



OFFICE OF
INSPECTOR GENERAL

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

June 30, 2016

TO: Andrew J. Ceresney, Director, Division of Enforcement

FROM: Carl W. Hoecker, Inspector General 

SUBJECT: *Final Management Letter: Evaluation of the SEC Division of Enforcement's Coordination Related to a Federal Civil Action*

The U.S. Securities and Exchange Commission (SEC or agency) Office of Inspector General (OIG) evaluated the SEC Division of Enforcement's (Enforcement) coordination of investigations.¹ The objective of the evaluation was to determine whether the SEC has processes and systems for ensuring that Enforcement investigations are coordinated internally and, when appropriate, across agency divisions and offices. We also assessed the SEC's efforts to coordinate an Enforcement investigation that was the subject of a Federal court's opinion and order. This final management letter summarizes the results of our evaluation.

Executive Summary

In August 2013, an Enforcement team at the SEC's Headquarters (HQ Team) began an investigation (HQ Investigation) involving microcap securities.² In a civil action filed by the SEC in connection with the HQ Investigation, a Federal court issued an opinion and order that discussed a perceived lack of coordination of SEC investigations with overlapping factual circumstances. The court suggested that the SEC examine agency procedures for ensuring that such investigations are properly coordinated and that scarce agency resources are deployed efficiently.

As a result, we reviewed Enforcement's policies and procedures for coordinating investigations and the Office of International Affairs' (OIA) policies and procedures for coordinating with Enforcement when necessary.³ We also (1) interviewed Enforcement and OIA staff, (2) reviewed relevant Federal court rules and documents, and (3) assessed Enforcement's internal coordination. Specifically, we assessed coordination between the HQ Team and an Enforcement team at the SEC's New York Regional Office (NYRO Team) that was conducting

¹ Enforcement conducts investigations into possible violations of Federal securities laws and prosecutes the SEC's civil suits in Federal court as well as through internal administrative proceedings.

² Microcap securities include low-priced stocks that tend to trade in low volumes. These securities are issued by small companies that typically have limited assets and operations.

³ We focused on Enforcement and OIA coordination because the HQ Investigation involved international entities. We reviewed Enforcement's policy manual, intranet site, and Hub case tracking system user guide. We also reviewed two memorandums that were jointly issued by Enforcement and OIA. These memorandums were (1) *Internal Control Policy for Productions from Foreign Regulatory and Law Enforcement Agencies* and (2) *Agreed Upon Procedures for Foreign Formal Order Matters*.

another investigation (NYRO Investigation). In addition, we reviewed (1) certain e-mails between Enforcement and OIA staff, and (2) evidence indicating that Enforcement's internal and external coordination efforts included the use of ad hoc communication, such as teleconferences and meetings. We conducted this evaluation between January and June 2016 in accordance with the Council of the Inspectors General on Integrity and Efficiency *Quality Standards for Inspection and Evaluation* (January 2012).

We found that the SEC has processes and systems for coordinating Enforcement investigations internally and, when appropriate, across agency divisions and offices. However, staff judgment, which is central to the SEC's processes for coordinating investigations, led to an instance of untimely information-sharing during the HQ Investigation. According to Enforcement management, however, earlier information sharing would not have changed the theory of liability or remedies Enforcement staff pursued in the HQ Investigation.

To further strengthen the SEC's policies and procedures for coordinating investigations, we recommended certain corrective actions. On June 20, 2016, we provided management with a draft of this management letter for review and comment. In its June 28, 2016, response, management concurred with our recommendations. We have included management's response as an attachment to this final management letter.

Background

In November 2015, and as a result of a civil action filed by the SEC in connection with the HQ Investigation, a Federal court suggested that "a[n SEC] self-examination may be appropriate" and "could lead to a review and effective implementation of procedures in [Enforcement] and related operational offices to ensure that investigations are coordinated and scarce resources are deployed efficiently." In the court's opinion, the SEC did not effectively coordinate investigations involving related parties and overlapping factual circumstances.

Enforcement investigations, including those involving microcap securities, are coordinated through several means, including investigative task forces, working groups, case tracking systems, and ad hoc communication among agency staff. Enforcement's Microcap Fraud Task Force (Task Force) investigates potential fraud involving microcap securities. According to Enforcement management, microcap fraud investigations are complex, and the perpetrators are often difficult to identify because the perpetrators frequently (1) transfer sales proceeds offshore, (2) use banks in jurisdictions with strict secrecy laws, and (3) use layers of intermediaries and multiple accounts to avoid detection. In addition, Enforcement manages hundreds of matters involving microcap issues. According to the co-head of the Microcap Fraud Task Force, the size of the Task Force (about 25 staff members) is insufficient to investigate all microcap fraud leads. Therefore, non-Task Force staff also investigate microcap fraud issues, such as in the HQ Investigation.

To share information, knowledge, and ideas about microcap-related issues among the various divisions and offices within the SEC, the SEC established the Microcap Fraud Working Group. The Working Group is an informal group of staff from various SEC divisions and offices interested in microcap fraud issues. Microcap Fraud Working Group members participate in monthly teleconferences and work closely with Microcap Fraud Task Force staff when necessary.

Case tracking systems also promote coordination within Enforcement. We reviewed Enforcement's policies and staff actions associated with two case tracking systems: the Name Relationship Search Index and Enforcement's Hub (Hub). The Name Relationship Search Index is an agency-wide database that enables staff to cross-reference information available in various SEC automated information systems. With regard to Enforcement-related automated information systems, such information includes:

- case names,
- case numbers,
- case statuses,
- related parties, and
- currently assigned staff.

The Hub is a web-based application accessible to all Enforcement staff that tracks information about all Enforcement matters. Such information includes:

- factual summaries of potentially violative conduct,
- related parties,
- historical investigative activity,
- current statuses,
- planned work, and
- currently assigned staff.

Enforcement policy requires that staff search these case tracking systems before opening an investigation, and recommends that staff communicate with investigators who are working on matters that involve related individuals, entities, or conduct.

Results

We determined that Enforcement staff judgment is central to the SEC's processes for coordinating investigations. Specifically, the Microcap Fraud Task Force's ability to effectively coordinate potentially related microcap fraud investigations and staff's use of the Hub to do so depend on staff judgment. For example, the Microcap Fraud Task Force coordinates through training, teleconferences, and weekly e-mails among Task Force staff. However, the degree to which staff share information about investigations that potentially involve related parties depends in large part on what information staff determine is relevant to others.

We identified instances in which staff judgment led to both effective and ineffective information sharing, including in the HQ Investigation. For example, in March 2014, OIA obtained

documents that included account opening information and trading records for a certain entity (Entity).⁴ That same month, OIA provided the documents to the NYRO Team because the NYRO Investigation involved the Entity. Subsequently, the NYRO Team searched the Hub and identified other Enforcement staff who appeared to have active investigations involving the Entity.⁵ Following this search, in July 2014, the NYRO Team e-mailed Enforcement staff identified during the Hub search, and the Microcap Fraud Task Force co-head, to offer them access to the documents. About 3 months later, in or around October 2014, the HQ Team determined that the Entity was relevant to the HQ Investigation.⁶ However, the HQ Team was not aware of the documents from OIA that the NYRO Team possessed. As a result, the HQ Team did not timely obtain the documents. In fact, the HQ Team did not obtain the documents until after the SEC filed a civil action related to the HQ Investigation.

Moreover, when the HQ Team searched the Hub for other investigations involving the Entity, the HQ Team decided to contact only Enforcement staff working on investigations that focused on the Entity and did not contact Enforcement staff whose investigations involved the Entity only as a related party.⁷ Because the Entity was related to, but not the focus of, the NYRO Investigation, the HQ Team did not contact the NYRO Team and, thus, missed an opportunity to coordinate both investigations—including sharing the documents provided by OIA.

In February 2015 (after the events described above occurred), Enforcement enhanced the SEC's ability to coordinate investigations without relying on staff to manually search the Hub. Specifically, Enforcement added to the Hub an alert function that automatically e-mails relevant staff when the same related party (entity or individual) is added to the Hub record of another investigation.

Although this alert function should decrease the likelihood of future missed opportunities for investigative coordination, the effectiveness of the alert function continues to depend on the judgment and actions of Enforcement staff. For example, staff need to timely and accurately add related parties to the Hub, and members of the HQ Team acknowledged that the Entity was not timely added to the HQ Investigation in the Hub.⁸ In addition, this Hub alert function works only if both related parties have the same Hub-generated identifier. Furthermore, when staff receive an alert from the Hub, they need to timely follow up with other investigators working on related matters. However, Enforcement has not established required actions or

⁴ The documents included over 2,700 pages of information in English, Spanish, or in some instances, a combination of the two.

⁵ Enforcement staff regularly search the Hub to identify and contact other Enforcement staff investigating related matters or entities. Enforcement's policy manual requires staff to search the Hub only when opening a matter, although staff we interviewed thought that they were required to search the Hub throughout an investigation.

⁶ Members of the HQ Team told us that they did not enter the Entity as a related party in the Hub at this point.

⁷ Although a single individual, entity, or group of individuals and/or entities may be the focus of an SEC investigation, investigations may also involve several related parties whose nexus to the investigation may or may not include potentially violative conduct. For example, the Hub included over 20 related parties for the HQ Investigation and over 70 related parties for the NYRO Investigation.

⁸ According to the HQ Team, they did not enter the Entity as a related party in the Hub until after the SEC filed a civil action related to the HQ Investigation.

timeframes for doing so. Rather, Enforcement management has advised staff to contact other investigators if staff want additional information about why a related party was added to the Hub.

Conclusion

Overall, we determined that the SEC has processes and systems for coordinating Enforcement investigations. We also found that, although processes and systems are in place, the SEC must rely on staff judgment to coordinate investigations. Regarding the HQ Investigation, we identified a missed opportunity to timely share information. Nonetheless, according to Enforcement management, earlier information sharing would not have changed the theory of liability or remedies Enforcement staff pursued in the HQ Investigation. Finally, we found that by adding an alert function to the Hub, the SEC enhanced its processes for coordinating Enforcement investigations, reducing the likelihood of such missed opportunities in the future. To further strengthen the SEC's policies and procedures for coordinating investigations, we are recommending additional corrective actions.

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

Recommendation 1: The Director of the Division of Enforcement, or his or her designee, should continue to emphasize to staff the importance of timely and accurately entering related party data in the Hub and other case tracking systems.

Recommendation 2: The Director of the Division of Enforcement, or his or her designee, should ensure the Division of Enforcement develops and disseminates policies or procedures that establish the action(s) staff must take once they receive an alert from the Hub and the timeframe(s) for taking those action(s).

Recommendation 3: The Director of the Division of Enforcement, or his or her designee, should ensure the Division of Enforcement considers updating its policies to require that staff search the Hub and other case tracking systems when related parties are identified and other key investigative milestones occur, and communicate when appropriate, with staff who are working on matters that involve the related parties.

Management's Response. As shown in the attachment to this final management letter, the Director of the Division of Enforcement concurred with all three recommendations, and stated that the Division of Enforcement will implement the recommendations promptly.

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

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

Attachment

cc: Mary Jo White, Chair
Andrew Donohue, Chief of Staff, Office of the Chair
Michael Liftik, Deputy Chief of Staff, Office of the Chair
Nathaniel Stankard, Deputy Chief of Staff, Office of the Chair
Michael S. Piwowar, Commissioner
Jaime Klima, Counsel, Office of Commissioner Piwowar
Kara M. Stein, Commissioner
Robert Peak, Advisor to the Commissioner, Office of Commissioner Stein
Anne K. Small, General Counsel
Keith Cassidy, Director, Office of Legislative and Intergovernmental Affairs
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MEMORANDUM

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

FROM: Andrew J. Ceresney, Director

RE: Division of Enforcement's Response to the Office of Inspector General's
Management Letter: Evaluation of the SEC Division of Enforcement's
Coordination Related to a Federal Civil Action

DATE: June 28, 2016

We appreciate the opportunity to review and comment on the Draft Management Letter. We concur with all three recommendations, and will implement them promptly.

We will continue to emphasize to staff the importance of timely and accurately entering related party data in the Hub and other case management systems as recommended in Recommendation 1, a practice the recommendation recognizes that the Division already undertakes. We also will develop and disseminate policies or procedures regarding the action(s) staff must take once they receive an alert from the Hub and the timeframe(s) for taking those action(s), as recommended in Recommendation 2. Finally, we will consider updating the Division's policies to require that staff search the Hub and other case tracking systems when related parties are identified and other key investigative milestones occur, and communicate when appropriate, with staff working on matters that involve the related parties, as recommended in Recommendation 3.