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REPORT OF INVESTIGATION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

Case No. OIG-531

Allegations of Failure of SEC to Investigate Illegal Insider Trading and Accounting Fraud; Alleged Misconduct by SEC Staff

Introduction

On July 15, 2009, (b)(7)(C) telefaxed a letter to the U.S. Securities and Exchange Commission ("SEC" or "Commission") Office of the Inspector General (OIG) regarding the SEC's settlement with two defendants in its case against Tyco International, Ltd. (Tyco). In his letter to the OIG, (b)(7)(C) stated:

I am requesting the [sic] your office investigate the SEC's Enforcement's Division [sic] proposed settlement with ex-Tyco officials Mr. Kozlowski and Mr. Swartz. I believe based on the facts in the SEC's file their [sic] may be a *quid pro pro* [sic] going on that is allowing the defendants to keep over \$100 million in assets when I have submitted evidence that shows the defendants are guilty of insider trading and that \$100 million should be seized through the use of a fine and substantial insider trading penalty. The funds should be put into a Fair Fund pot and distributed to victimized shareholders of record from 1997-2002.

See Letter dated July 15, 2009 from (b)(7)(C) to SEC Inspector General Kotz, attached hereto as Exhibit 1.

In addition to his claim that the SEC failed to pursue its allegations of illegal insider trading at Tyco and establish a Fair Fund for reimbursement of shareholders, (b)(7)(C) also alleged that the SEC failed to appropriately investigate and prosecute accounting fraud at Tyco,¹ that SEC staff may have engaged in inappropriate or unethical conduct such as a *quid pro quo*

¹ (b)(7)(C) stated that he believed Enforcement dropped an accounting issue involving Tyco and its subsidiary, ADT, and covered it up. He inferred that (b)(7)(C) in the Division of Enforcement (Enforcement), may have been involved in these actions. See Facsimile cover sheet dated July 15, 2009 from (b)(7)(C) to Kotz, attached hereto as Exhibit 2.

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with Tyco,² obstruction of justice, mail and wire fraud,³ and bestowing favors in return for future employment,⁴ that the SEC Commissioners may not have had all the facts before they voted to approve settlements in the Tyco matter,⁵ and that the SEC failed to pay (b)(7)(C) a bounty for information he provided to the SEC regarding alleged insider trading in Tyco stock.⁶ (b)(7)(C) further requested that the OIG investigate his allegations that the SEC's Division of Enforcement (Enforcement) had failed appropriately to investigate and prosecute the Tyco matter.⁷

The OIG opened a preliminary inquiry (PI 09-101) into (b)(7)(C) complaints on July 15, 2009. We converted the preliminary inquiry into an investigation (OIG-531) on January 19, 2010.

Summary of Results of the Investigation

The OIG investigation did not find evidence to substantiate (b)(7)(C) allegations that the SEC's Division of Enforcement failed to appropriately investigate and prosecute the Tyco

(b)(7)(C) stated, "The SEC and Tyco may be engaging in a *quid pro quo* as to who gets the remaining assets from the defendants. . . . I believe there is a strong possibility that a particular ongoing accounting practice that I first brought to Tyco and the SEC's attention repeatedly from 2002-2009 might be the reason for this inappropriate back scratching." See Letter dated July 15, 2009 from (b)(7)(C) to the Honorable Robert W. Sweet, U.S. District Court Judge for the Southern District of New York, p. 2, attached hereto as Exhibit 3.

³ In a December 9, 2009 e-mail addressed to Robert Khuzami (Khuzami), Director of Enforcement at the SEC, which he copied to the OIG, (b)(7)(C) stated: "If on the other hand you suspect that this is not just a simple screw up, meaning I am right and you can't tell me, then I should send a copy of this email and attachments to the FBI and others immediately. The request is to initiate a RICO investigation for what I believe was a successful and brilliant public corruption scheme to defraud the US Treasury by various parties who engaged in **obstruction of justice, mail and wire fraud** in this joke of a settlement." [Emphasis added.] See e-mail dated December 9, 2009 from (b)(7)(C) addressed to Khuzami and copied to the OIG, attached hereto as Exhibit 4.

⁴ (b)(7)(C) implied that an SEC employee may have given favors in return (b)(7)(C)

(b)(7)(C)
SEC says yes. Was that the case here?" *Id.*

⁵ See July 15, 2009 letter from (b)(7)(C) to the Honorable Robert W. Sweet, USDC Judge, SDNY, which (b)(7)(C) forwarded to the OIG by fax, attached hereto as Exhibit 3.

⁶ (b)(7)(C) second bounty application stated, "I am applying for and requesting that The Commission approve and award me a bounty based on information, evidence and 'smoking gun' documents I provided to the staff over the years which assisted them in settling this claim and recovering a penalty. All the documents were in the hands of your agency, the defendants and their lawyers long before their criminal conviction's [sic] and your agency's tentative settlement of this case with them a few months ago. I understand that the Commission will vote on the staff's recommendation within the next thirty days. If the tentative agreement has been structured properly the Commission will then be in a position to award a bounty. The Commission should consider voting on the final approval and my request at the same time after review of the file and due consideration." See Letter dated June 15, 2010 from (b)(7)(C) to the SEC Office of the Secretary, attached hereto as Exhibit 5.

⁷ *Id.*, Letter dated July 15, 2009 from (b)(7)(C) to SEC Inspector General Kotz, attached hereto as Exhibit 1.

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matter, or that (b)(7)(C) or any other SEC staff member had engaged in inappropriate or unethical conduct.

(b)(7)(C) claimed that Enforcement "dropped" an accounting issue involving Tyco and its subsidiary, ADT, and "covered it up." The OIG did not find evidence that this occurred. In fact, the SEC's case against Tyco regarding fraudulent accounting resulted in a \$50 million settlement, which was used to establish a Fair Fund to provide restitution to investors.

(b)(7)(C) also claimed that Enforcement should have pursued its insider trading claims against Kozlowski and Swartz, and that \$100 million could be seized through the use of a fine and substantial insider trading penalty, to be put into a Fair Fund and distributed to victimized shareholders. The OIG found that Enforcement's recommendations to the Commission with respect to its decision to settle claims were based upon their stated attempt to balance the litigation risks, the totality of the circumstances, and available SEC resources. We did not find evidence that Enforcement's recommendations or the Commission's decisions were an abuse of authority or *per se* improper.

(b)(7)(C) suggested in his complaint that the current SEC Commissioners may not have had all the facts before they voted to approve the Kozlowski and Swartz settlements. The OIG found that the Action Memorandum Enforcement distributed to the Commission before it voted to approve the settlement offers, provided significant information to the Commissioners about the settlements, and that the Commission discussed the pertinent issues.

(b)(7)(C) also complained that he did not receive a bounty for information leading to a finding of insider trading. The OIG found that when the final settlement agreements with Kozlowski and Swartz were filed for approval with the U.S. District Court in July 2009, they did not include disgorgement or civil penalties, nor did they address the SEC's insider trading allegations. See Litigation Release No. 21129, July 24, 2009, Exhibit 6. Two necessary criteria for payment of an insider trading bounty are the imposition of a civil penalty and recovery of that penalty.⁸ In addition, during the time period that (b)(7)(C) requested his bounty, the SEC only had authority to pay bounties for information that led to insider trading charges.⁹ Thus, we found that there was no evidence of wrongdoing in the SEC's decision to deny (b)(7)(C) request for a bounty.

Scope of the Investigation

In its investigation of (b)(7)(C) complaints, the OIG reviewed hundreds of pages of correspondence and supporting materials sent by (b)(7)(C) including (b)(7)(C) complaints to the OIG, and a series of complaints (b)(7)(C) had filed with Enforcement beginning in 2002. We also reviewed copies of the SEC Litigation Releases regarding the Tyco cases, all eleven Commission Action Memoranda relating to the Tyco investigation, and data from the SEC's Name Relationship Search Index ("NRSI").

⁸ 15 U.S.C. § 78u-1(e).

⁹ *Id.*

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The OIG took the sworn, on-the-record testimony of (b)(7)(C) by telephone on April 22, 2010, excerpted portions of which are attached hereto as Exhibit 7. We also took the sworn, on-the-record testimony of SEC Enforcement (b)(7)(C) in person on May 14, 2010, excerpted portions of which are attached hereto as Exhibit 11.

Applicable Statutes, Regulations and Policies

I. Bounty Award for Information Leading to Recovery for Insider Trading (15 U.S.C. 78u-1(e))

Section 21A(e) of the Securities Exchange Act of 1934 ("Exchange Act") authorized the SEC to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader, from a person who tipped information to an insider trader, or from a person who directly or indirectly controlled an insider trader. The SEC has sole discretion whether to pay a bounty, the amount of the payment, and to whom the payment would be made. The total amount of the bounty may not exceed ten percent of the amount recovered from a civil penalty pursuant to a court order, and shall be paid from amounts imposed as a penalty under Section 21A(e) of the Exchange Act and recovered by the Commission.¹⁰

II. Disqualification by an Employee from Participation in any Particular Matter that will have a Direct and Predictable Effect on the Financial Interests of a Person with whom he is Negotiating or has any Arrangement Concerning Prospective Employment (18 U.S.C. § 208(a))

18 United States Code (U.S.C.) § 208 prohibits a government employee from participating personally and substantially as a government employee in a particular matter in which an organization with whom he is negotiating or has any arrangement concerning prospective employment has a financial interest.

III. Bribery of Public Officials (18 U.S.C. § 201)

18 U.S.C. § 201(b) imposes criminal penalties upon "whoever . . . corruptly gives, offers or promises anything of value to any public official . . . with intent . . . to influence any official act; or who . . . being a public official . . . corruptly demands, seeks, receives, accepts, or agrees to receive or accept anything of value personally or for any other person or entity, in return for . . . being influenced to commit or aid in committing, or to collude in, or allow, any fraud, or make opportunity for the commission of any fraud, on the United States. . . ."

¹⁰ Section 21A(e) of the Exchange Act was repealed on July 21, 2010, when the Dodd-Frank Wall Street Reform and Consumer Protect Act was signed into law. The new law increases potential bounty awards to between 10% and 30% of the amounts over \$1 million recovered, and expands the recovery potential beyond insider trading, to cover violations of other federal securities laws as well.

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IV. Obstruction of Justice (18 U.S.C. § 1505)

18 U.S.C. § 1505 prohibits the corrupt obstruction of legal proceedings before any department or agency of the United States.

V. Mail Fraud (18 U.S.C. § 1341)

18 U.S.C. § 1341 provides that whoever devises a scheme or artifice to defraud, and uses the U.S. mail service for that purpose, shall be liable to be fined and imprisoned for up to 20 years. Proof of material misrepresentations, or the omission or concealment of material facts, reasonably calculated to deceive persons of ordinary prudence, is necessary to satisfy the element of a "scheme or artifice to defraud."

VI. Wire Fraud (18 U.S.C. § 1343)

18 U.S.C. § 1343 prohibits the knowing and willful furtherance of a scheme or artifice to defraud or obtaining money or property by means of false or fraudulent pretenses, through the use of wire, radio, or television in interstate commerce. Violators can be fined and imprisoned up to 20 years.

VII. Honest Services Fraud (18 U.S.C. § 1346)

Under 18 U.S.C. § 1346, the term "scheme or artifice to defraud", which is contained in the mail and wire fraud statutes described above, is expanded to include a scheme or artifice designed to deprive another of the intangible right of honest services. Public officials are presumed to owe the public a duty of honest services.

Results of the Investigation

I. Background on Enforcement's Tyco Investigation

On January 30, 2002, Enforcement staff opened a Matter Under Inquiry ("MUI") into Tyco's possible failure to make certain financial disclosures. See first SEC Name Relationship Search Index ("NRSI") entry attached hereto as Exhibit 8. The sources that prompted this inquiry were newspaper articles appearing in the press on January 30, 2002. See Action Memorandum dated June 24, 2009, excerpted portions of which are attached hereto as Exhibit 9. On February 28, 2002, Enforcement converted the MUI into an Enforcement investigation. See second NRSI entry attached hereto as Exhibit 10.

(b)(7)(C) sent his first complaint to the SEC's then-Director of Enforcement Stephen Cutler (Cutler) on August 7, 2002, alleging insider trading in Tyco stock and applying for a bounty. This first complaint from (b)(7)(C) reached the SEC more than six months after Enforcement had opened its MUI on Tyco, five months after the MUI became an investigation, and approximately seven weeks after the Commission issued its formal Order to investigate Tyco for accounting irregularities and other violations of the securities laws.

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(b)(7)(C) testified that (b)(7)(C) complaint did not prompt Enforcement to add insider trading as an additional element of its investigation of Tyco. See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 17, attached hereto as Exhibit 11. (b)(7)(C) letter was received one month before Enforcement filed its complaint on September 12, 2002, alleging insider trading and other violations of the federal securities laws against three former senior officers of Tyco, but the events of April 2002 that (b)(7)(C) complained of were not the basis for the insider trading causes of action in the SEC's Complaint. See (b)(7)(C) letter dated August 7, 2002, which is attached hereto as Exhibit 12. cf *SEC v. Kozlowski, Swartz, and Belnick*, Civ. Action No. 02-CV-07312-RWS (S.D.N.Y.) filed September 12, 2002, attached hereto as Exhibit 13.

The SEC's investigation continued over the next seven years, ultimately resulting in six separate SEC actions against a total of nine defendants. Several criminal actions and other civil actions also resulted from this investigation. The defendants in the SEC actions were Tyco, seven of its former executive officers, and the PricewaterhouseCoopers LLP (PWC) engagement partner who was responsible for the audits of Tyco's 1997 through 2001 financial statements. As a result of the Tyco investigation, the SEC obtained judgments against all nine defendants in six separate cases, and recovered \$53,200,758.10.

Throughout the course of the SEC's investigation, (b)(7)(C) continued to forward complaints to Enforcement regarding Tyco, its accounting practices, and allegations of insider trading. Enforcement's (b)(7)(C) testified that he was in charge of the Tyco investigation. See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 11. (b)(7)(C) said he had received numerous communications from (b)(7)(C) and that he spoke to (b)(7)(C) on the phone a handful of times. *Id.* (b)(7)(C) Testimony Tr. at pp. 13 & 15. (b)(7)(C) testified not only that (b)(7)(C) complaints did not prompt Enforcement to add insider trading as an additional element of its investigation of Tyco, but that the information (b)(7)(C) supplied over the years was not helpful to his investigation. *Id.* (b)(7)(C) Testimony Tr. at pp. 15, 17, & 22. (b)(7)(C) added, "The issues changed over the years, and as we would file something, he would often adapt that as either a new theory, or it might become even the core . . . theory, whereas it hadn't been until the filing was made." *Id.* (b)(7)(C) Testimony Transcript, at p. 16.

II. (b)(7)(C) Claims of Enforcement's Failure to Conduct Appropriate Investigations

A. (b)(7)(C) Claims Relating to Accounting Fraud

(b)(7)(C) claimed that Enforcement "dropped" an accounting issue involving Tyco and its subsidiary, ADT, and "covered it up." The OIG did not find evidence to substantiate this claim. In fact, the SEC's case against Tyco regarding fraudulent accounting for a "Dealer Connection Fee" arrangement between Tyco and ADT,¹¹ and other fraudulent accounting practices, resulted

¹¹ The SEC's complaint alleged that Tyco inflated its operating income by \$567 million from its fiscal year 1998 through its fiscal quarter ended December 31, 2002, by means of connection fees that Tyco's ADT Security Services, Inc. subsidiary charged to dealers from whom it purchased security monitoring contracts. The "Dealer Connection Fee" was fully offset by a simultaneous increase in the purchase price ADT allocated to the dealers' security monitoring contracts. As a result, the connection fee transaction lacked economic substance and should not have been recorded in Tyco's income statement.

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in a \$50 million settlement paid to the SEC by Tyco. These funds were used to establish a Fair Fund to provide restitution to investors. See Litigation Release No.19657, April 17, 2006, Exhibit 14.

Moreover, (b)(7)(C) answered this allegation directly in his testimony:

Q. Okay. There's also a claim that with regard to the ADT Tyco accounting issue that (b)(7)(C) raised that enforcement dropped this issue and covered it up. Is that true?

A. No. We didn't cover up or drop any issue, and my group was eager to and we did assert every claim that we thought was meritorious and that we could assert against either Tyco, Kozlowski, Schwartz, or the three other former Tyco executives we sued.

See May 14, 2010 (b)(7)(C) Testimony Tr. at pp. 27.

(b)(7)(C) initially raised the issue of accounting irregularities at Tyco in a letter dated January 29, 2003, to (b)(7)(C) in the Enforcement Division of the SEC. See (b)(7)(C) letter to (b)(7)(C) dated January 29, 2003, attached hereto as Exhibit 15. However, his letter alleged a sales practice issue, which was that ADT boosted revenues by failing to run credit checks on new customers, thereby increasing its number of new customers.

It was not until November 12, 2003 that (b)(7)(C) raised with the SEC the issue of the Dealer Connection Fee. In a letter to (b)(7)(C), (b)(7)(C) stated, "My understanding has been that the ADT dealer connection fee concept was approved by your agency but I now have reason to question that based on what has surfaced over the past seventeen months. I could not bring up the dealer item before now because it had not appeared in the public domian [sic] until July." See (b)(7)(C) letter to (b)(7)(C) dated November 12, 2003, attached hereto as Exhibit 16.

The Commission authorized a civil injunctive action against Tyco, together with the acceptance of Tyco's settlement offer, on April 13, 2006. On April 17, 2006, Enforcement staff filed a settled civil injunctive action against Tyco in the U.S. District Court for the Southern District of New York. The complaint alleged a billion dollar accounting fraud by Tyco, slightly more than half of which it attributed to accounting transactions involving the Dealer Connection Fee. See *SEC v. Tyco International, Ltd.*, Civ. Action No. 06 CV 2942 (S.D.N.Y.) filed April 17, 2006, attached hereto as Exhibit 17.

Counts 28 through 31 of the SEC's Complaint (The Dealer Connection Fee) contained allegations of accounting fraud similar to that alleged by (b)(7)(C). These counts stated in pertinent part:

In 1997, Tyco implemented a scheme designed to overstate its operating income . . . as part of the scheme, Tyco management directed ADT to implement a \$200 "connection fee" to be paid by the dealers to ADT for each customer contract purchased from them and simultaneously to increase the price ADT paid the

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dealers for those contracts by \$200. . . . Tyco immediately recognized the \$200 connection fee in its income statement, while the offsetting \$200 growth bonus was amortized over ten years. As a result, Tyco inflated its operating income by approximately \$567 million from its fiscal year ended September 30, 1998, through its fiscal quarter ended December 31, 2002. . . . [T]he \$200 connection fee and the offsetting \$200 growth bonus did not alter the economic substance of ADT's purchase of a security monitoring contract and should not have been recognized under GAAP. . . . The scheme also artificially increased Tyco's operating cash flow . . . by approximately \$719 million due to the accounting treatment given the dealer connection fee. *Id.*, SEC v. Tyco International, Exhibit 17, *The Dealer Connection Fee*, at pp. 11-12.

The complaint prayed for relief, including disgorgement of ill-gotten gains and pre-judgment interest on all such gains, and payment of a civil penalty. *Id.*, at pp. 21-22. Without admitting or denying the allegations in the Complaint, Tyco consented to the entry of a final judgment permanently enjoining it from violating the applicable sections of the securities laws, and ordering Tyco to pay \$1 in disgorgement and a \$50 million civil penalty. See Litigation Release No. 19657, April 17, 2006, Exhibit 14.

(b)(7)(C) also inferred that (b)(7)(C) in the Division of Enforcement (Enforcement), may have been involved in the "dropping" of the accounting claim and subsequent cover up. *Id.*, Facsimile cover sheet dated July 15, 2009 from (b)(7)(C) to Kotz, Exhibit 2. However, the OIG found no evidence of this and noted that (b)(7)(C) headed the SEC's investigation of Tyco, which found that Tyco had engaged in fraudulent accounting for the Dealer Connection Fee.

In summation, the OIG did not find evidence substantiating (b)(7)(C) claim that Enforcement "dropped" the Dealer Connection Fee accounting issue and covered it up, but found evidence that Enforcement identified the issue, and with the help of the SEC Division of Corporation Finance, pursued it to a settlement of \$50 million with Tyco.

B. (b)(7)(C) Claims Regarding Insider Trading Allegations

1. (b)(7)(C) Claims

(b)(7)(C) claimed that Enforcement should have pursued its insider trading claims against Kozlowski and Swartz, and that \$100 million could have been seized through the use of a fine and substantial insider trading penalty, to be put into a Fair Fund and distributed to victimized shareholders.

2. The Initial Action Brought by Enforcement

The Commission issued a Formal Order of Investigation in the Tyco matter on June 24, 2002, and it authorized the staff to file a civil injunctive action against Kozlowski, Swartz and Belnick on September 3, 2002.

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On September 12, 2002, Enforcement staff filed a civil complaint in the U.S. District Court for the Southern District of New York against three former top executives of Tyco, Kozlowski, Swartz and Mark A. Belnick (Belnick). *See SEC v. Kozlowski, Swartz, and Belnick*, Civ. Action No. 02-CV-07312-RWS (S.D.N.Y.), filed September 12, 2002, attached hereto as Exhibit 13. The complaint alleged multiple violations of the federal securities laws, including fraud, false and misleading proxy statements, fraudulent stock sales, and reporting violations by Kozlowski, Swartz, and Belnick, as well as record-keeping violations by Kozlowski and Swartz. The complaint alleged that Kozlowski and Swartz engaged in insider trading by selling Tyco securities while preventing disclosure to shareholders and potential investors of the material facts concerning their self-dealing and fraudulent loans. Count 69 of the Complaint set forth allegations of insider trading against each of the three defendants, as follows:

While concealing material information concerning their undisclosed self-dealing transactions from investors, Kozlowski, Swartz and Belnick knowingly or recklessly sold hundreds of millions of dollars in Tyco securities, in breach of the duty they owed to Tyco and its shareholders. *Id.*, Exhibit 13 at p. 11.

The complaint prayed for relief, including disgorgement of ill-gotten gains the defendants received as a result of their violations of the federal securities laws, and pre-judgment interest on all such gains, including "all losses avoided by Kozlowski, Swartz and Belnick on their sales of Tyco securities subsequent to their fraudulent acts and omissions." *Id.*, Exhibit 13 at p. 13.

(b)(7)(C) testified that insider trading was an element of Enforcement's fraud claims against the defendants. He stated:

And another thing you should know is that insider trading claims were asserted against both Mr. Kozlowski and Mr. Schwartz [sic], but that's not uncommon in a large financial fraud, especially in that time period when it was pleaded. And it was viewed as, and I clearly remember my (b)(7)(C) saying this, it's really just another way you plead the financial fraud.

See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 19.

3. The SEC Settlements in the Tyco Case

On May 1, 2006, the Commission filed a proposed settled Judgment against Belnick, the former Chief Corporate Counsel of Tyco. *See* Litigation Release 19678, May 1, 2006, Exhibit 18. The settlement did not address the Commission's allegations in its Complaint that Belnick engaged in insider trading by selling Tyco securities while aware that his loans were undisclosed. *See* SEC Complaint against Kozlowski, Swartz and Belnick, Exhibit 13.

Similarly, on July 14, 2009, the Commission filed settled Final Judgments against Kozlowski, the former Chairman and Chief Executive Officer of Tyco, and Swartz, the former Chief Financial Officer of Tyco. *See* Litigation Release 21129, July 14, 2009. Exhibit 6. As in the case of Belnick, the settlements did not address the Commission's allegations of insider

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trading in Tyco securities by the defendants. *See* SEC Complaint against Kozlowski, Swartz and Belnick, Exhibit 13.

In its Action Memoranda to the Commission recommending the acceptance of Kozlowski, Swartz and Belnick's settlement offers, Enforcement staff provided the Commission with its recommendations together with the reasoning behind Enforcement's recommendations.

4. Enforcement's Reasons for Recommending Settlement

(b)(5)



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(b)(5)

See Action Memorandum dated June 24, 2009, attached hereto as Exhibit 9.

(b)(5)

See Action Memorandum dated June 24, 2009, Case No. HO-09421, Exhibit 9.

In addition, (b)(7)(C) testified that under Commission policy, funds are paid first to disgorgement, next to prejudgment interest, and finally to any penalties assessed. See May 14, 2010 Frohlich Testimony Tr. at p. 20. He explained that “you would have to have more on the order of, I’m guessing, in the order of billions instead of millions from Kozlowski and Swartz in

¹² The Memorandum provided the following additional explanatory information in footnotes 2 and 3, at p. 1 of the

(b)(5)

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order to cover all the prayed for disgorgement, plus the prejudgment interest on all that disgorgement, which would be a gigantic number, before you ever got to anything that the Commission would consider . . . to be a[n insider trading] penalty.” *Id.*, (b)(7)(C) Testimony Tr. at p. 21.

Finally, (b)(7)(C) also testified as follows:

Q. Okay. And so what was the reason why the decision was made to go forward with the settlement with Kozlowski and Schwartz that you did?

(b)(5),(b)(6),(b)(7)(C)

See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 23.

5. Allegation that SEC Commissioners Were Not Informed of the Facts Before they Voted to Accept Kozlowski and Swartz' Settlement Offers

(b)(7)(C) suggested that the current SEC Commissioners may not have had all the facts before they voted to approve the Kozlowski/Swartz settlements. See July 15, 2009 letter from (b)(7)(C) to the Honorable Robert W. Sweet, USDC Judge, SDNY, which (b)(7)(C) forwarded to the OIG by fax the same day, attached hereto as Exhibit 3.

(b)(7)(C) was asked to respond to this issue in his testimony. The transcript of his testimony regarding this issue reads as follows:

Q. Okay. Now, (b)(7)(C) claims that the SEC Commissioners may not have had all the facts before them when they voted to approve the settlement offered Kozlowski and Schwartz. Is that true?

A. That is not true;

*

*

*

Q. Okay. Discussed what subject, specifically?

A. What I clearly remember is (b)(5) The recommendation was authorized and approved, I believe, without dissent.

Q. Okay.

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(b)(5)

Q. Okay, and then, but you also provided an action memorandum which the Commission and Commissioners received, which discussed all aspects of the case.

A. Absolutely did.

See May 14, 2010 (b)(7)(C) Testimony Tr. at pp. 23-25.

The staff's Action Memorandum to the Commission dated June 24, 2009 (Exhibit 9),

(b)(5), (b)(6), (b)(7)(C)

Given (b)(7)(C) testimony and the substantial analysis Enforcement staff provided to the Commission in its Action Memorandum, the OIG concluded that (b)(7)(C) allegation that the SEC Commissioners may not have had all the facts before they voted was not substantiated.

III. (b)(7)(C) Claim that His Bounty Application Should Have been Accepted

A. (b)(7)(C) Initial Bounty Application Was Acknowledged

(b)(7)(C) an attorney in the SEC's Enforcement Division, acknowledged (b)(7)(C) August 7, 2002 bounty application in a response letter to (b)(7)(C) dated September 25, 2002. See Exhibit 20. (b)(7)(C) second bounty application, dated June 15, 2009 and addressed to the Office of the Secretary (Exhibit 5), was not acknowledged, but (b)(7)(C) testified that he had seen it.

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B. The Criteria for a Bounty Award Under Section 21A(e) Were Not Met

The criteria set forth in Section 21A(e) of the Exchange Act for the award of a bounty for information leading to the recovery of a civil penalty for insider trading were:

- Receipt of information leading to the recovery of a civil penalty for insider trading;
- A finding that the insider trading rules were violated;
- The assessment of a civil penalty for insider trading;
- The recovery of payment of the insider trading penalty;
- An application for a bounty received by the SEC within the specified time period (90 days after the judgment, settlement, or other resolution), made by the provider of information;
- Determination, in the sole discretion of the SEC, as to whether to pay a bounty, the amount of payment, and to whom the payment would be made; and
- Payment of the bounty from proceeds received as a civil penalty for insider trading.¹³

(b)(7)(C) testified that (b)(7)(C) application did not meet the criteria for a bounty. He said:

Q. So basically there [are] certain criteria in place for when an individual was entitled to a bounty, and (b)(7)(C) did not meet those criteria?

A. Correct.

...

Q. Do you know who made the final decision on his bounty application?

A. I can tell you what I do remember. (b)(7)(C) sent [the] standard . . . reply letter that goes out to every bounty request, because really it's in the staff's discretion, I think, whether to propose to the Commission, and my staff has proposed on the Royal Ahold matter, by the way, and successfully. By that I mean the Commission paid.

I believe I would guess since the letter is non-committal that it would be ultimately me and maybe my supervisors that are saying that it doesn't deserve a bounty, and I believe that's true.

...

MR. KOTZ: [W]e're going to mark this document as Exhibit 2. It's a four-page letter from (b)(7)(C) to Office of the Secretary dated June 15, 2009, and it copies you on the letter. Take a look at it.

...

¹³ 15 U.S.C. 78u-1(e).

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Q. And is that the letter that you reviewed as part of the analysis as to whether (b)(7)(C) was entitled to the bounty?

A. Yes, and there actually may have been another letter about the same time that was shorter. My memory is of a slightly shorter letter, but at any rate, this letter would have done the job in that it would have. This letter is framed in terms of things I know about, unlike Exhibit 1. Exhibit 2 I'm familiar with the issues that he's talking about and I'm familiar with the timeframe.

Q. And you thoroughly analyzed and reviewed the claims that (b)(7)(C) made about whether he was entitled to a bounty and determined that based upon the information that he provided and your knowledge of the case, he was not entitled to the bounty under the criteria that was set forth.

A. That is correct.

See May 14, 2010 (b)(7)(C) Testimony Tr. at pp. 31-33.

(b)(7)(C) made his application for a bounty twice, and both times his application was received within the specified time period. However, there was no finding of a violation of the insider trading laws, and no civil penalty for insider trading was assessed or paid. Therefore, the SEC had no authority to award (b)(7)(C) a bounty.¹⁴

IV. (b)(7)(C) Other Allegations of SEC Staff Misconduct

A. Allegation of Favors Obtained in Return for Legal Employment

(b)(7)(C) also alleged that an unnamed senior SEC employee may have given favors in return for a job with the law firm representing Tyco. See e-mail dated December 9, 2009 from (b)(7)(C) addressed to Khuzami and copied to the OIG, attached hereto as Exhibit 4.

In his testimony, however, (b)(7)(C) was unable to identify the individual in question. When a former SEC attorney's name was mentioned, he thought it might be familiar, but he said he had not had any dealings with that individual, and he did not know if the attorney had worked on the Tyco investigation as evidenced in the following exchange.

Q. Let me ask you another question. In one of the e-mails you sent, I guess in December of 2009 to Robert Khuzami, you said that "A senior SEC official went to the law firm that was representing Kozlowski and Swartz."

A. Yes.

¹⁴ (b)(7)(C) also claimed that he did not receive written notification that his application for a bounty had been denied. The OIG did not find evidence that the SEC informed (b)(7)(C) that his bounty application was denied and notes that although (b)(7)(C) bounty request did not meet the required criteria for a bounty, significant misunderstanding may have been alleviated had (b)(7)(C) been notified of the SEC's decision.

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Q. Who was that official?

A. Let's see here. There's [sic] a couple of them. There was a guy – right now I'm looking at the – there was a branch chief that was in Miami. I don't know his – I can't remember his name. He went from – and this is right around the time of the settlement. Okay. Either right before or right after. I think it might have been right after. Where the branch chief ended up at Boies' firm, soon after. And then

Q. And that was Boies, Schiller, that's the firm?

A. Yes, Boies, Schiller, right. They are handling the case right now against Kozlowski and Swartz. You know, they're co-counsel at Tyco.

Q. Right.

A. You know, they're Tyco's outside counsel.

Q. So an SEC official from Miami went to that firm.

A. Yes, along with an assistant attorney general.

Q. Now, do you know if the SEC attorney – I think it was David Nelson. Does that name sound familiar?

A. From Miami. Nelson kind of rings a bell, but like I said, it's been a while. There's [sic] so many facts to this thing, you can't remember them all.

Q. Now, do you have any reason that Mr. Nelson was working on the Tyco matter or any related matter while at the SEC?

A. Don't know. You'd have to check that.

Q. Okay.

A. If he's not working on it, then the question is, you know, does he know anything about it that could help them.

Q. Right. But in your communications with the SEC, you never dealt with David Nelson, did you?

A. Oh, no, not at all. Not at all. And he's in Miami. This whole thing is taking place in New York and Washington.

See April 22, 2010 (b)(7)(C) Testimony tr. at pp. 40-42, attached hereto as Exhibit 7.

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(b)(7)(C) testimony confirmed that the SEC employee who joined Tyco's outside law firm was not involved in the Tyco investigation.

Q. Okay. There's also another claim by (b)(7)(C) that [a] senior SEC official went to a law firm that was representing Kozlowski and Schwartz and that might have engaged in some conflict.

A. That really puzzles me. One of my staff thinks it may be somebody in the Miami office.

Q. Yeah, we think it may be Dave Nelson. He went to Hoie [sic] Schiller.

A. One of my staff attorneys told me that that was his best guess.

Q. But did Dave Nelson, after he left the Commission and was in private practice, have any representation related to Tyco?

A. To my knowledge Dave Nelson had zero to do with Tyco while he was at the Commission and zero to do with it after he left the Commission. I am not sure I have ever spoken to Nelson.

See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 27.

Thus, the only individual identified as potentially violating ethics rules as alleged by (b)(7)(C) was David Nelson, the former Director of the SEC's Miami Regional Office. However, the OIG found no evidence that Nelson had worked on the Tyco case. Accordingly, the OIG was unable to substantiate (b)(7)(C) allegations of favors exchanged for a promise of future employment.

B. Allegation of Bribery of Public Officials

In his July 15, 2009 letter to the federal judge who approved the SEC's settlement agreements with Kozlowski and Swartz, (b)(7)(C) stated, "The SEC and Tyco may be engaging in a *quid pro quo* as to who gets the remaining assets from the defendants. . . . I believe there is a strong possibility that a particular ongoing accounting practice that I first brought to Tyco and the SEC's attention repeatedly from 2002-2009 might be the reason for this inappropriate back scratching." See Letter dated July 15, 2009, from (b)(7)(C) to the Honorable Robert W. Sweet, U.S. District Court Judge for the Southern District of New York, p. 2, attached hereto as Exhibit 3.

When asked to respond to this accusation by (b)(7)(C) testified as follows:

Q. And (b)(7)(C) also claims that SEC and Tyco may have been engaging in a *quid pro quo* as to who gets the remaining assets from the defendants. Is that true?

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A. That's not true. And I don't really understand what he's getting at there. Possibly, his comments are being prompted by the fact that the court in New York found Tyco to be the victim for purposes of criminal restitution, and it is true that money's [sic] paid by Kozlowski and Schwartz, through, again, New York State criminal prosecution. Not through us, but through that prosecution went back to the company.

Q. Okay. But there's no quid pro quo that you're aware of?

A. Well, to me that's the opposite of a quid pro quo.

The OIG found no evidence that the SEC or any of its staff members engaged in a *quid pro quo* with Tyco, Kozlowski, Swartz, or any of their attorneys, regarding the remaining assets and who might be entitled to them.

C. Allegation of Obstruction of Justice

(b)(7)(C) also alleged obstruction of justice, mail and wire fraud in his December 9, 2009 e-mail to Khuzami, which he copied to the OIG. Referring to the SEC's settlement with Kozlowski and Swartz, he stated in part:

... what I believe was a successful and brilliant public corruption scheme to defraud the US Treasury by various parties who engaged in obstruction of justice, mail and wire fraud in this joke of a settlement. See e-mail dated December 9, 2009 from (b)(7)(C) addressed to Khuzami and copied to the OIG, attached hereto as Exhibit 4.

In a letter to the OIG dated April 22, 2010, (b)(7)(C) also said:

The parties illegally divert[ed] a minimum of \$110 million (b)(7)(C) into the hands of outside third parties in violation of the duties imposed on these lawyers by their code of conduct and violation of various laws. This is obstruction of justice. See Letter dated April 22, 2010 from (b)(7)(C) to the OIG, attached hereto as Exhibit 21.

As discussed above, we found that Enforcement's Action Memorandum to the Commission outlined in detail the reasons for the recommendation, including the facts that both Kozlowski and Swartz had already paid millions of dollars in restitution (\$97.8 million and \$37.4 million respectively), that both defendants had paid additional criminal penalties, that Tyco was the appropriate party to press claims for disgorgement against them, that Tyco already had filed claims for restitution against both defendants, and that Kozlowski and Swartz were both serving terms in prison for their conduct. Enforcement's recommendation to the Commission indicated that in light of these circumstances, it seemed appropriate to accept settlement offers that did not include restitution or civil penalties. Moreover, as noted above, (b)(7)(C) testified that the

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Commissioners discussed the question, and voted unanimously in favor of accepting Kozlowski and Swartz's settlement offers.

The OIG found no evidence that (b)(7)(C) or any other SEC staff had engaged in an obstruction of justice.¹⁵

D. Allegation that Enforcement Attorney Was Belligerent During Phone Conversation

(b)(7)(C) also alleged that (b)(7)(C) was belligerent towards him in a phone conversation, and that he thought (b)(7)(C) was trying to dissuade him from contacting the OIG, stating, "Call to (b)(7)(C) dissuade me from filing a complaint with your office obstruction of justice." See letter to (b)(7)(C) of the OIG dated April 22, 2010 Exhibit 21. He described the conversation in his testimony.

Q. So tell me exactly what you remember about that conversation.

A. Let me see. . . . The tone that he started off with was, like I said, belligerent, which got me a little bit upset because he's not who should have been a little bit angry. I got the impression that maybe the fact, that maybe I stumbled onto something and they were kind of upset that I had the audacity to question them.

Q. In what way was he belligerent? Was it just the –

A. The first couple of words, I forget what it was, but my radar went up immediately, like, you know, it wasn't even a condescending attitude. It was more belligerent like "How dare you question me or question us?"

Q. Had he used those words, or you inferred from the tone?

A. No, no, no, no. That's the tone that I got out of his voice. You know, he works for me. He works for the government. I fund the government with my tax money. He's answerable to me. It's not the other way around. Okay. I'm not the one who dropped the ball on this thing.

Q. So did he say anything that was belligerent or it was the tone?

A. It was the tone. You know, I heard – you know, I think the way it started – you know, "I head you were going to file an objection with the court." You know, who am I to question him?

¹⁵(b)(7)(C) did not mention a basis for his claims of mail and wire fraud, but he mentioned them in the same sentence in which he claimed there was an obstruction of justice. See e-mail dated December 9, 2009 from (b)(7)(C) to Khuzami, Exhibit 4. Therefore, it appears the claims are related. As the OIG found no evidence that there was an obstruction of justice, there appears to be no basis for the related mail fraud and wire fraud claims.

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So at that point, I basically spoke to him about, "You've got all this proof. You've got all this evidence. How come you didn't collect not one dollar in disgorgement, interest or penalties when you had smoking-gun evidence in front of you?"

And he couldn't – there was no answer. There was dead silence. Because there is no justifiable answer. I basically told them that I was not angry that they didn't collect anything. I was not surprised. But I was disappointed. And my tone of voice, the way that I'm speaking [to] you, is not the way I spoke to him. That I kept my emotions under control and just basically just tried to play the game where, you know, I'm going to drop the issue.

Once the – again, this is maybe a two-or three-minute conversation. I think I said to him a couple of times, twice in fact, that I was extremely disappointed with what I've seen. And based on how I know they operate and how they work, and all the settlements they've – a couple of hundred settlements they've had over the years, I knew that this was not right.

At that point, I basically told them I'm going to file an objection with the court, the same way I filed an objection in the Tyco class action suit when it came down.

See April 22, 2010 (b)(7)(C) Testimony tr. at pp. 17-18.

(b)(7)(C) denied that he acted in a belligerent manner toward (b)(7)(C) in the following exchange:

Q. Okay. Do you remember anything particular about those phone calls?

A. The one I remember the most was the last one, not only because it was the most recent, but also because he had filed a letter with Judge Sweet in the U.S. District Court for the Southern District of New York contending that the Commission's proposed settlement with Dennis Kozlowski and I believe with mark Schwartz as well, of whom were former Tyco executives shouldn't be approved. I'm not sure how much more specific I can be, but should not be approved.

Q. Right.

A. And at that point, although I and my staff had talked to (b)(7)(C) from time to time, I told him. You've now filed in court and this is now litigation. So we told him we really think the proper course for communication now is through the court.

Q. Okay. So in that phone conversation did you ever raise your voice or convey, you know, kind of a negative tone towards (b)(7)(C)

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A. No, I did not. And, in fact, it was I thought very straightforward and cordial, and he seemed – my memory is he seemed, if not literally apologetic, but he was like, well then, I will, you know, I'll have to see what I can do and I'm just doing what I think is right, that sort of thing.

Q. So in all the conversations you had with (b)(7)(C) do you at any point in time yell at him, raise your voice, use inappropriate language or otherwise use a very negative or inappropriate tone?

A. No, to each of those, no.

See May 14, 2010 (b)(7)(C) Testimony Tr. at p. 14.

In light of the above, the OIG was unable to substantiate (b)(7)(C) claim of belligerent conduct by (b)(7)(C)

E. Honest Services Fraud

(b)(7)(C) complaints also generally alleged corrupt behavior by the SEC attorneys who worked on the Tyco case, including language that could constitute a claim that SEC staff had violated 18 U.S.C. § 1346, which prohibits Honest Services Fraud. Under 18 U.S.C. § 1346, the term “scheme or artifice to defraud”, which is contained in the mail and wire fraud statutes, is expanded to include a scheme or artifice designed to deprive another of the intangible right of honest services.

In his letter of April 22, 2010 to (b)(7)(C) in the OIG, (b)(7)(C) stated:

The SEC lawyers in this case represent, work for, are paid by and their agency is funded by the US Government which ultimately are the citizens, the taxpayers if you will. SEC lawyers do not represent outside third parties and own [sic] no duty or loyalty or favors to them. They are not entitled to transfer anything of value to anyone as a favor or accept outright bribes, promises of future job or compensation, a finders fee, a kick back, and they should [not] do anything that would jeopardize the recovery of monies to the US Treasury. . . . This evidence in this case points to outrageous, unethical, morally reprehensive, slimy, devious, unjustifiable conduct and intentional criminal behavior by SEC employees from the top down to the trial level lawyers along with outside lawyers. Various parties at a minimum can be shown to have engaged in willful blindness and reckless disregard in their duties as official representatives of the SEC and officers of the court which is criminal in nature. The SEC lawyers and commissioners in this case intentionally did not put the best interests of it [sic] client first but last behind their own best financial, social and professional interests. The money that rightfully belongs to the US government in this case was stolen by these lawyers.

See Letter dated April 22, 2010 from (b)(7)(C) to (b)(7)(C) attached hereto as Exhibit 21.

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However, (b)(7)(C) provided no grounds for these allegations, either in his numerous e-mails and letters to the OIG, or in his testimony. When (b)(7)(C) was asked a series of questions to follow up on this issue, his responses were in the negative.

Q. Do you or did you at any time in the past have any personal interest in a relationship with Tyco, its related affiliates, or any of its officers, directors or employees?

A. Absolutely not.

Q. And are you aware of anyone in the Commission who did who worked on the matter?

A. No. Absolutely not.

Q. And do you or did you at any time in the past own any securities at Tyco or its related entities?

A. No.

Q. All right. Why don't we go off the record for a second?

A. Wait. Can I clarify one thing?

Q. Sure.

A. If, for instance, I hold Magellan, and I frankly don't know if Magellan holds Tyco, but if they do, I hold it indirectly. I certainly have never held it directly.

In light of the foregoing, the OIG concluded that there was no evidence to support (b)(7)(C) allegation of honest services fraud.

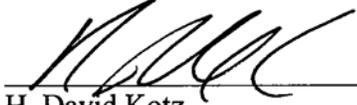
The OIG analyzed the issue based on the circumstances and law in place at the time the events took place and the allegations were made. We note, however, that in *Skilling v. United States*, (08-1394), June 24, 2010, the U.S. Supreme Court held that Section 1346, which proscribes fraudulent deprivations of "the intangible right of honest services," covers only bribery and kickback schemes.

Conclusion

The OIG investigation did not find evidence substantiating the claim that the SEC's Division of Enforcement failed to prosecute the Tyco matter appropriately, or that (b)(7)(C) or any other SEC staff member engaged in inappropriate or unethical conduct. We also found no evidence that (b)(7)(C) bounty application was improperly denied.

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In light of the foregoing, the OIG is closing this matter. A copy of this report is being provided to the Deputy Chief of Staff to the Chairman and the Director of Enforcement for informational purposes.

Submitted:	(b)(7)(C)	Date: <u>August 11, 2010</u>
Concur:		Date: <u>August 11, 2010</u>
Approved: <u></u>		Date: <u>Aug. 11, 2010</u>

H. David Kotz