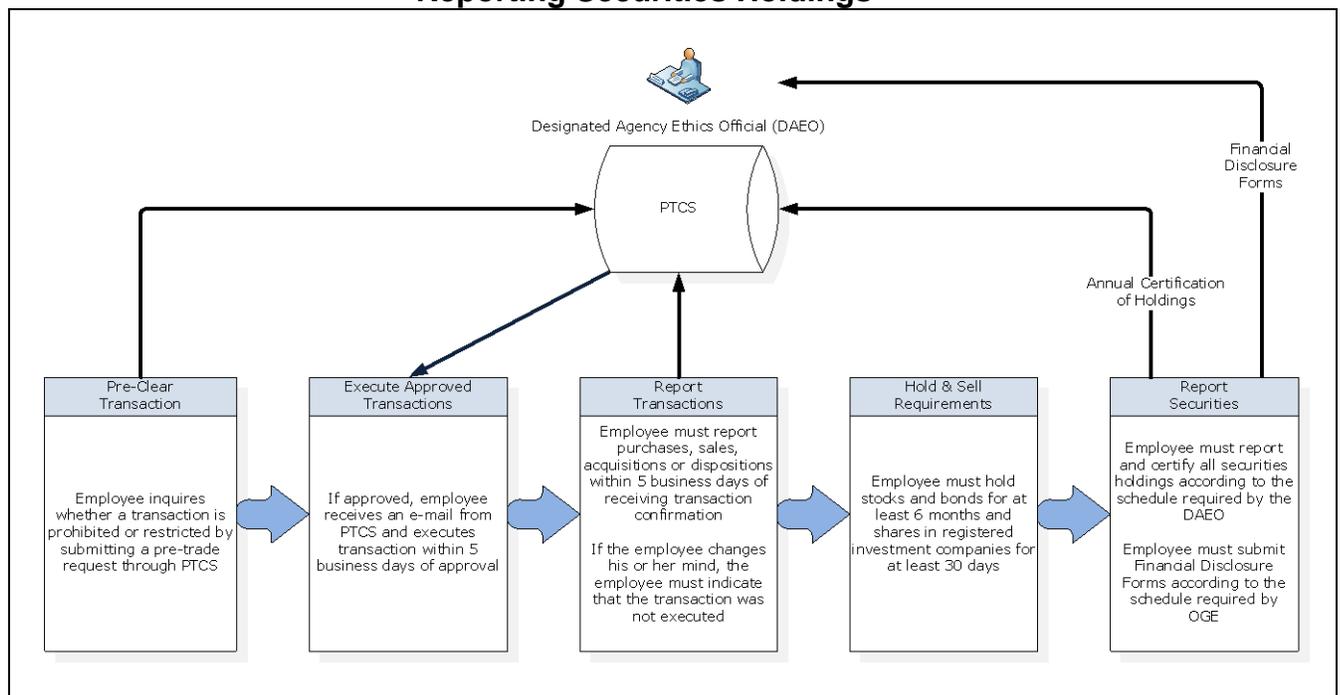
⁷ Reportable holdings include, but are not limited to, stocks; bonds; mutual funds and exchange traded funds that are held in brokerage accounts or mutual fund accounts or are the underlying holdings of individual retirement accounts (IRA), Roth IRA accounts, 401(k) plans or other former employer or spousal retirement plans; and 529 college savings plans. Employees are not required to report Federal Deposit Insurance Corporation-insured bank products, U.S. government agency securities, or Thrift Savings Plan holdings.

⁸ Form 450 must be filed annually by SEC employees in the following covered positions: SK-16 and SK-17 employees; SK-14 and SK-15 attorneys, auditors, financial analysts, information technology specialists, market surveillance specialists, and investigators; all accountants; examiners; financial economists; fellows (unless notified by OEC to file an OGE Form 278, Public Financial Disclosure Report); employees with the following Federal Acquisition Certifications (FAC): FAC-C (contracting), FAC-COR (Contracting Officer's Representatives), FAC-P/PM (program/project management); employees in the Office of Acquisitions; employees who have procurement authority; and credit card holders with purchasing authority.

OGE Form 278, *Public Financial Disclosure Report (Form 278)*.⁹ The purpose of both financial disclosure forms is to identify and prevent potential conflicts of interest by providing a systematic review of the financial interests of employees. OEC has further expanded the purpose of both forms to include a review for prohibited holdings. Generally, OGE requires employees to submit Form 450 and Form 278 to the DAEO by February 15 and May 15, respectively, each year.

Figure 2 below depicts the cycle employees undertake each year when buying or selling securities, confirming transactions, certifying their securities holdings, and filing financial disclosure forms.

Figure 2. Process for Pre-clearing, Confirming, and Reporting Securities Holdings



Source: OIG-generated based on the SEC Ethics Handbook and OEC standard operating procedures.

To assist employees in becoming familiar and complying with the supplemental ethics regulation, OEC provides employees with a variety of tools and resources. For example, new employees receive an approximately 1-hour presentation from OEC as part of new employee orientation. The presentation covers the supplemental ethics regulation, the applicability of the regulation, prohibitions, holding periods, and PTCS. New employees also receive an SEC New Employee Guide that contains guidance on

⁹ Form 278 and Form 278-T, *Periodic Transaction Report*, must be filed annually by Presidential Appointees; Senior Officers; Administrative Law Judges; the DAEO; Schedule C non-exempt appointees; Administratively Determined Pay System Appointees (who meet the 278 pay criteria); Special Government employees (who work a certain number of days and meet the 278 pay criteria); Intergovernmental Personnel Act Appointees (who are appointed to a covered 278 position); and employees acting in, promoted to, or resigning from one of the above positions.

reporting and pre-clearing financial interests and transactions. In addition, the new hire welcome e-mail contains a link to PTCS and the PTCS Quick Reference Guide. OEC has also developed ethics training which all employees are required to complete annually. Moreover, OEC maintains a website on the SEC intranet that contains examples of prohibited holdings, PTCS quick reference guides, frequently asked questions, the SEC Ethics Handbook, and links to various applicable laws.

Appendix I summarizes other SEC administrative regulations, policies, and procedures we reviewed during our audit.

Objectives

Our objective was to evaluate OEC's effectiveness in ensuring employees comply with ethics regulations pertaining to prohibited holdings and temporarily-restricted trades. Specifically, we sought to:

- determine whether OEC has developed and implemented policies and procedures that are in accordance with Federal laws and regulations, including 5 CFR § 4401.102, *Prohibited and restricted financial interests and transactions*;
- evaluate the operating effectiveness of internal controls¹⁰ designed and implemented by OEC over the employee securities transactions and holdings pre-clearance and reporting processes; and
- determine whether OEC has established a mechanism to ensure employee compliance with 5 CFR § 4401.102, *Prohibited and restricted financial interests and transactions*.

We interviewed the DAEO, Chief Compliance Officer, and other OEC employees to gain an understanding of OEC's program, internal controls, and policies and procedures. We reviewed relevant SEC administrative regulations, policies, and procedures and compared them to relevant Federal laws and regulations, including 5 CFR § 4401.102, to ensure the SEC incorporated all aspects of the Federal laws and regulations.

Further, we tested key internal controls to assess the effectiveness of processes and procedures OEC implemented. Specifically, we reviewed OEC's process for informing employment candidates that they have prohibited holdings which they must divest; tested the automated and manual controls of the SEC clearance system, which employees use to pre-clear trades; and assessed the completeness of information OEC relies on to process employees' pre-trade requests. We also evaluated OEC's annual compliance testing plan, which includes reviewing employees' financial disclosure forms

¹⁰ According to the Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, an internal control is any method or process implemented by an organization to achieve effectiveness and efficiency of operations and compliance with applicable laws and regulations.

and a sample of employees' brokerage statements. Specifically, we evaluated OEC's sampling methodology and the efficiency of its review.

Appendix I includes additional information on our scope and methodology; our review of internal controls; prior audit coverage; applicable Federal laws and regulations; and SEC regulations, policies, and procedures.

Results

Finding 1: Further Improvements Are Needed in OEC's Review of Form 682, *Employee Filing Form*

To ensure new employees comply with 5 CFR § 4401.102 and do not own prohibited holdings when they commence employment at the SEC, the SEC requires employment candidates to disclose all securities they own, including underlying securities holdings,¹¹ regardless of value, on Form 682. Since taking over the responsibility of reviewing Forms 682 sometime in 2011,¹² OEC has worked to improve the process for receiving and reviewing the forms by developing and implementing an automated workflow using Microsoft SharePoint.¹³ Specifically, once OEC receives from OHR a new employee's Form 682, the automated workflow allows OEC to upload the form into SharePoint and assign an attorney to review it. Within SharePoint, the attorney indicates whether any prohibited holdings were identified. Once the review is complete, an automated e-mail is sent to OHR verifying that the form has been reviewed, therefore indicating that OHR can continue with the on-boarding process.

Our audit found that OEC is reviewing Forms 682; however, improvements are needed in the review process and in the follow-up with new employees. Specifically, we determined the following:

- since 2011, 9 out of almost 1,000 new hires commenced employment without OEC first reviewing their Form 682 for prohibited holdings;
- OEC did not always follow up with employees within 10 business days of their start date to confirm they divested all prohibited holdings; and
- OEC did not require employees to submit proof of divestiture and instead relied solely on employees' verbal or written confirmations.

According to the DAEO, these conditions occurred because OEC (1) either did not receive all Forms 682 from OHR or, in one instance, did not review the form that was received; (2) did not receive timely or accurate information from OHR; and (3) lacked adequate human resources. As a result, the SEC lacks effective controls to ensure that all new employees comply with the supplemental ethics regulation.

¹¹ Underlying securities holdings are the assets that comprise an account, such as a 401(k) account or IRA.

¹² OEC could not provide the exact date it became responsible for reviewing Form 682. For the purpose of our audit, we used January 1, 2011, as a baseline date.

¹³ Microsoft SharePoint is a web application platform that integrates intranet, content management, and document management, among other things.

OEC Did Not Review Form 682 for All New Employees Since 2011. Between January 2011 and June 2014¹⁴ – since OEC took over the responsibility of reviewing Forms 682 – nearly 1,000 employees joined the SEC. We reviewed OEC’s records to gain reasonable assurance that it had reviewed a Form 682 for each new employee during that period. Because OEC did not begin uploading Forms 682 into SharePoint until December 2012 and did not finalize the automated workflow in SharePoint until February 2014, during our audit, OEC was still in the process of uploading into SharePoint Forms 682 it had reviewed prior to December 2012. We found that OEC did not have a record of reviewing a Form 682 for 9 of the nearly 1,000 new employees. For eight of the nine employees (including a Senior Officer), OEC informed us that it did not have a record of ever receiving a Form 682 from OHR. According to the DAEO, tracking of Forms 682 prior to the use of SharePoint was “not nearly as good” and OEC had not yet established a coordinated system for Form 682 transmission and review. We confirmed all eight employees joined the SEC before December 2012. We were informed that one of the eight employees, who joined the SEC in January 2011, held prohibited securities acquired prior to commencing employment at the SEC. OEC only identified these prohibited holdings after the employee contacted OEC in January 2013 to ask about the particular securities.¹⁵ Based on a review of their most recent brokerage statements as of the date of our audit, the DAEO confirmed that the other seven employees did not hold any prohibited securities.

Although we found that eight of the nine employees for whom OEC did not have a record of reviewing Form 682 joined the SEC before December 2012, we found that the remaining employee commenced employment with the SEC in April 2014 – after the SharePoint automated workflow was finalized. According to the DAEO, OEC received the employee’s Form 682 from OHR but did not upload it to SharePoint. As a result, an OEC attorney was never assigned to review the form. Nevertheless, OHR continued with the on-boarding process even though it did not receive confirmation from OEC that the employee’s Form 682 had been reviewed. According to OHR, this was due to human error. We did not identify any other similar instances.¹⁶

OEC Did Not Always Timely Follow up to Confirm New Employees Divested Prohibited Holdings. Since October 2012, OEC has identified prohibited holdings in its review of Form 682 for 125 new employees. We selected a random sample of 20 of those employees to determine whether OEC followed up within 10 business days from the employees’ first day of work to confirm they divested the prohibited holdings. We were able to independently confirm that OEC followed up with 18 of the 20 employees

¹⁴ Our testing period was between January 1, 2011, and June 9, 2014.

¹⁵ On January 18, 2013, OEC referred this matter to the OIG.

¹⁶ After being alerted to the situation, OEC obtained and reviewed the employee’s Form 682 and found no prohibited securities.

via e-mail.¹⁷ Of the 18 we confirmed, OEC did not follow up with 14 employees within the established 10-business day period. Table 1 shows the range of business days from the 18 employees' start dates to the dates of OEC's follow up.

Table 1. Timeframe of OEC's Follow-up with Employees

No. of Business Days from Employee's Start Date	No. of Instances
0-10	4
11-30	4
31-100	8
More than 100	2

Source: OIG's review of OEC's e-mail correspondence with employees.

In two instances it took OEC 206 and 292 business days (or about 10 months and 14 months, respectively) after the employees began working at the SEC to follow up with them.¹⁸ We found this occurred because OEC relied on the annual Form 450 review process to follow up with these employees.

According to the DAEO, OEC has found it impossible to consistently meet its own requirement of following up with employees within 10 business days due to the difficulty in identifying an employee's start date. As of August 2014, OEC received lists of new employees from OHR every 2 weeks. However, according to OEC, there is often a lag of up to a month between an employee's start date and his or her inclusion on the list. In addition, OEC stated that employees' start dates as reflected in the lists may be inaccurate. As such, in September 2014 OEC removed the 10 business day period from its standard operating procedures and is instead working to verify divestiture "as soon as practicable;" however, the term "practicable" is undefined.

At the time of our audit, OEC was working with OHR to improve the frequency and accuracy of employee on-boarding lists to improve OEC's follow-up processes. During an August 12, 2014, meeting between OHR and OEC, OHR agreed to send OEC lists from its Workforce Transformation Tracking System, which monitors hiring activity with automated interfaces to the Federal Personnel Payroll System, USA Staffing, Enter on Duty System, and the Electronic Official Personnel Folder.

¹⁷ OEC told us that it followed up via telephone with one of the two employees whom we were unable to confirm. However, because OEC does not maintain phone logs, we were unable to verify that this occurred or that the employee confirmed divestiture. In the case of the second employee, OEC was unable to provide evidence that it followed up because, prior to the implementation of SharePoint, OEC stored data in different places and follow-ups were not always coordinated among OEC personnel. We confirmed that the SharePoint automated workflow now allows OEC attorneys who review Forms 682 to check a field labeled "divestiture required" to indicate which employees OEC must follow up with to confirm prohibited holdings have been divested.

¹⁸ In the other 12 instances, OEC's follow up occurred between 12 and 64 business days after the employees began working at the SEC.

OEC Did Not Require Employees to Submit Proof of Divestiture. Prior to September 2014, OEC did not require employees to submit proof that they divested prohibited holdings. As part of our review of OEC's follow up with employees, we found that all 18 employees with whom OEC followed up confirmed via e-mail to OEC that they divested their prohibited holdings. In two instances, the employees offered to provide OEC proof of divestiture. However, OEC did not collect proof and instead relied on the employees' verbal or written confirmation. The DAEO stated that, in the past, OEC did not have adequate human resources to obtain proof of divestiture. According to OEC, beginning in September 2014, its standard operating procedures require proof of divestiture.

The SEC Lacks Effective Controls to Ensure that All New Employees Comply With the Supplemental Ethics Regulation

Although OEC has worked to significantly improve the process for receiving and reviewing Forms 682 since it took over this responsibility, we found that further improvements can be made to ensure new employees comply with the supplemental ethics regulation. Because OEC is supposed to review Form 682 for all candidates regardless of position or grade level, we believe this process represents the most ideal opportunity to ensure all new employees divested prohibited holdings. We recognize that in some instances, new employees may not be able to divest prohibited holdings until after they commence employment. Therefore, it is critical that OEC follow up with new employees timely to confirm divestiture, or as a second reminder of their requirement to comply with the supplemental ethics regulation. As such, we believe OEC's new guidelines – which require follow-up to be completed “as soon as practicable” – are indefinite and could allow an employee to retain known prohibited securities beyond a reasonable time. By not reviewing Forms 682 for all employment candidates, following up timely with employees to confirm they divested prohibited holdings, and requiring proof of that divestiture, OEC cannot ensure that new employees are complying with the supplemental ethics regulation, which is the goal of OEC's process.

Recommendations, Management's Response, and Evaluation of Management's Response

To improve the process by which the Office of the Ethics Counsel receives and reviews Forms 682 to help employees comply with the supplemental ethics regulation, we recommend that:

Recommendation 1: The Office of Human Resources update its policies and procedures for on-boarding new staff to require confirmation from the Office of Ethics Counsel regarding its review of an employment candidate's Form 682 prior to completing the on-boarding process.

Management's Response. The Office of Human Resources concurred with the recommendation and, along with the Office of the Ethics Counsel, developed

joint standard operating procedures for processing Forms 682. The standard operating procedures require the Office of Human Resources to receive confirmation from the Office of the Ethics Counsel regarding its review of Form 682 prior to completing the on-boarding process.

OIG's Evaluation of Management's Response. The recommendation is resolved and closed based on verification of management's corrective action.

Recommendation 2: The Office of the Ethics Counsel document a process with the Office of Human Resources to obtain timely and accurate information regarding new employees that allows follow-up to occur within a prescribed timeframe.

Management's Response. The Office of the Ethics Counsel and the Office of Human Resources concurred with this recommendation. The Directors of the Office of the Ethics Counsel and the Office of Human Resources issued a joint memorandum to their respective staff documenting the process they should follow for obtaining timely and accurate information from new employees that will assist with follow-up occurring within a prescribed timeframe.

OIG's Evaluation of Management's Response. The recommendation is resolved and closed based on verification of management's corrective action.

Recommendation 3: The Office of the Ethics Council update SEC policies and procedures and inform employees of the requirement to submit proof that they have divested prohibited holdings.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation and updated its standard operating procedures for processing Forms 682 to include a requirement that employees submit proof of divestiture. Attorneys from the Office of the Ethics Counsel track required divestiture in an electronic database and do not close out the entry until proof is received.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; however, management should also update the Ethics Handbook to inform all employees – not just new employees – of the requirement to submit proof when divesting prohibited holdings. The recommendation is resolved and will be closed upon completion and verification of the action taken.

Finding 2: The Personal Trading Clearance System Lacks Certain Functionality to Help Employees Comply with the Supplemental Ethics Regulation

In February 2012, the SEC launched an in-house securities clearance system called PTCS. As previously mentioned, all employees are required to use PTCS to pre-clear and report all securities transactions. PTCS utilizes Microsoft technologies to provide users with the ability to initiate, process, comment on, and submit pre-trade requests, confirmations, and annual certifications of holdings to the SEC. PTCS processes pre-trade requests based on programmatic business rules and criteria identified by OEC. Specifically, PTCS compares the data in the pre-trade request to lists of prohibited and restricted securities. In some instances, PTCS requires OEC employees to manually process pre-trade requests, such as when it identifies a security to be potentially restricted based on the list of potentially restricted securities OEC receives from the Division of Enforcement (Enforcement).

Our audit found that PTCS lacks certain functionality that would help employees comply with the supplemental ethics regulation. Specifically, we determined that:

- PTCS cannot readily identify employees who hold securities that become prohibited;
- ticker information from Enforcement's case management system, which OEC relies on to process pre-trade requests, is incomplete and creates a risk that pre-trade requests may be erroneously approved;
- the securities data feed from the current external provider is incomplete and has resulted in manual data entry for almost 3,000 securities; and
- PTCS does not use existing information to verify required securities holding periods when employees submit pre-trade requests to sell securities.

These conditions occurred because OEC relies on mitigating controls; the SEC has not formalized Enforcement's role in identifying and rejecting requested trades of prohibited securities; and the agency has not maximized the use of a securities clearance system. As a result, the SEC cannot fully rely on PTCS to help employees comply with the supplemental ethics regulation.

PTCS Cannot Readily Identify Employees Who Hold Securities that Become Prohibited. Generally, employees are required each year to upload into PTCS year-end brokerage statements and certify that they have complied with the supplemental ethics regulation. However, at the time of our audit, PTCS did not have optical character recognition capability and as such could not use employees' uploaded brokerage statements to identify prohibited holdings. As a result, when securities become prohibited, PTCS cannot identify all employees who hold that security and automatically notify them to divest or seek a waiver. PTCS also functions as a

repository for confirmed transactions; however, even though technically feasible, OEC did not search those confirmed transactions to identify employees who had purchased securities that later became prohibited.

When asked about PTCS's capability to help employees comply with the supplemental ethics regulation, OEC officials told us that it is the responsibility of each employee to know if the securities he or she holds become prohibited. Further, OEC officials believe that actions taken by OEC help employees identify holdings that may become prohibited. Such actions include:

- (1) publishing a list of prohibited securities so that employees can review their own holdings and take necessary action;
- (2) reviewing employees' annual financial disclosure forms to identify prohibited holdings; and
- (3) conducting annual compliance testing of selected employee holdings to identify any that are prohibited.

However, these controls do not necessarily ensure that prohibited holdings will be identified.

First, to assist employees, OEC publishes a list of prohibited holdings on its intranet site. OEC updates the list periodically (usually monthly) and highlights new additions to the list. However, the list is not all-inclusive and OEC includes the following disclosure at the top of the list: "This is not an exhaustive list – it is possible that a holding may be prohibited, but may not appear on this list."

Second, as stated in footnotes 8 and 9, only employees in certain covered positions are required to file annual financial disclosure forms. Although as of June 2014, about 80 percent of the SEC's employees were required to do so, the remaining 20 percent were not. Moreover, because the financial disclosure forms only require employees to report assets over a certain dollar threshold, prohibited holdings under those thresholds would go undetected.

Third, OEC's 2014 annual compliance testing was designed to review brokerage statements for only 10 percent of employees from selected offices. Because OEC selects employees from those offices randomly, the possibility exists that some employees will not undergo any type of review from OEC. This issue is further discussed in Finding 3 on page 20.

OEC Relies on Incomplete Ticker Information from Enforcement's Case Management System to Process Pre-trade Requests. Under the supplemental ethics regulation, employees are prohibited from purchasing or selling any security issued by an entity that is under investigation by the SEC, a party to a proceeding

before the SEC, or a party to a proceeding to which the SEC is a party.¹⁹ OEC developed an internal control within PTCS to identify and reject requested trades on securities that meet this definition using ticker information reflected in Enforcement's case tracking system, the Hub. However, we determined that ticker information in the Hub is incomplete and the SEC has not formalized Enforcement's role in helping OEC identify and reject requested trades of prohibited securities.

Specifically, officials from OEC and Enforcement determined in 2010 that information from the Hub was the best source for identifying entities that are related to an SEC investigation. To assist OEC in obtaining information needed to review employee trade requests, Enforcement added a ticker field to the Hub and developed a data feed of ticker information from active matters²⁰ that is submitted daily to OEC. This list, which OEC calls the Watch List, is then manually uploaded into PTCS by OEC. Each time an employee submits a pre-trade request, PTCS attempts to match the security in question to the Watch List based on pre-determined matching criteria. If a match exists, an OEC employee manually processes the pre-trade request by reviewing case details in the Hub.

Because there is no secondary source for this information, OEC must rely on the Watch List to identify possibly restricted securities. As such, the Watch List must be complete. However, as designed, the Watch List only includes entities that have ticker symbols in the Hub and the Hub does not include a system control that requires information in the ticker symbol field. Rather, Enforcement employees have been required by their management to use the ticker symbols search feature when entering in the Hub entities that are public companies.²¹ In 2010, Enforcement's Managing Executive informed employees that doing so provides a reliable means to identify each public company through its ticker symbol, and that such information is needed as part of OEC's oversight of employee securities holdings. Despite management's requirements, according to Enforcement officials, as of September 24, 2014, there were at least 144 entities labeled as issuers²² in the Hub for which no ticker symbol was present. Although Enforcement did not provide the total number of entities listed as issuers in the Hub, Enforcement informed us these 144 entities are contained within 50 active matters out of the 1,913 total active matters as of that date. Therefore, approximately 3 percent

¹⁹ 5 CFR § 4401.102(c)(7).

²⁰ "Active matters" are Enforcement investigations or Matters Under Inquiry that have a status other than void or closed completely.

²¹ A September 2009 Hub Release Guide required Enforcement staff to use the ticker search feature when entering in the Hub related parties that are public companies. The guide further explains how entering a public entity includes incorporation of the ticker symbol.

²² "Issuers" in the Hub may include issuers of publicly-traded or non-publicly traded securities, entities that ceased issuing publicly-traded securities within the time a matter was open, and entities improperly assigned this label.

of total active matters contain at least one entity labeled as an issuer for which no ticker symbol was present.²³

While the DAEO acknowledges that the Watch List may be incomplete and there are risks to relying on this source of information, we believe that OEC does not have any alternative for obtaining this information.

An example of the potential impact of incomplete Watch List information was documented in a February 2014 draft academic study titled *Stock Picking Skills of SEC Employees* conducted by a professor at Emory University and a PhD student at Georgia State University. The study stated that 87 trades were executed by SEC employees in advance of an enforcement action against the security's issuer – presumed by the study's authors to be the period in which the issuers were under investigation – suggesting violations of the supplemental ethics regulation. However, we found that 8 of the 87 trades were executed during an open investigation of the security's issuer due to failure of the Watch List as an internal control.²⁴ We found that each of the 8 trades was automatically approved by EPS (replaced by PTCS in February 2012) because the data feed did not identify the entity as an issuer due to a lack of ticker information in the Hub. The employees were not in violation of the supplemental ethics regulation because they obtained approval for the trades.

Securities Data Feed from External Data Provider is Incomplete. When entering a pre-trade request in PTCS, employees can search for a security using the ticker symbol, security name, or CUSIP number²⁵ and the system's "Search for Security" auto-fill search function. Selecting a security from the search results automatically populates the security information in the pre-trade request. If an employee is unable to locate a specific security, he or she has to manually enter the security's information and, as a result, an OEC employee is required to manually process the pre-trade request.

As noted above, the supplemental ethics regulation requires the DAEO to administer the SEC's employee securities clearance systems. To do so, OEC obtains the securities data that drives PTCS' auto-fill search function from an SEC contract with an external vendor. This vendor's data is used agency-wide. However, the securities data did not allow PTCS to function as automatically as designed. According to SEC employees, the current data feed often abbreviates company names and excludes international securities. As a result, securities for which employees seek pre-trade clearance may not appear as an auto-fill option, requiring employees to type in the

²³ These figures were provided to us by Enforcement, without independent validation.

²⁴ Our review of the remaining 79 trades found no violation of the supplemental ethics regulation. For example, most were executed before the implementation of the supplemental ethics regulation, while others were the subject of waivers.

²⁵ A CUSIP [Committee on Uniform Securities Identification Procedures] number is a nine-digit alphanumeric code that identifies a North American financial security for the purposes of facilitating clearing and settlements of trades.

security's information. Since the inception of PTCS, employees have had to manually enter information for many securities when submitting pre-trade requests. Each requested trade manually entered by an employee seeking clearance has to be manually processed by OEC staff. To provide a more robust security feed and reduce the number of manually processed trades, in 2013 OEC employees voluntarily supplemented the external data feed by manually entering into PTCS information for nearly 3,000 securities. In our opinion, the incompleteness of the securities data feed unnecessarily increases OEC's staff workload – both by requiring staff to manually enter securities information into PTCS and to manually process pre-trade requests.

Because the securities data feed used by other SEC offices does not meet OEC's needs, OEC is procuring a new, more complete data feed that will improve the effectiveness and efficiency of the pre-clearance process. OEC anticipates implementing the new feed by January 2015. The new data feed should reduce or eliminate the need for OEC employees to manually enter security information into PTCS and should reduce the number of manually processed trades.

PTCS Does Not Verify Securities Holding Periods Using Existing System Information. The supplemental ethics regulation requires that employees hold a security purchased after commencement of employment with the SEC for a minimum of 6 months from the trade date.²⁶ When employees submit a pre-trade request to sell a security, PTCS requires employees to enter the purchase date for that security. If the period between the purchase date and the pre-trade request date does not meet holding period requirements, PTCS rejects the pre-trade request. While OEC has created this system control to help ensure employees comply with holding period requirements, the control is effective only to the extent that employees enter and certify the correct purchase date. We found that PTCS does not have the capability to independently verify the purchase date by comparing the security associated with the pre-trade request to the employee's current securities in PTCS. We note that PTCS was launched in February 2012 and only maintains securities purchased by employees since its implementation. Because data from the previous system was not migrated, PTCS would be unable to verify initial purchase dates for securities purchased prior to February 2012. However, for securities purchased after February 2012, PTCS contains but does not use purchase date information to automatically ensure employees comply with holding period requirements.

The SEC Cannot Fully Rely On PTCS to Support Employees In Complying With the Supplemental Ethics Regulation

Although OEC implemented and maintains a securities clearance system that allows employees to pre-clear, confirm, and report securities transactions and holdings, we

²⁶ This holding period does not apply to securities sold for 90 percent or less of the original purchase price, securities with an initial term of less than 6 months that are held to term, and money market funds. Moreover, employees are required to hold shares in registered investment companies for a minimum of only 30 days.

found that PTCS lacks certain functionality to help employees fully comply with the supplemental ethics regulation. Because PTCS has been operational for over 2 years and given the ample resources OEC provides employees on how to use PTCS, we believe employees have had sufficient time and have been provided sufficient information to become familiar with the system. However, by not ensuring PTCS has the capability to readily identify employees with prohibited holdings, process pre-trade requests based on a complete Watch List, provide employees with complete securities data, or use information already in the system to confirm that employees have met minimum holding periods; the SEC has not maximized its use of a securities clearance system. As a result, PTCS has limited capability to help employees comply with the supplemental ethics regulation.

Recommendations, Management's Response, and Evaluation of Management's Response

To improve PTCS and help employees comply with the supplemental ethics regulation, we recommend that:

Recommendation 4: The Office of the Ethics Counsel develop a method to use employee brokerage statements to identify all employees holding prohibited securities.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation and has partnered with the Office of Information Technology to procure an optical character recognition tool in the Personal Trading Compliance System. The Office of the Ethics Counsel and the Office of Information Technology are testing a trial offer.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Recommendation 5: The Division of Enforcement establish an internal control or mechanism to ensure ticker symbols are included in the Hub and remind its employees of the current requirement. Additionally, the Division of Enforcement and the Office of the Ethics Counsel should determine the viability of using related name information in the Personal Trading Compliance System to identify potentially restricted securities.

Management's Response. The Division of Enforcement concurred with this recommendation and has undertaken work to improve the relevant data quality in the Hub. The Division of Enforcement reviewed the information provided to the Office of Inspector General detailing the relevant population of issuer entities and the specific entities where no ticker was present. The Division of Enforcement identified a subset of the specific entities where a ticker exists, and added the ticker information in the Hub. In a division-wide message sent on December 1, 2014, staff was reminded of the requirement to use the ticker search feature when entering public companies in the Hub.

Moreover, the Division of Enforcement has also begun development of an enhanced report that provides the names of all relevant entities in the Hub to supplement the ticker information provided daily to the Office of the Ethics Counsel. The Division of Enforcement will coordinate with the Office of the Ethics Counsel on the viability of using the enhanced report, or other means of drawing on entity name information, in the Office of the Ethics Counsel's identification of securities where employees are potentially prohibited from trading.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Recommendation 6: The Office of the Ethics Counsel obtain a securities data feed for the Personal Trading Compliance System that reduces the risk that pre-trade requests will have to be manually processed.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation. As stated in the report, the Office had identified this issue and has been diligently working to correct it. In September 2014, a contract was awarded to a vendor that can provide a more robust securities master list. It is currently being tested by the Office of Information Technology.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Recommendation 7: The Office of the Ethics Counsel consider the feasibility of using all data available in the Personal Trading Compliance System to confirm that employees have met minimum holding period requirements.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation and will consider the feasibility of using existing data to confirm that employees have met the minimum holding period requirements.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Finding 3: Improvements Are Needed in Annual Compliance Testing

Although not required by regulation, OEC implemented a compliance testing program in May 2012 with the stated objective of ensuring employees are complying with the supplemental ethics regulation with respect to holdings, transactions, and reporting of personal securities. Since then, OEC has submitted annually a written compliance testing plan to the SEC Chair detailing its methodology for that particular year. Generally, OEC has selected employees from various SEC offices and divisions for testing, which includes reviewing employees' brokerage statements or financial disclosure forms to identify instances of failure to pre-clear trades or holding prohibited securities. In 2012, OEC randomly selected 166 employees from 25 SEC offices and divisions and identified 29 violations (or about 17 percent). In 2013, OEC conducted similar testing but instead selected 1,296 employees from 10 SEC offices and divisions and found 43 violations (or about 3 percent).

OEC submitted its 2014 testing plan to the SEC Chair in November 2013. According to its plan, OEC intended to begin testing in April 2014 with the following goals:

- (1) to test 100 percent of employees using Form 450 or Form 278 to identify prohibited holdings; and
- (2) to test a minimum of 10 percent of employees using their brokerage statements to identify prohibited holdings and employees' failure to pre-clear trades.

Although OEC's compliance testing program has allowed OEC to identify and address violations,²⁷ its 2014 testing plan may preclude OEC from meeting its stated objective of ensuring employees comply with the supplemental ethics regulation in at least two ways.

First, as of October 2014, OEC was at risk of not meeting its target date of year's end to complete its review of Forms 450, which OEC informed us it relies on, in part, to conduct its sample testing.²⁸ Because OEC did not have in 2014 the human resources to review financial disclosure forms, brokerage statements, and PTCS transactions to identify prohibited holdings for each employee, it determined that the highest level of assurance could be gained by reviewing 100 percent of Forms 450. However, OEC was only able to assign one attorney to review the over 3,200 Forms 450 that were filed

²⁷ Violations, or non-compliance with the supplemental ethics regulation, were generally cleared by counseling employees, instructing employees to divest or seek a waiver, or referring the violations to the OIG.

²⁸ Our scope of testing was 2014 Forms 450 that were due to OEC on February 18, 2014, and reviewed by OEC as of October 2014.

by SEC employees in 2014. As of October 2014, OEC had reviewed just over 50 percent of all Forms 450 for prohibited holdings.²⁹

Second, as in 2012 and 2013, OEC's use of a non-statistical sample in 2014 will prevent OEC from concluding that violations identified are representative of an agency-wide rate of violations and, therefore, no conclusion or trend analysis may be made over time based on these results. In 2014, OEC's testing plan stated that OEC would test 10 percent of employees from 9 SEC offices and divisions.³⁰ As of June 2014, this equated to 146 employees. As of that same date, there were over 4,100 employees at the SEC. This means that OEC's testing sample will assess employee compliance with the supplemental ethics regulation for only about 4 percent of all employees.

By not being able to timely determine the degree to which all of its employees are in compliance with the supplemental ethics regulation, the SEC cannot adjust its approach to compliance accordingly. During our audit, the DAEO recognized the benefit of a representative sample and agreed to develop a testing plan for 2015 that would allow OEC to conclude on agency-wide compliance with the supplemental ethics regulation.

OEC's Compliance Testing Program May Not Achieve Its Objective

Although OEC has voluntarily implemented an annual compliance testing program that exceeds the requirements of the supplemental ethics regulation, we found that OEC can improve the program's effectiveness and efficiency in order to better ensure employee compliance with the supplemental ethics regulation. Because employees are required annually to certify their securities holdings, submit brokerage statements and report all purchases and sales of securities, and file Forms 450 and Forms 278 (as applicable), we believe OEC has the necessary information to determine whether employees hold any prohibited securities or have failed to pre-clear transactions. We acknowledge that performing an in-depth review using all information available for all employees is not feasible given OEC's resources. However, by not implementing a well-developed compliance testing plan that simultaneously ensures efficient use of resources and sufficient agency coverage, OEC cannot gauge employee compliance agency-wide or compare results from year to year in order to adjust its operations.

²⁹ On November 12, 2014, the DAEO stated that additional resources, including a new OEC attorney, were assigned to assist with the review of Forms 450. Consequently, the DAEO believes the review will be completed by the stated deadline.

³⁰ Over the 3 years, OEC has attempted to select different offices and divisions for its annual compliance testing. For example, offices and divisions selected for 2014 included those not selected for testing in 2013. In 2014, the selected offices and divisions were as follows: Fort Worth Regional Office, Los Angeles Regional Office, Philadelphia Regional Office, Salt Lake Regional Office, San Francisco Regional Office, Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and the Office of International Affairs. OEC will test 10 percent of randomly selected employees from each of these offices and divisions.

Recommendations, Management's Response, and Evaluation of Management's Response

To improve the efficiency and effectiveness of its annual compliance testing program, we recommend that:

Recommendation 8: The Office of the Ethics Counsel develop a statistical sampling plan for its compliance testing program to be able to assess agency-wide compliance with the supplemental ethics regulation.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation and has partnered with the Division of Economic and Risk Analysis to determine a testing sampling protocol for all future compliance testing. The Office of the Ethics Counsel expects to deploy the new sampling method in 2015.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Recommendation 9: The Office of the Ethics Counsel combine its review of Forms 450 with the current compliance testing.

Management's Response. The Office of the Ethics Counsel concurred with this recommendation and will implement it in the compliance testing starting in 2015.

OIG's Evaluation of Management's Response. Management's proposed actions are responsive; therefore, the recommendation is resolved and will be closed upon completion and verification of the action taken.

Other Matters of Interest

During the course of our audit, we identified other matters of interest that did not warrant recommendations. We discussed these matters with OEC.

SEC and OEC Policies and Procedures Incorporate All Aspects of Applicable Federal Laws and Regulations. As part of our audit objectives, we reviewed relevant SEC policies and procedures and compared them to relevant Federal laws and regulations, including 5 CFR § 4401.102, to ensure the SEC incorporated all aspects of the Federal laws and regulations. We found that the SEC has developed and implemented policies and procedures in accordance with Federal laws and regulations, including the supplemental ethics regulation. Therefore, we have no findings or recommendations related to this audit objective.

OEC Should Determine the Propriety of Sharing its Prohibited Holdings List Outside the SEC and Include Its Qualifying Statement on All Pages of the List. OEC periodically updates a list of prohibited holdings and makes it available to employees for their reference. However, OEC has not issued guidance to employees regarding whether employees may share this list with spouses or investment advisors. OEC should work with the Office of General Counsel to determine the propriety of sharing this list outside of the SEC.

Additionally, we recognize that OEC's list of prohibited holdings includes a qualifying statement reminding employees that the list is not exhaustive and that a holding may be prohibited but not included on the list (see page 14 of this report). However, this statement appears only on the first page of the list. If an employee were to print only one page of the list, there is a risk that the qualifying statement would be missed and an employee could over-rely on the completeness of the list. OEC should include the qualifying statement on each page of the list.

The Ethics Handbook Does Not Reference the New Clearance System. The SEC's Ethics Handbook effective at the time of our audit was dated March 2011 and referred to EPS, which was replaced by PTCS in February 2012. OEC should update this manual.

Appendix I. Scope and Methodology

We conducted this performance audit from April 2014 through December 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Scope. The audit covered the period of August 2010 to September 2014,³¹ and our objective was to evaluate OEC's effectiveness in ensuring that employees comply with ethics regulations pertaining to prohibited holdings and temporarily-restricted trades. Specifically, we sought to:

- determine whether OEC has developed and implemented policies and procedures that are in accordance with Federal laws and regulations, including 5 CFR § 4401.102, *Prohibited and restricted financial interests and transactions*;
- evaluate the operating effectiveness of internal controls designed and implemented by OEC over the employee security transactions and holdings pre-clearance and reporting processes; and
- determine whether OEC has established a mechanism to ensure employee compliance with 5 CFR § 4401.102, *Prohibited and restricted financial interests and transactions*.

We conducted fieldwork at the SEC's headquarters in Washington, D.C. While our focus was on OEC, we also considered OHR and Enforcement processes and how these processes were incorporated into OEC's oversight of employee securities holdings and transactions.

Methodology. To determine whether OEC has developed and implemented policies and procedures that are in accordance with Federal laws and regulations, we interviewed the DAEO, Chief Compliance Officer, and other OEC personnel to gain an understanding of the office, its policies and procedures, and overall management style. Additionally, we reviewed relevant Federal laws and regulations and focused on the sections of the laws and regulations that address employees' and the DAEO's responsibilities regarding securities holdings. To determine whether the SEC has incorporated all required aspects of these Federal laws and regulations (particularly, those of 5 CFR Part 4401) into its agency-wide policies and procedures, and to determine if OEC policies and procedures are aligned with the SEC-wide policies and

³¹ We reviewed OEC's policies, procedures, and practices as of August 2010 as compared to the supplemental ethics regulation. We reviewed the operating effectiveness of internal controls designed and implemented by OEC as of October 1, 2012.

procedures, we conducted a crosswalk of SEC and OEC policies and procedures to the relevant Federal laws and regulations.

To evaluate the operating effectiveness of OEC's internal controls over employee security transactions, we interviewed OEC personnel and reviewed OEC procedures. With OEC management, we identified and discussed inherent risks to OEC's program related to the oversight of employee securities holdings and the mitigating internal controls. We assessed the design and implementation of internal controls and identified and tested key internal controls. Specifically, we reviewed the process by which OEC reviews securities holdings of employment candidates to determine whether they hold prohibited securities; tested the automated and manual controls of the SEC clearance system, which employees use to pre-clear trades; and assessed the completeness of information OEC relies on to process employees' pre-trade requests.

To determine whether OEC has established a mechanism to ensure employee compliance with the supplemental ethics regulations, we interviewed personnel and reviewed data concerning the 87 trades mentioned in the study *The Stock Picking Skills of SEC Employees*. We gained an understanding of how the study identified the trades, and reviewed the trades identified by the SEC to assess the study's claims that the trades were made in violation of the supplemental ethics regulation. Further, we evaluated training of, and communication to, employees regarding the supplemental ethics regulation. Additionally, we evaluated OEC's annual compliance testing plan.

The Federal laws and guidance, as well as the SEC administrative regulations, policies, and procedures we reviewed included:

Federal Laws and Regulations:

- United States Code, Section 106, Title 5, Appendix, Ethics in Government Act of 1978, Review of Reports, October 26, 1978.
- 5 CFR Part 4401, *Supplemental Standards of Ethical Conduct for Members and Employees of the Securities and Exchange Commission*, August 19, 2010.
- 17 CFR Part 200 Subpart M, *Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission*, as amended, August 19, 2010.
- 5 CFR Part 2635, *Standards of Ethical Conduct for Employees of the Executive Branch*, February 3, 1993.
- 5 CFR Part 2634, *Executive Branch Financial Disclosure, Qualified Trusts, and Certificates of Divestiture*, April 7, 1992.
- 5 CFR Part 2638, *Office of Government Ethics and Executive Agency Ethics Program Responsibilities*, June 10, 1997.

- Office of Management and Budget Circular No. A-123, *Management's Responsibility for Internal Control*, December 21, 2004.

SEC Administrative Regulations, Policies, and Procedures:

- U.S. Securities and Exchange Commission Ethics Handbook, March 2011.
- Administrative Notice, *I Have to File What? A Guide to the Financial Disclosure Obligations of SEC Employees*, April 2011.
- Administrative Notice, *Introducing the New Personal Trading Compliance System (PTCS)*, February 2012.
- SharePoint 2010: Personal Trading Compliance System (PTCS) v4.0.0.2 Admin Guide, March 10, 2014.
- OEC Standard Operating Compliance Procedures, April 9, 2014.
- OEC Standard Operating Procedures for Confidential Financial Disclosure Reports.
- OEC Standard Operating Procedures for Public Financial Disclosure Reports (278) and periodic Transaction Reports (278-T).
- SEC Administrative Regulations, SECR 30-1, Management Accountability and Control Program, June 10, 1996.

Internal Controls. We gained an understanding of OEC's oversight of employee securities holdings and transactions and identified key internal controls. We then tested the operating effectiveness of those internal controls using random and judgmental samples. Although test results were not projected, negative results allowed the audit team to identify the root causes for the exceptions.

Computer-processed Data. The Government Accountability Office's *Assessing the Reliability of Computer-Processed Data* (GAO-09-680G, July 2009) states that "data reliability refers to the accuracy and completeness of computer-processed data, given the uses they are intended for. Computer-processed data may be data (1) entered into a computer system or (2) resulting from computer processing." The OIG identified the following computer-processed data that would have a material impact on the audit's findings, conclusions, or recommendations: (1) Enforcement Watch List, (2) the Cardinal feed, and (3) the OHR new employee lists.

We conducted interviews to understand how the Watch List and Cardinal List are compiled and used. We also reviewed the database structure of the source of the Cardinal feed. Based on data provided by Enforcement, we determined that the Watch List is not complete. (See finding 2.) Additionally, we assessed OHR new employee lists as part of Report No. 528, *Audit of the Representation of Minorities and Women in*

the SEC's Workforce.³² We relied solely on employees' start dates and we deemed this specific data to be sufficiently reliable. Therefore, we concluded that for the purposes of the audit, the computer-processed data that had a material impact on the audit findings, conclusions, or recommendations is sufficiently reliable.

Prior Coverage. On March 3, 2009, the SEC OIG issued a report on its investigation into two Enforcement attorneys' securities transactions during a 2 year period. The investigation sought to determine whether the attorneys engaged in insider trading, traded on non-public information, or violated the SEC's Rule 5 of the Conduct Regulation (17 CFR § 200.735-5). The OIG determined that the SEC had essentially no compliance system in place to ensure that employees, with the tremendous amount of non-public information they had at their disposal, did not engage in insider trading themselves. The report noted that the disclosure requirements and compliance system were based on the honor system, and there was no way to determine if an employee failed to report a securities transaction. Moreover, there were no spot checks conducted and the SEC did not obtain duplicate brokerage account statements. In addition, there was little to no oversight or checking of the reports that employees filed to determine their accuracy, or even whether an employee had reported at all.

To improve the SEC's monitoring of employees' compliance with 17 CFR § 200.735-5, the OIG made 11 recommendations. Specific recommendations are summarized below:

- one office have primary responsibility for ensuring compliance with Rule 5;
- there be an integrated, computerized system for every facet of Rule 5 compliance;
- the SEC give serious consideration to obtaining duplicate copies of brokerage record confirmations for each securities transaction for every SEC employee; and
- the office primarily responsible for Rule 5 compliance conduct regular, thorough spot checks for Rule 5 compliance for randomly selected employees each quarter.

³² U.S. Securities and Exchange Commission, Office of the Inspector General, Audit Report No. 528, *Audit of the Representation of Minorities and Women in the SEC's Workforce*, November 20, 2014. The report can be accessed at: <http://www.sec.gov/oig/reportspubs/528.pdf>.

As of March 2014, all 11 recommendations have been closed.³³

On September 16, 2011, the SEC OIG issued a report of investigation of the facts and circumstances surrounding the SEC's former General Counsel and Senior Policy Director's participation in Bernard L. Madoff-related matters. In its report, the OIG recommended that:

- the SEC Ethics Counsel should report directly to the Chairman, rather than to the General Counsel;
- the SEC Ethics Office should take all necessary steps, including the implementation of appropriate policies and procedures, to ensure that all advice provided by the Ethics Office is well-reasoned, complete, objective, and consistent, and that Ethics officials ensure that they have all the necessary information in order to properly determine if an employee's proposed actions may violate rules or statutes or create an appearance of impropriety; and
- the SEC Ethics Office should take all necessary actions to ensure that all ethics advice provided in significant matters, such as those involving financial conflict of interest, is documented in an appropriate and consistent manner.³⁴

In 2013, OGE released a report (No.13-18) on its November 2012 review of the SEC's ethics program. OGE concluded that the SEC's program appeared to be effectively administered and in compliance with laws, regulations, and policies. Although OGE reviewed both the public and confidential financial disclosure forms for timeliness of filing and review, its audit scope did not include a review of OEC's policies or procedures regarding the prohibited and restricted holdings lists; pre-employment or transaction clearances; annual submission of statements or attestations of compliance; or any other SEC-specific financial matters. The report did state that the review team noted extensive evidence of ethics officials' analysis and research of public disclosure forms and communication with public report filers. No substantive recommendations

³³ U.S. Securities and Exchange Commission, Office of the Inspector General, Report of Investigation No. 481, *Employee's Securities Transactions Raise Suspicions of Insider Trading and Create Appearances of Impropriety; Violations of Financial Reporting Requirements; and Lack of SEC Employee Securities Transactions Compliance System*, March 3, 2009. Rule 5 has now been effectively replaced by the supplemental ethics regulation, and 17 CFR § 200.735-5 now states that, "[s]ecurities transactions by members and employees must comply with the provisions of 5 CFR 4401.102 (Prohibited and restricted financial interests and transactions)."

³⁴ U.S. Securities and Exchange Commission, Office of the Inspector General, Report of Investigation No. 560, *Investigation of Conflict of Interest Arising from Former General Counsel's Participation in Madoff-Related Matters*, September 16, 2011. The report can be accessed at: <http://www.sec.gov/about/offices/oig/reports/investigations/2011/oig-560.pdf>

were made; however, the report suggested the SEC continue efforts to improve the late certifications of confidential disclosure reports.³⁵

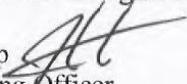
³⁵ U.S. Office of Government Ethics, Compliance Division, Ethics Program Review Report No. 13-18, *U.S. Securities and Exchange Commission*, April 2013. The report can be accessed at: <http://www.oge.gov/Program-Management/Program-Review/Program-Review-Reports/Program-Review-Reports/>

Appendix II. Management Comments

MEMORANDUM

To: Rebecca Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects,
Office of Inspector General

From: Shira Pavis Minton 
Ethics Counsel and Designated Agency Ethics Official

Jeffrey Heslop 
Chief Operating Officer

Andrew Ceresney 
Director, Division of Enforcement

Date: December 4, 2014

Subject: Response to SEC IG's Draft *Audit of the Office of the Ethics Counsel's Oversight of Employee Securities Holdings*, Discussion Draft Report No. 527, November 19, 2014.

Thank you for the opportunity to review and comment on the recommendations in draft Audit Report, *Office of the Ethics Counsel's Oversight of Employee Security Holdings*, dated November 19, 2014. The Office of Ethics Counsel (OEC) appreciates the recommendations designed to improve the SEC's oversight of employee securities holdings.

We are pleased the OIG found that OEC has developed and implemented policies and procedures as required by Federal laws and regulations. Further we are pleased that the OIG recognized that OEC had voluntarily implemented additional compliance processes.

We welcome your suggestions on improvements to our policies and processes. OEC is committed to assuring that we have adequate controls to oversee employee securities holdings.

Recommendation 1:

Office of Human Resources update its policies and procedures for on-boarding new staff to require confirmation from the Office of Ethics Counsel regarding its review of an employment candidate's Form 682 prior to completing the on-boarding process.

OHR concurs with this recommendation. OHR and OEC have developed a joint 682 Standard Operating Procedure for on-boarding new staff that requires confirmation from OEC to OHR regarding its review of Form 682 prior to completing the on-boarding process.

Recommendation 2:

The Office of the Ethics Counsel document a process with the Office of Human Resources to obtain timely and accurate information regarding new employees that allows follow-up to occur within a prescribed timeframe.

OHR and OEC concur with this recommendation. The Directors of OHR and OEC have issued a joint memorandum to their staffs documenting the process that should be followed for obtaining timely and accurate information from new employees that will assist with follow-up occurring within a prescribed timeframe.

Recommendation 3:

The Office of the Ethics Counsel update SEC policies and procedures and inform employees of the requirement to submit proof that they have divested prohibited holdings.

OEC concurs with this recommendation. As of August 2014 we have updated our 682 Standard Operating Procedure to include a requirement that employees submit proof of divestiture. OEC attorneys track required divestiture in an electronic database and do not close out the entry until proof is received.

Recommendation 4:

The Office of Ethics Counsel develop a method to use employee brokerage statements to identify all employees holding prohibited securities.

OEC concurs with this recommendation. OEC has partnered with OIT to procure an optical character recognition tool in PTCS. A trial offer is currently being tested by OIT and OEC.

Recommendation 5:

The Division of Enforcement establish an internal control or mechanism to ensure ticker symbols are included in the HUB and remind its employees of the current requirement. Additionally, the Division of Enforcement and the Office of the Ethics Counsel should determine the viability of using related name information in the Personal Trading Compliance System to identify potentially restricted securities.

Enforcement concurs with this recommendation, and has undertaken work to improve the relevant data quality in its case management system, HUB. Enforcement reviewed the information provided to OIG detailing the relevant population of issuer entities and the specific entities where no ticker was present. Many of the specific entities are not publicly traded entities. Enforcement identified a subset of the specific entities where a ticker exists, and added the ticker information in HUB. In a Division-wide message on December 1, 2014, Enforcement reminded staff of the requirement to use the ticker search feature when entering public companies in HUB.

Enforcement has also begun development of an enhanced report that provides the names of all relevant entities in HUB to supplement the ticker information provided daily to OEC. Enforcement will coordinate with OEC on the viability of using the enhanced report, or other means of drawing on

entity name information, in OEC's identification of securities where employees are potentially prohibited from trading.

Recommendation 6:

The Office of Ethics Counsel obtain a securities data feed that reduces the risk that pre-trade requests will have to be manually processed.

OEC concurs with this recommendation. As recognized in your report, OEC had identified this issue prior to the audit and has been diligently working to correct it. In September 2014, a contract was awarded to a vendor that can provide a more robust security master list. It is currently being tested by the Enterprise Data Warehouse (EDW) in OIT.

Recommendation 7:

The Office of the Ethics Counsel consider the feasibility of using all data available in the Personal Trading Compliance System to confirm that employees have met minimum holding period requirements.

OEC concurs with this recommendation and will consider the feasibility of using existing data to confirm that employees have met minimum holding period requirements.

Recommendation 8:

The Office of the Ethics Counsel develop a statistical sampling plan for its compliance testing program to be able to assess agency-wide compliance with the supplemental ethics regulation.

OEC concurs with this recommendation and has partnered with DERA to determine a testing sampling protocol for all future compliance testing. We expect to deploy the new sampling method in 2015.

Recommendation 9:

The Office of Ethics Counsel combine the review of Forms 450 with the current compliance testing.

OEC concurs with this recommendation and will implement this in the next round of testing starting in 2015.

Appendix III. OIG Response to Management Comments

We are pleased that SEC management concurred with all nine recommendations for corrective action. Management's proposed actions are responsive to the recommendations; therefore, the recommendations are resolved. Management took immediate action to address Recommendations 1 and 2, which we verified prior to issuance of our final report. Therefore, those recommendations are closed for reporting purposes. The remaining seven recommendations will be closed upon completion and verification of the appropriate corrective action. Full implementation of our recommendations should help the agency in its efforts to oversee employee securities holdings.

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Comments and Suggestions

If you wish to comment on the quality or usefulness of this report or suggest ideas for future audits, please contact Rebecca Sharek, Deputy Inspector General for Audits, Evaluations, and Special Projects at sharekr@sec.gov or call (202) 551-6061. Comments, suggestions, and requests can also be mailed to the attention of the Deputy Inspector General for Audits, Evaluations, and Special Projects at the address listed above.