



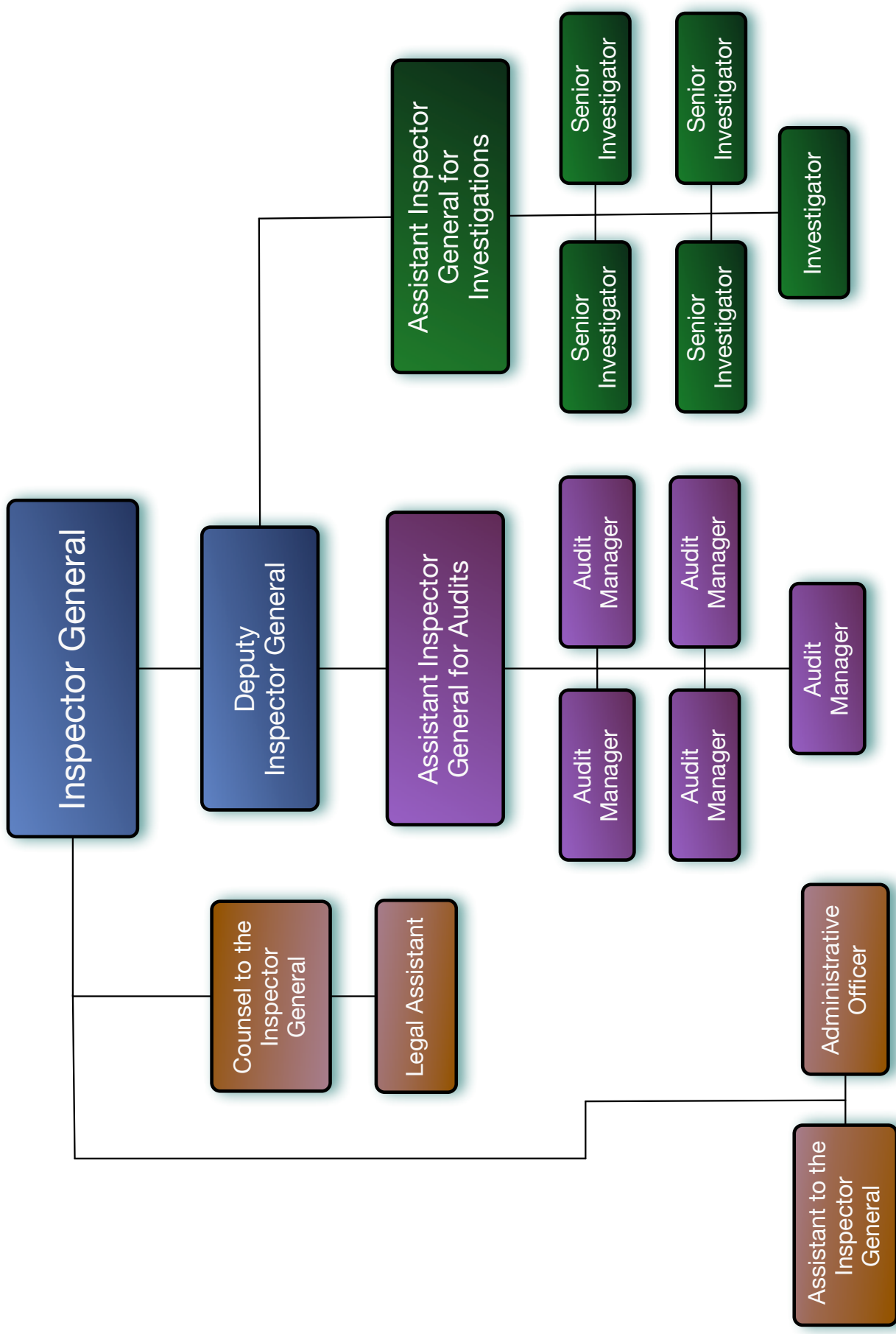
U.S. SECURITIES AND EXCHANGE COMMISSION  
OFFICE OF INSPECTOR GENERAL

SEMIANNUAL REPORT TO CONGRESS

APRIL 1, 2009 - SEPTEMBER 30, 2009

# Organizational Chart

Office of Inspector General



April 1, 2009 - September 30, 2009



**U.S. Securities  
and Exchange  
Commission**

# OFFICE OF INSPECTOR GENERAL SEMIANNUAL REPORT TO CONGRESS

## MISSION

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

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





# SEMIANNUAL REPORT TO CONGRESS

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## Message from the **Inspector General**

I am pleased to present the U.S. Securities and Exchange Commission (SEC) Office of Inspector General's (OIG) Semiannual Report to Congress for the period of April 1, 2009 through September 30, 2009. This report is required by the Inspector General Act of 1978, as amended, and covers the work performed by the OIG during the period indicated.

The reporting period was a very busy and productive one for the OIG. On August 31, 2009, we completed a 457-page Report of Investigation on the "Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." The report was the culmination of a nine-month long investigation into the numerous examinations and investigations that the SEC had conducted of Bernard Madoff (Madoff), and his firms over a nearly 20-year period. The investigation was conducted by a team of just six OIG attorneys, and incorporated the review of approximately 3.7 million e-mails and 140 testimonies or interviews. The investigative report was the result of the extraordinary efforts of this six-person OIG team who were incredibly devoted to this important project, and completed a remarkable amount of work within a very short period of time.

The report concluded that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Madoff and his firms for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, the SEC never conducted a thorough and competent investigation or examination of Madoff. We found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. However, we found that the SEC's examinations and investigations of Madoff were inadequate and failed to take the basic steps necessary to uncover the Ponzi scheme.

Shortly after the issuance of the Madoff report, on September 10, 2009, I testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs about the Madoff investigation. In that testimony, I summarized the report we had conducted and provided recommendations about how to reform SEC operations.

In addition to the 457-page comprehensive investigative report that described in detail the investigations of Madoff conducted by the SEC's Division of Enforcement (Enforcement) and the examinations by the SEC's Office of Compliance Inspections and Examinations (OCIE), on September 29, 2009, we issued two audit reports in which we provided 58 concrete and specific recommendations to the SEC to improve the operations of Enforcement and OCIE. Enforcement and OCIE have concurred with all 58 recommendations and have already begun making the necessary improvements to ensure that they are able to detect fraud more effectively in the future. We plan to

follow up to ensure that all 58 recommendations are implemented in full and report back to the Congress on the status of these efforts. We also intend to conduct a follow-up audit to determine if the changes to OCIE's and Enforcement's operations are having the desired and appropriate effect.

Although we devoted significant resources during the reporting period to Madoff-related investigations and audits, we also conducted numerous additional investigations and audits.

On August 27, 2009, we completed an important review of the SEC's oversight of Nationally Recognized Statistical Rating Organizations (NRSROs). We found that several improvements were needed to ensure compliance with the Credit Rating Agency Reform Act of 2006 (Rating Agency Act) and the SEC's implementing regulations and to enhance NRSRO oversight. Our audit report made 24 concrete recommendations designed to ensure compliance with the NRSRO application approval process established by the Rating Agency Act, improve the effectiveness of OCIE's NRSRO examination program, and augment SEC oversight of credit rating agencies.

During the reporting period, we also issued both a Management Alert and full audit report on the SEC's Procurement and Contract Management functions, in which we identified significant risk areas, which hindered the SEC from having an effective and efficient procurement and contracting operation. We provided numerous recommendations designed to address the deficiencies we found.

We also issued a report reviewing the SEC's compliance with the Freedom of Information Act (FOIA) and found that improvements were necessary to ensure that the public receives documents to which they are entitled under the law in a timely, complete and transparent manner. We made recommendations to reverse what we found to be a presumption in favor of withholding, rather than disclosing, information through the SEC FOIA process, and to ensure that FOIA requesters receive fair and unbiased reviews during FOIA appeals.

Further, in addition to the Madoff investigative report, we issued 12 other comprehensive investigative reports during the reporting period on a variety of critical matters, including the unauthorized disclosure of non-public information, abuse of authority, ethical conflict of interests, retaliation against whistleblowers, various fraudulent schemes operating within the SEC, and the misuse of position and resources.

I also testified at another hearing on July 13, 2009, before the U.S. House of Representatives Committee on Financial Services' Subcommittee on Oversight and Investigations on the subject of an investigation report that we issued during the preceding reporting period concerning the securities trading of SEC Enforcement attorneys. In this testimony, I described our year-long investigation of these Enforcement attorneys, which encompassed a comprehensive review and analysis of more than two years of brokerage records, ethics filings, securities transaction filings, and e-mail records, as well as interviews of numerous current and former SEC employees. I also

discussed the SEC's decision to revamp completely its current process for monitoring SEC employees' securities transactions based upon our findings.

I am very proud of the extraordinary accomplishments of this Office during the past six months that have been achieved with a very small staff. Particularly, during these turbulent financial times, I believe that the work of this Office has been critical in providing the SEC, the U.S. Congress, and the public with valuable information about the regulatory climate, and we intend to continue this important work in the future.



H. David Kotz  
Inspector General





# SEMIANNUAL REPORT TO CONGRESS

## MANAGEMENT AND ADMINISTRATION

### AGENCY OVERVIEW

The U.S. Securities and Exchange Commission's (SEC) mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public's trust and characterized by transparency and integrity. The SEC's core values consist of integrity, accountability, effectiveness, teamwork, fairness, and commitment to excellence.

To achieve its mission, the SEC fosters and enforces compliance with the Federal securities laws; promotes healthy capital markets through an effective and flexible regulatory environment; facilitates access to the information investors need to make informed investment decisions; and enhances its performance through effective alignment and management of human, information and financial capital.

SEC staff monitor and regulate a securities industry that includes more than 35,000 registrants, including about 12,000 public companies, 8,000 mutual funds, 11,300 investment

advisers, 5,500 broker-dealers, 600 transfer agents, 11 national securities exchanges, ten nationally recognized statistical rating organizations, and self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board, and the Public Company Accounting Oversight Board.

In order to accomplish its mission most effectively and efficiently, the SEC is organized into five main divisions (Corporation Finance, Enforcement, Investment Management, Trading and Markets and Risk, Strategy, and Financial Innovation), and 17 functional offices. The Commission's headquarters is located in Washington, D.C., and there are 11 regional offices located throughout the country. In Fiscal Year 2009, the SEC had 3,652 full-time equivalents (FTEs), consisting of 3,580 permanent and 72 temporary FTEs.

### OIG STAFFING

During the reporting period, the Office of Inspector General (OIG) added a new position, Assistant to the Inspector General. The

duties of this critical position include report editing, investigatory inquiry research, and FOIA response coordination.

In April 2009, we were very fortunate to have the position filled by Roberta Raftovich. Ms. Raftovich comes to us from the Peace Corps Office of Inspector General, where she spent two years working with the Peace Corps OIG investigators. As their Criminal Research Analyst, she helped coordinate all Peace Corps OIG investigations and served as the Peace Corps OIG's FOIA Officer. Ms. Raftovich is a 2002 graduate of the University of Maryland in College Park, where she received a Bachelor of Arts degree in Criminology and Criminal Justice and was a member of the National Society of Collegiate Scholars.

We also obtained the services of two additional investigators on detail to assist within the OIG's investigation of Bernard Madoff's Ponzi scheme from other offices with the SEC, Heidi L. Steiber from the Office of General Counsel (OGC), and Christopher Wilson from the Office of Investor Education and Advocacy (OIEA). In the OGC, Ms. Steiber served as Senior Counsel in the Legal Policy Group where she provided legal advice and policy analysis to the Commission on enforcement and regulatory recommendations. Prior to joining the SEC in 2007, Ms. Steiber was a litigation associate in

the securities enforcement group of Mayer Brown LLP, where she represented clients in SEC, FINRA, and DOJ investigations, litigation and private securities class actions. In the OIEA, Mr. Wilson served as Senior Counsel, where he provided guidance and assistance to securities professionals and investors regarding federal securities law issues. In 1999, Mr. Wilson began his employment at the SEC as an investigator in the Office of Equal Employment Opportunity. During his tenure at the SEC, Mr. Wilson was selected to serve on detail to the Division of Enforcement's Office of Chief Counsel during the financial corporate scandals of 2002, and as a Special Assistant U.S. Attorney in the U.S. Attorney's Office for the District of Columbia in 2008-2009. Prior to joining the SEC, Mr. Wilson was a litigation associate for Wilson Jacobson PC in New York.

Two of our investigators left the OIG during the reporting period to pursue other opportunities. Investigator Ray Arp, Sr. left the OIG on August 15, 2009, and Special Agent Brian Bressman departed the OIG on August 29, 2009. The OIG appreciates the dedicated service of these two investigators. We have moved quickly to advertise these vacancies and expect to have both positions filled by the end of October 2009.



Office of  
Inspector  
General

# SEMIANNUAL REPORT TO CONGRESS

## CONGRESSIONAL TESTIMONY, BRIEFINGS AND REQUESTS

During the reporting period, the OIG had extensive communications with Congressional Committees, Members of Congress and staff through testimony, meetings, and written and telephonic communications. These communications pertained to the OIG's investigation of the SEC's failure to uncover Bernard Madoff's Ponzi scheme, a prior OIG investigation into the trading activities of two SEC Enforcement attorneys, the OIG's previous audits involving the SEC's oversight of Bear Stearns and related entities, and other topics of interest relating to the SEC and the Inspector General (IG) community.

On September 10, 2009, the IG testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs on the subject of "Oversight of the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance." In that testimony, the IG provided a briefing on the comprehensive

and thorough investigation the OIG completed on August 31, 2009, into the SEC's failure to uncover Bernard Madoff's Ponzi scheme. Specifically, the IG provided a synopsis of the extensive work performed during the course of the investigation, including: (1) requests for and search of approximately 3.7 million e-mails; (2) review and analysis of documents produced in response to the OIG's comprehensive document requests, including: (a) records of all SEC investigations conducted relating to Madoff, his firms, Madoff family members or Madoff associates from 1975 to 2009, (b) the workpapers and examination files of nine SEC examinations of Madoff's firms conducted from 1990 to 2008, and (c) documents obtained from outside third parties regarding Madoff's trading records; and (3) 140 testimonies under oath or interviews of 122 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Madoff and his firms. The IG also de-

scribed the outside expertise the OIG obtained to assist in conducting the investigation, which included the retention of FTI Consulting, Inc. to aid in the review of the SEC examinations of Madoff and his firms, and the retention of First Advantage Litigation Consulting Services to assist in the restoration and production of relevant electronic data.

The IG then briefed the Committee on the results of the OIG's investigation, as contained in a 457-page report of investigation issued to the SEC Chairman on August 31, 2009. The IG informed the Committee that the OIG's investigation found that between June 1992 and December 2008, the SEC received six substantive complaints that raised significant red flags about Madoff's investment adviser operations that should have led to questions about whether Madoff was actually trading. The IG also testified that the SEC was aware of two 2001 articles in reputable publications that questioned Madoff's unusually consistent investment returns. The IG informed the Committee that the OIG's report of investigation concluded that notwithstanding these six complaints and two articles, the SEC never conducted a competent and thorough examination or investigation of Madoff for operating a Ponzi scheme and, had such an investigation been conducted, the SEC may have been able to uncover the fraud. The IG then provided a detailed discussion of each of the six complaints and two articles that provided numerous red flags that Madoff was operating a Ponzi scheme, but were not adequately pursued and, in many cases, were ignored by the SEC investigators or examiners. The IG also informed the Committee, however, that the OIG's investigation did not uncover evidence that any SEC personnel who worked on an examination or investigation of Madoff or his firms had any financial or other inappropriate connection with Madoff or his family that influenced the conduct of the examination or investigatory work, or that there was any inappropri-

ate interference in the examinations or investigations by higher-level SEC officials.

The IG informed the Committee that, as a result of the investigation's findings, the OIG has recommended that the Chairman carefully review the report and share with appropriate management officials the portions relating to performance failures by employees who still work at the SEC, so that appropriate action (which may include performance-based action) is taken on an employee-by-employee basis, to ensure that future examinations and investigations are conducted in a more appropriate manner and the mistakes and failures outlined in the OIG's report are not repeated. Finally, the IG discussed three additional reports the OIG planned to issue in an effort to address the systematic breakdowns that occurred in connection with the SEC's investigations and examinations of Madoff and his firms. These included two separate audit reports providing the SEC with specific and concrete recommendations to improve the operations of its enforcement and examination programs, and a third report analyzing the reasons why the SEC's investment adviser examination unit did not examine Madoff after he was forced to register as an investment adviser in 2006, and prescribing recommendations to improve this process. The full text of the IG's written testimony is contained in Appendix A to this Semiannual Report, and information about the entire hearing is available at

[http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=7b38b6a3-f381-4673-b12c-f9e4037b0a3f](http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=7b38b6a3-f381-4673-b12c-f9e4037b0a3f).

In addition to the IG's testimony on the Madoff investigation, the IG had numerous communications with Members of Congress and staff regarding issues pertaining to that investigation. On June 23, 2009, the IG met with the Honorable Paul E. Kanjorski (D-Pennsylvania), Chairman of the Subcommittee



on Capital Markets, Insurance, and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services, and provided a briefing on the status of the OIG's Madoff investigation. Subsequently, on June 30, 2009, the IG provided a letter to Chairman Kanjorski, in which the IG set forth several suggestions for possible legislative revisions that arose out of the OIG's Madoff investigatory work. These suggestions included: (1) extending the regulatory jurisdiction of the Public Accounting Oversight Board to include audit reports prepared by a domestic registered or foreign public accounting firm regarding issuers, broker-dealers, investment advisers and any companies subject to U.S. securities laws; (2) amending the Investment Advisers Act of 1940 to require the use of independent custodians in a manner similar to the requirement for use of an independent custodian by mutual funds contained in the Investment Company Act of 1940; (3) imposing a requirement of certification by senior officers of registered investment advisers, including all funds of hedge funds, that they have conducted adequate due diligence in connection with investments; and (4) amending the Securities Exchange Act of 1934 to authorize the SEC to award a bounty for information leading to the recovery of a civil penalty from any violator of the Federal securities laws, not just insider trading violations. In addition, on several occasions in April and September 2009, the IG provided briefings on the Madoff investigation and OIG report to various staff members of the U.S. Senate Committee on Banking, Housing and Urban Affairs, the U.S. Senate Committee on Finance, and the U.S. House of Representatives Committee on Financial Services.

On July 13, 2009, the IG testified before the Subcommittee on Oversight and Investigations of the House of Representatives Committee on Financial Services on the subject of "Preventing Unfair Trading by Government Officials." In

this testimony, the IG focused on the OIG's investigation into the securities transactions of two SEC Enforcement attorneys over a two-year period, which was completed on March 23, 2009, and reported on in the OIG's Semiannual Report to Congress for the period ending March 31, 2009. The IG discussed the work performed during the investigation, including a comprehensive review and analysis of more than two years of brokerage records, ethics filings, securities transaction filings and e-mail records, as well as several sworn testimonies and interviews. The IG then described the findings of the OIG's report of investigation, which included suspicious conduct, appearances of improprieties and evidence of possible trading based on non-public information on the part of the two SEC attorneys. The IG informed the Subcommittee that because of the seriousness of the information uncovered by the investigation, the OIG had referred the matter to the Fraud and Public Corruption Section of the U.S. Attorney's Office for the District of Columbia, which, together with the Federal Bureau of Investigation (FBI), was pursuing an investigation of possible criminal and civil violations.

The IG's testimony also described the numerous violations of the SEC's current securities reporting requirements by the two attorneys that were uncovered during the course of the investigation. The IG informed the Subcommittee of the serious deficiencies identified in the current reporting system, noting that although the SEC is charged with prosecuting violations of the Federal securities laws, including insider trading cases, the SEC had essentially no compliance system in place to ensure that its own employees, with tremendous amounts of non-public information at their disposal, did not engage in insider trading themselves. The IG further testified that the OIG's report had recommended disciplinary action against the two attorneys who violated the

SEC's securities transaction requirements and provided 11 specific recommendations for improvements to ensure adequate monitoring of employees' securities transactions in the future. Finally, the IG pointed out that the OIG's investigation underscored the need for the SEC to revamp completely its current process for monitoring employees' securities transactions, and that SEC Chairman Mary Schapiro had announced several concrete steps the SEC planned to take to address the serious issues identified by the OIG's investigation. The full text of the IG's written testimony is contained in Appendix B to this Semiannual Report, and information about the entire hearing is available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/oigr\\_070609.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/oigr_070609.shtml). In addition to his testimony before the Subcommittee, the IG also met with various Subcommittee staff members on June 22, 2009, and provided a briefing on the OIG's investigation of the attorneys' securities trading.

On April 11, 2009, the IG, along with an OIG auditor and expert consultant, met with several staff members of the Senate Permanent Subcommittee on Investigations, and provided an extensive briefing on the OIG's two audit reports pertaining to the SEC's oversight of Bear Stearns and related entities, both of which were reported on in the OIG's Semiannual Report to Congress for the period ending September 30, 2008. The specific topics addressed during this briefing included: (1) additional information about the OIG audit reports' findings and recommendations; (2) how the SEC administered the Consolidated Supervised Entity (CSE) program, in which Bear Stearns had been a participant, including: (a) the frequency with which the SEC examined the CSE firms, (b) the credentials and expertise of the CSE program staff, and (c) the number of staff assigned to examine each CSE firm; (3) how the CSE firms measured risks and the internal control failures that led to Bear

Stearns' demise; (4) the liquidity, capital and leverage ratios of Bear Stearns and what impact they had on Bear Stearns' demise; and (5) areas where the SEC's oversight had failed and needed improvements.

During the semiannual reporting period, the IG also met with Congressional staff members who sought his input and views pertaining to H.R. 885, the Improved Financial and Commodity Markets Oversight and Accountability Act, which would require Presidential appointments and Senate confirmation of the Inspectors General of the Commodity Futures Trading Commission (CFTC), the National Credit Union Administration (NCUA), the Pension Benefit Guaranty Corporation (PBGC), the Board of Governors of the Federal Reserve System (FRB), and the SEC. Specifically, on July 9, 2009, the SEC IG, along with the IGs of the CFTC, NCUA, PBGC and FRB, met with staff of Senator Charles Grassley (R-Iowa), Ranking Member of the Senate Committee on Finance. On July 13, 2009, the IG met with staff of Representative John B. Larson (D-Connecticut), the sponsor of the legislation. In addition, on July 7, 2009, the SEC IG, jointly with the CFTC, NCUA, PBGC and FRB IGs, provided letters to Senator Joseph I. Lieberman (D-Connecticut), Chairman, and Senator Susan M. Collins (R-Maine), Ranking Member, of the Senate Committee on Homeland Security and Governmental Affairs, setting forth their views on S. 1354, which is comparable to H.R. 885.

Finally, on August 20, 2009, the SEC IG and Neil M. Barofsky, Special Inspector General for the Troubled Asset Relief Program (SIGTARP), jointly provided a letter to Representative Elijah E. Cummings (D-Maryland), in response to his request for an investigation pertaining to issues related to the proposed settlement of an SEC action brought against Bank of America. In that letter, the IGs informed Representative Cum-

mings that they shared his concerns and had coordinated their efforts to determine the best approach to examine the issues he had raised. The IGs further stated in the letter to Representative Cummings that the SEC IG was in a bet-

ter position to review independently the information he requested and, accordingly, the SEC IG would conduct the investigation outlined in his request.





# SEMIANNUAL REPORT TO CONGRESS

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

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

### **CHALLENGE: CONDUCTING ADEQUATE ENFORCEMENT INVESTIGATIONS**

The OIG has identified the SEC enforcement function as a management challenge.

The OIG recently completed an extensive investigation into the failure of the SEC's Division of Enforcement (Enforcement), as well as its Office of Compliance Inspections and

Examinations (see second challenge below), to uncover a multi-billion dollar Ponzi scheme perpetrated by Bernard L. Madoff (Madoff). The OIG's investigation found that Enforcement received multiple detailed and credible complaints regarding Madoff's financial wrongdoing, but failed to take the appropriate steps in its investigations to uncover the fraud.

As a result of the findings in the OIG investigation, we have identified several deficiencies within Enforcement that should be remedied in order to ensure that it conducts adequate Enforcement investigations and uncover violations of securities laws and fraud. These deficiencies include:

- Enforcement staff lacking adequate guidance on how to analyze complaints appropriately;

- Enforcement staff failing to exercise due diligence in their handling of critical information;
- Inexperience of Enforcement staff conducting investigations;
- Enforcement staff failing to seek assistance from other offices and divisions as needed in their investigations;
- Lack of supervision of junior Enforcement staff;
- Enforcement staff failing to verify information provided by the subject of an investigation with independent sources;
- Enforcement staff not adequately evaluating additional information received from a complainant during the course of an investigation; and
- Enforcement staff failing to open or close its investigations in a timely manner.

Enforcement has stated that it has already taken significant steps toward creating a better organized and more effective Division and plans to engage in a restructuring effort that is the most significant in its history.

### **CHALLENGE: CONDUCTING ADEQUATE COMPLIANCE EXAMINATIONS**

The OIG has identified the SEC compliance examinations function as a management challenge.

The OIG recently completed an extensive investigation into the failure of the SEC's Office of Compliance Inspections and Examinations (OCIE), as well as its Division of Enforcement (see first challenge above) to

uncover a multi-billion dollar Ponzi scheme perpetrated by Madoff. The OIG's investigation found that OCIE received multiple detailed and credible complaints regarding Madoff's financial wrongdoing, but failed to take the appropriate steps in its examinations to uncover the fraud.

As a result of the findings in the OIG investigation, we have identified several deficiencies within OCIE that should be remedied in order to ensure that it conducts adequate examinations and uncover violations of securities laws and fraud. These deficiencies include:

- Inadequate evaluation of complaints from industry sources and failure to define the appropriate scope for an examination triggered by the complaints;
- Inadequate planning of examinations;
- Inadequate communication and information sharing among OCIE personnel;
- Failure to form examination teams with sufficient skills and experience necessary to conduct the examinations;
- Failure to contact outside entities to corroborate representations made by entities under examination and failure to seek and analyze information from outside sources to verify information found in documents produced in an examination;
- Failure to follow up on contradictions discovered during the examinations and leaving discrepancies uncovered by examiners unresolved;
- Failure to adequately track the progress of examinations; and

- Improperly closing examinations without addressing numerous issues raised in the complaints that triggered the examinations.

OCIE has indicated that it concurs with the OIG's recommendations for improvement and has already begun the process of implementing changes in its operations.

## **CHALLENGE: PROCUREMENT AND CONTRACTING**

Though significant improvements have been made in this area, the Commission's procurement and contracting function continues to be a management challenge. Since the OIG first identified the procurement and contracting function as a management challenge in the fiscal year (FY) 2008 Performance and Accountability Report, the Office of Acquisitions (OA) within the SEC's Office of Administrative Services has represented to the OIG that it has made significant efforts to improve performance with respect to the agency's Regional Offices. These efforts include conducting outreach visits to regional offices to ascertain the status of their procurements, offering staff assistance and training opportunities, partnering with the SEC University to identify training requirements and available funding to ensure regional office employees who perform procurement and contracting activities are sufficiently trained, and implementing a new litigation support policy in collaboration with the Office of Financial Management (OFM) to improve procurement processes for certain Enforcement needs within the regional offices.

OA has also represented that they have made significant progress with regard to automation of the Commission's purchasing and contracting functions. OA implemented a new automated procurement system,

PRISM, on April 22, 2009, and is actively using the system as a contract writing and management tool. OA is also conducting various other activities with regard to PRISM including training and data migration, in order to implement the system. Further, until the system is fully implemented, OA represented that they are consolidating multiple contract tracking tools and manual records into a single searchable database to address the OIG's concerns regarding the failure to maintain a "single" list of all contract actions.

While the OIG acknowledges the efforts OA stated it has taken to remedy the OIG's concerns, the procurement and contracting function remains a significant challenge for the Commission due to the breadth and complexity of the issues that OA faces. During this reporting period, the OIG conducted work in the procurement area that identified a number of problems that need to be remedied, as well as areas for improvement in internal controls. The OIG issued Management Alert-Microsoft Premiere Support Services Contracts, Report No. 469, in August 2009 and Audit of the Office of Acquisitions Procurement and Contract Management Function, Report No. 471, in September 2009.

OIG Report No. 469 identified significant problems with the acquisition practices related to the award of a sole-source contract valued at approximately \$1 million. Specifically, the basis for making a sole-source award was not clearly supported, the sole-source justification was not signed by the appropriate official, the document form used to award the contract was incorrect, a modification was executed that inappropriately expanded the scope of the contract, and the price reasonableness determination cited an incorrect regulatory provision.

In addition, OIG Report No. 471 identified the following key organizational issues that management needs to address:

- OA is unable to provide complete operational data (a consolidated record of the universe of active, pending, completed and cancelled contracts, agreements, and purchase orders) to manage the procurement and contracting function and report on performance, due to years of using manual processes. Additionally, OA does not have standard operating procedures stating what information contracting officers should maintain and track;
- OA is in the process of fully automating its procurement and contracting function after two previous failed attempts to implement an automated procurement system. Data migrated to the new system must be reconciled with OFM's accounting system (Momentum), years of manual records maintained by separate contracting officers, procurement data maintained by the regional offices, and data contained in the previous automated procurement system (SAM); and
- Select individuals in the regional offices have been delegated warrant authority to execute contracts without adequate procurement training, experience, or oversight by OA. Additionally, contract activities in the regional offices are not being reported in the Federal Procurement Data System (FPDS). FPDS is a web-based tool used by agencies to report contract data to the President, Congress, the Government Accountability Office, Federal executive agencies and the general public.

Thus, as reported in FY 2008, comprehensive procurement and contracting policies and procedures are still needed, and OA does not yet have complete oversight over regional offices procurement and contracting activities.

## **CHALLENGE: INFORMATION TECHNOLOGY MANAGEMENT**

Information Technology (IT) management continues to be a management challenge, though significant improvements have been made since the OIG initially identified this area as a management challenge. The 2008 Federal Information Security Management Act review revealed that additional safeguards must be implemented as the OCIE Advisor Surveillance & Intelligence System's (OASIS) exposure increases. The SEC must evaluate the system access controls to ensure that OASIS has an adequate formal account management process and to improve its information flow control policies and enforcement mechanisms. These issues should be addressed before the system is introduced into the agency's architecture.

Furthermore, attention is still needed in specific key IT areas, such as IT capital investment, the administration and oversight of IT contracts and IT human capital. These key initiatives remain challenges since work has not been completed to mitigate deficiencies that were identified in the past.

## **CHALLENGE: PERFORMANCE MANAGEMENT**

In February 2007, the OIG issued an audit report on the Enforcement performance management process. This audit found that Enforcement did not consistently perform all parts of the performance appraisal process. In addition, the audit report found that the SEC's performance management written policies and procedures did not provide adequate guidance in many areas, including managing employees with performance problems and implementing all phases of the performance review cycle. Further, the performance proc-



ess was not aligned with the fiscal year, and did not timely reward employees for their significant, performance-based contributions.

The SEC has, however, taken numerous steps to remedy this challenge. Beginning in FY 2008, SEC employees began transitioning to a new performance management process, which includes a five-level rating system. At

present, SEC employees at the SK-17 (supervisory) level and above have migrated to the five-level rating system, and SEC employees below these levels are expected to migrate to the new process by the end of FY 2010. As it moves forward with this new system, the SEC must also set the parameters for the merit pay process and determine how merit pay increases will be implemented.





# SEMIANNUAL REPORT TO CONGRESS

## ADVICE AND ASSISTANCE PROVIDED TO THE AGENCY

During this semiannual reporting period, the OIG provided advice and assistance to management on numerous issues that were brought to our attention during the course of audits and investigations conducted by the OIG and otherwise. This advice was conveyed through written communications, as well as in meetings and conversations with agency officials. The advice provided included comments on draft policies and procedures and suggestions for improvements in existing policies and procedures.

### **Procedure for Addressing Manager Requests to OIT for Access to Employee E-mail Accounts and Other IT Support**

During the reporting period, the OIG became aware of an increasing number of requests by managers for access to the e-mail accounts of former employees whom they supervised, as well as requests for employee computer hard drives, network files and network logs. As there was no formal policy in place to address these types of requests, the OIG convened a meeting of Office of

Information Technology (OIT) and Office of General Counsel (OGC) staff members to address this issue. At the meeting, OIT agreed to revise and expand a draft implementing instruction on the use of SEC-wide digital forensic tools that was never finalized. In the meantime, OIT agreed to implement an interim procedure for processing management requests to OIT for access to employee e-mails and other IT support. Thereafter, the OIG provided written comments on OIT's proposed interim process and draft directive to OIT staff regarding that process. OIT incorporated the OIG's suggestions and implemented the interim process.

### **OIT and OIG Collaboration to Address HSPD-12 Requirement for 2009 FISMA Submission**

In August 2009, the Office and Management and Budget (OMB) issued a directive stating that all Federal agencies must comply with the procedures of Homeland Security Presidential Directive-12 (HSPD-12) in order to tender its 2009 submission pursu-

ant to the Federal Information Security Management Act of 2002 (FISMA). The OIG learned that the SEC was not in compliance with HSPD-12 and had obtained a waiver from OMB to delay implementation of HSPD-12 until 2011. The OIG assisted OIT in taking the necessary actions to ensure that the SEC can successfully submit its 2009 FISMA report.

OIG and OIT staff have participated in numerous conference calls and meetings with OMB regarding OMB's directive and have attended mandatory training sessions. We also will assist OIT staff with testing the applicable HSPD-12 technology that will be used throughout the SEC to ensure its compliance with HSPD-12.

### **Advice Concerning OIT Electronic Data Retention Procedures**

During the course of the OIG's investigation into the SEC's failure to uncover Bernard Madoff's Ponzi scheme, the OIG worked closely with OIT to restore and produce e-mails from three different SEC offices covering a span of ten years (1999 to 2009). The OIG also retained an outside expert, First Advantage Litigation Consulting Services (First Advantage), to assist with the independent production of electronic data using different methods and equipment. During this process of electronic discovery, the OIG and First Advantage identified several flaws in the SEC's historical and current data retention procedures and conveyed concerns about the effect of these flaws to OIT.

OIT's access to e-mails generated prior to 2008 is limited to the data that OIT restored from magnetic backup tapes in February 2008. Those tapes were supposed to have

been created at the end of each month. However, the OIG learned that approximately one-half of the backup tapes that should have existed as of February 2008 had never been restored. The OIG further learned that contrary to the procedures in place at the time, backup tapes were often not created at the end of a month. In addition, some tapes that may have been created have since been lost or corrupted. Finally, no existing tapes prior to 2001 have ever been restored.

There are also inadequacies in the SEC's e-mail retention procedures, which only provide for the archiving of e-mails after a certain period of time. In addition, only e-mails from certain user folders are saved.

The OIG and First Advantage described the different approaches that may be utilized to ameliorate the conditions they identified, and OIT informed us that they would consider taking action to address these issues.

### **OIT Implementing Instruction on Preservation and Destruction of Electronic Mail**

The OIG reviewed and provided written comments on a draft OIT Implementing Instruction on Preservation and Destruction of Electronic Mail on May 27, 2009. In those comments, the OIG expressed significant concerns about the Implementing Instruction's proposed imposition of a five-year retention period for storage of e-mail. The OIG expressed the view that this retention period would have a serious negative impact on the OIG's ability to conduct investigations in accordance with the Inspector General Act. Specifically, the OIG pointed out that in order to conduct a thorough review of the allega-

tions made to the SEC regarding Bernard Madoff, the OIG was required to retrieve employee e-mails going back to 1999, and that a five-year e-mail retention policy would have made it virtually impossible for the OIG to perform a comprehensive investigation in the Madoff matter. The OIG's written comments also provided clarification of the OIG's roles and functions under the Inspector General Act.

The SEC decided not to move forward with the Implementing Instruction after receiving comments from the OIG and other offices.

### **Review and Revision of Processes and Procedures for the Release of OIG Investigative Reports Under the Freedom of Information Act**

During this reporting period, certain OIG reports of investigation were released to the public by the SEC's Freedom of Information Act (FOIA) Office or the OGC, which contained non-public information.

The OIG met with agency officials from the Office of Investor Education and Advocacy (which oversaw the FOIA Office) and OGC to provide advice and assistance in determining a process to protect non-public and private information in connection with the release of OIG investigative reports under the FOIA. As a result of this collaboration and heightened awareness surrounding the sensitivity of information contained in OIG inves-

tigative reports, a new process has been instituted whereby the FOIA Office and OGC collaborate on potential redactions and issues prior to the release of the requested documents. Also under this new process, the OIG is afforded an opportunity to review the document prior to its release in order to identify any remaining issues of concern for the agency.

### **Office of Equal Employment Opportunity Guidance on Leveraging Diversity Competency**

The OIG reviewed two guidance documents prepared by the Office of Equal Employment Opportunity (EEO) regarding a new competency on leveraging diversity under which SEC managers were to be evaluated beginning in Fiscal Year 2009. Based upon its review of these documents, the OIG provided written and verbal comments to the EEO Office in early April 2009, suggesting possible improvements in these documents. For example, the OIG recommended that managers should not be evaluated under the new competency until after the pertinent information and tools necessary to meet the competency became available. The OIG also suggested that the guidance be revised to provide some clarification or measures as to what would be a reasonable amount of official time to spend on meeting the new element. The EEO revised these documents, based in part on the OIG's comments, and they were issued to managers on April 13, 2009.





# SEMIANNUAL REPORT TO CONGRESS

## AUDITS AND EVALUATIONS

### OVERVIEW

The OIG is required by the Inspector General Act of 1978, as amended, to conduct audits and evaluations of agency programs, operations and activities. The OIG's Office of Audits focuses its efforts on conducting and supervising independent audits and evaluations of the programs and operations of the various SEC divisions and offices. The Office of Audits also hires independent contractors and subject matter experts to conduct work on its behalf. Specifically, the Office of Audits conducts audits and evaluations to determine whether:

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

Each year the Office of Audits prepares an annual audit plan. The plan includes work that is selected for audit or evaluation based on risk and materiality, known or perceived vulnerabilities and inefficiencies, resource availability, and complaints that are received from Congress, internal SEC staff, the Government Accountability Office (GAO), and the public.

### Audits

Audits examine operations and financial transactions to ensure that proper management practices are being followed and resources are adequately protected in accordance with governing laws and regulations. Audits are systematic, independent, and documented processes for obtaining evidence. In general, audits are conducted when firm criteria or data exist, sample data is measurable, and testing internal controls is a major objective. Auditors collect and analyze data and verify agency records by obtaining supporting documentation, issuing questionnaires, and through physical inspection.

The OIG's audit activities include performance audits that are conducted of SEC programs and operations relating to areas such as the oversight and examination of regulated entities, the protection of investor interests, and the evaluation of administrative activities. The Office of Audits conducts its audits in accordance with the generally accepted government auditing standards (Yellow Book) issued by the Comptroller General of the United States, OIG policy, and guidance issued by the Council of the Inspectors General on Integrity and Efficiency (CIGIE).

## Evaluations

The Office of Audits also conducts evaluations of the SEC's programs and activities. Evaluations consist of reviews that often cover broad areas and are typically designed to produce timely and useful information associated with current or anticipated problems. Evaluations are generally conducted when a project's objectives are based on specialty and highly technical areas, criteria or data are not firm, or needed information must be reported in a short period of time. The Office of Audits' evaluations are conducted in accordance with OIG policy, Yellow Book non-audit service standards and guidance issued by the CIGIE.

## Audit Follow-up and Resolution

Office of Management and Budget (OMB) Circular A-50, Audit Follow-up, requires recommendations to be resolved within six months of the report issuance date. The Office of Audits actively monitors the status of open recommendations and tracks their closure. On September 30, 2009, Chairman Schapiro issued SEC Regulation (SECR) 30-2, Audit Follow-up and Resolution, in accor-

dance with OMB Circular A-50. This regulation specifies the policies and procedures to be followed to ensure that corrective action on OIG recommendations is being taken in the required timeframe and establishes a resolution process for disagreements about recommendations between the OIG and management.

## AUDITS AND EVALUATIONS CONDUCTED

### Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC (Report No. 468)

#### Background

The OIG retained the services of a team of experts at FTI Consulting, Inc. (referred to as the FTI Engagement Team) to assess the adequacy of examinations conducted by the SEC's Office of Compliance Inspections and Examinations (OCIE) in response to complaints regarding the activities of Bernard L. Madoff (Madoff) and his investment firm, Bernard L. Madoff Investment Securities, LLC (BMIS).

The FTI Engagement Team reviewed the OIG's Report of Investigation dated August 31, 2009, including related findings, exhibits, witness testimony and supporting documentation, and analyzed the workpapers from OCIE's examinations of Madoff, OCIE's manuals, OCIE's guidance documents and policies, and other governmental and private reports relating to examination programs. In addition, the FTI Engagement Team interviewed over a dozen key OCIE managers and staff to gain an understanding of the OCIE examination process.



## Results

The review made the following specific findings. The FTI Engagement Team found that OCIE did not properly evaluate the information provided in 2001 news articles that raised significant red flags about Madoff's operations. The FTI Engagement Team explained that information received relating to a potential violation must be properly vetted and opined that, in the case of the 2001 articles about Madoff, there was sufficient detail in these articles to warrant additional scrutiny due to the red flags raised.

The FTI Engagement Team further found that OCIE did not properly evaluate a complaint in 2003 and a referral in 2004 from highly credible sources that provided specific and concrete information about the possibility that Madoff was not engaged in trading. The review found that given the credibility of the information triggering the examinations, the significant delays before the examinations commenced were unreasonably long, there was insufficient review of the complaints, and the cause examinations failed to address critical issues raised in the complaints. The review found that, at the time, OCIE had no formal policies or procedures in place for handling tips and complaints, which led to mishandling of the information.

The FTI Engagement Team also found that the Planning Memoranda for the OCIE examinations were either inadequate or not drafted at all. The review found that there were no formal policies or procedures at that time that required the preparation of a Planning Memorandum. The FTI Engagement Team concluded that had the scope of the examinations been adequately analyzed and related to the complaints, the cause examinations would have more closely fo-

cused on the possibility that Madoff was conducting a Ponzi scheme.

The FTI Engagement Team further found that there was inadequate communication and information sharing among OCIE personnel in connection with their examinations of Madoff. In addition, the pre-examination preparation was inadequate, the examination tracking system was not properly used to log the initiation of the cause examinations, and the examiners did not adequately close the examinations. The review found that while OCIE senior personnel had an initial conversation with Madoff concerning the cause examination, there were no policies or procedures in place requiring them to document substantive interviews and, as a result, no clear contemporaneous record of this and other critical discussions was made. The review also found that OCIE did not have formal policies and procedures requiring the preparation of closing memoranda for examinations.

The FTI Engagement Team found that OCIE did not form appropriate examination teams to conduct the examinations. The review found that one of the examinations lacked a Branch Chief and both teams lacked staff with the expertise necessary to identify signs of fraud effectively. The FTI Engagement Team concluded that the failure to form appropriate examination teams with sufficient expertise must be remedied in order for OCIE to uncover fraud in future cause examinations.

The FTI Engagement Team found that OCIE failed to contact Madoff's clients to corroborate his representations in the examinations, even though several of these clients were SEC-registered investment funds that were subject to SEC books and records requirements. The review found that SEC

examiners failed to follow up on numerous contradictions discovered during the examinations and many discrepancies were left unresolved.

The FTI Engagement Team found that OCIE failed to understand how BMIS executed, cleared and settled its purported trades, and these failures contributed to OCIE's inability to uncover Madoff's Ponzi scheme. The review found that SEC examiners did not acquire and analyze trading data from an independent source to verify the trading volume Madoff represented in client account statements and, had such an analysis been conducted, they would have likely discovered Madoff's fictitious trades. The FTI Engagement Team replicated several aspects of the cause examinations of Madoff and demonstrated how obtaining the pertinent information could have uncovered the fraud.

The FTI Engagement Team also found that the examinations were improperly closed without resolving numerous issues, the staff on one examination team actually believed they might be subjected to legal liability if they contacted Madoff's feeder funds, and the Madoff examination teams failed entirely to investigate the allegations in two complaints about the lack of independence of Madoff's auditor.

### **Recommendations**

The OIG issued a final report summarizing the results of the FTI Engagement Team's review on September 29, 2009. The report presented 37 specific and concrete recommendations designed to improve nearly every aspect of OCIE's operations. These recommendations were as follows:

- (1) OCIE should provide all examiners with access to relevant industry publications and third-party database subscriptions sufficient to develop examination leads and stay current with industry trends, and should regularly assess whether they have adequate access to relevant industry publications and other such sources and make reasonable attempts to gain such access.
- (2) OCIE should establish a protocol for searching and screening news articles and information from relevant industry sources that may indicate securities law violations at broker-dealers and investment advisers. The protocol should include flexible searching capability to help identify specific areas of risk or concern and should include access to all relevant industry publications. The protocol should also include adequate screening criteria to eliminate unnecessary results and/or to define a search more narrowly in order to generate sufficient results. The screening criteria and any changes should be documented and the protocol should be re-assessed regularly in order to determine if any modifications are appropriate.
- (3) OCIE should establish a protocol that explains how to identify red flags and potential securities law violations based on an evaluation of information found in news reports and relevant industry sources. The protocol should also determine how, and by whom, decisions on whether to initiate cause examinations are made, set a reasonable time frame (i.e., 90 days) for evaluation of the search results and provide notification to OCIE management when such time has expired.

- (4) OCIE should implement an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or complaint and also chronicles the vetting process to document why each tip or complaint was or was not acted upon and who made that determination. All OCIE examiners should be given access to the system in order to timely view and monitor tips and complaints that may be relevant to examinations they are preparing to conduct or are actively conducting.
- (5) OCIE should annually review and test the effectiveness of its policies and procedures with regard to its tip and complaint collection system. OCIE should also modify these policies and procedures where needed.
- (6) Tips and complaints reviewed by OCIE that appear on the surface to be credible and compelling should be probed further by in-depth interviews with the sources to assess their validity and to determine if there are other issues that need to be investigated. Any apparent contradictions in tip or complaint information need to be resolved as early as possible in the examination process through interviews with appropriate sources or further independent research. Findings from such interviews should be adequately documented and should be required reading for examination team members.
- (7) All OCIE-related tips and/or complaints that are not vetted within 30 days of receipt should be brought to the attention of the OCIE Director with an explanation for the delay. All OCIE-related tips and/or complaints that merit a cause examination for which the examination does not begin within 60 days of receipt (a Post-60 Day Examination) must be reported to the OCIE Director, with a monthly tally of yet-to-be-opened Post-60 Day Examinations sent to the SEC Chairman.
- (8) All potentially relevant information received by OCIE from a tip or complaint source should be preserved as a complete unit and should be augmented with relevant information that may have been provided in subsequent submissions by that source. Once an examination has been initiated, such information should be required reading for examination team members.
- (9) OCIE should augment its policies and procedures related to the use of scope memoranda to better reflect particular consideration given to information collected as the result of tips and complaints that lead to cause examinations. When all potentially relevant tip and complaint source data, background information and research have been collected into one complete unit, examination staff should identify all relevant potential securities law violations and other concerns and then prepare a Planning Memorandum that ties each and every potential violation and issue into the scoping discussion in the memorandum. The Planning Memorandum should include the basic steps that need to be taken to address the issues identified in the scope discussion. The Planning Memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e., assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.
- (10) OCIE should timely modify or append the scope memorandum when

- significant new facts and issues emerge. The modified or supplemental scoping memorandum should be reviewed, approved and signed (or initialed) by senior OCIE management (i.e., assistant director level or higher) and should include the names of the individuals who prepared and reviewed the document.
- (11) After examination scoping provisions have been approved, along with all other elements of the Planning Memorandum, the Planning Memorandum should be subjected to concurring review by an unaffiliated OCIE Associate or Assistant Director (Concurring Director Review), and the person performing the Concurring Director Review should also recommend additional concurring reviews by the SEC's Office of Economic Analysis, Office of Chief Accountant, or other offices or divisions of the SEC as needed. All concurring reviewers should sign off on the Planning Memorandum indicating their approval and add any comments on the proposed scope or other areas discussed in the memorandum.
- (12) After the Planning Memorandum is first drafted, it should be circulated to all examination team members, and all team members should then meet, in person or electronically, to discuss the examination approach and methodology set out in the memorandum, as well as any other issues the team members wish to raise.
- (13) The examination team leader should ensure that all steps of the examination methodology, as stated in the Planning Memorandum, are completed, and either the team leader or the appropriate team member should sign off on each step as it is completed.
- (14) Substantive interviews conducted by OCIE of registrants and third parties during OCIE's pre-examination activities and during the course of an active examination should be documented with notes circulated to all team members. After each substantive interview during the examination, the team leader should re-evaluate the examination scope and methodology as set out in the Planning Memorandum to determine if the examination needs to be expanded and indicate by initialing the interview notes that the team leader has performed this evaluation.
- (15) The workpapers for a given examination should be in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues.
- (16) When logging all OCIE examinations into an examination tracking system, the team leader should verify that the appropriate entry is made in the tracking system and, with a notation in the Planning Memorandum, indicate that such entry has been made with the team leader's initials.
- (17) OCIE should annually review and test the effectiveness of its policies and procedures with regard to conducting, documenting and concluding its examinations and modify the policies and procedures where needed.
- (18) The focus of an examination should drive the selection of the examination team and team members should be selected based upon their expertise related to such focus. There should also be a clearly defined examination

team leader. Staffing decisions should be made by senior OCIE management Assistant Director level or higher, after management has performed adequate pre-examination preparation so management can make appropriate choices. The examination team should not be selected solely based on availability.

- (19) Senior OCIE management should ensure that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs (i.e., options expertise). OCIE should regularly seek out the appropriate expertise from other offices or divisions within the SEC and encourage intra-agency collaboration wherever possible.
- (20) OCIE should assign a Branch Chief, or a similarly designated lead manager, on every substantive project including all cause examinations. The Branch Chief or designated lead manager must be onsite or in direct communication with the onsite staff daily during the onsite portion of the examinations. Lower lever or junior staff examiners must not be left unsupervised during substantive discussions with principals or senior executives at the registrant during the examination.
- (21) OCIE should develop a formal plan with specific goals associated with achieving and maintaining professional designations and/or licenses by industry certification programs that are relevant to the examination activities conducted by OCIE. For instance, within the next three years, 50% of OCIE staff and management associated with examination activities should be qualified by means of a certification applicable to their profession such as the Association of Certified Fraud Examiners' Certified Fraud Examiner designation, the American Institute of Certified Public Accountants' Certified in Financial Forensics designation and/or the Financial Industry Regulatory Authority (FINRA) General Securities Principal license required of investment professionals. There should be an annual continuing education component for each of these licenses.
- (22) OCIE should develop and implement interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations. Similar exercises should be administered annually to all active examination staff and management in order to identify areas that need further development.
- (23) Subject to approval of the examination team leader, OCIE examiners should contact clients of a broker-dealer or investment adviser when necessary to confirm statements made by broker-dealer or investment adviser personnel. Examiners should be encouraged to verify representations of third parties by contacting such parties, and appropriate methods used to contact third parties should become a part of OCIE's training of examiners.
- (24) In the course of an examination, if an examiner becomes aware of a potential securities law violation at another firm, that examiner should consult with the team leader and OCIE should make a referral to the appropriate personnel or agency.
- (25) OCIE examiners should be trained in the mechanics of securities settlement,

both in the U.S. and in major foreign markets.

- (26) OCIE examiners should be trained by the SEC Office of International Affairs (OIA) in methods to access the expertise of foreign regulators, such as the United Kingdom's Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities. OCIE examiners should also be trained by OIA in methods to request and receive information pursuant to SEC memoranda of understanding with those foreign regulators. OCIE, in conjunction with OIA, should develop templates for the most frequent types of requests (e.g., sample trade data) from foreign regulators based on past experience in order to facilitate the process. OCIE, in conjunction with OIA, should develop and utilize contact lists with such regulators for use by appropriate examination staff.
- (27) For significant issues such as whether trades have been executed and who has custody of assets, in the absence of third-party (counterparties, custodians, etc.) documentation, OCIE examiners should not simply rely on representations of broker-dealer or investment adviser personnel but should contact third parties directly. OCIE should provide guidance or training that clarifies for examiners circumstances that require such contact with third parties.
- (28) OCIE examination staff should be required to verify a test sample of trading or balance data with counterparties and other independent third parties, such as the FINRA, the Depository Trust Company (DTC), or National Securities Clearing Corporation (NSCC), whenever there are specific allegations of fraud involved in an examination.
- (29) OCIE examiners should be trained jointly with the Office of Economic Analysis (OEA) economists by FINRA, other self-regulatory organizations (SROs) and exchange staff in understanding the trading databases provided by FINRA, the National Association of Securities Dealers Automated Quotations (NASDAQ), the New York Stock Exchange, Archipelago Exchange, American Stock Exchange, regional exchanges, the Options Clearing Corporation, option exchanges, and DTC/NSCC, etc. As trading and trading venues change over time, the OCIE training should be recurring and updated.
- (30) OCIE staff should be given direct access to certain databases maintained by SROs or other similar agencies to allow examiners to access necessary data for verification or analysis of registrant data. Such databases should include exchange trading execution data, DTC/NSCC data, the FINRA Order Audit Trail System (OATS) and the FINRA Central Registration Depository (CRD).
- (31) When an examination team is pulled off the examination for a project of higher priority, upon completion of that project, the examination team should return to the original examination and bring the examination to a conclusion.
- (32) One person in OCIE should be responsible for tracking the progress of all cause examinations, and the tracking should include the number of cause examinations opened, the number ongoing and the number closed for each month. Such data should be reported at least quarterly to the

OCIE Director and to the SEC Chairman. Any cause examinations open for more than 180 days should be reported to the OCIE Director and the SEC Chairman with an explanation as to why the examination requires more time.

- (33) OCIE's policies and procedures should clearly indicate that at the conclusion of each examination, the examination team must prepare a closing report (Closing Memorandum) that begins with the scope discussion from the Planning Memorandum, as modified by new issues that arise during the course of the examination. For each and every issue discussed in the scoping discussion in the Planning Memorandum, the Closing Memorandum should provide findings relevant to each issue and state the team's conclusions. All members of the examination team should sign the Closing Memorandum.
- (34) Examination staff should not leave open any substantive issue without providing a sufficient basis for such a determination or a plan to pursue that issue at an appropriate later time. In the event that issues are unresolved or cannot be pursued further, examination staff should formerly refer those issues to the appropriate SEC staff that may further investigate and resolve such issues.
- (35) OCIE training should include instruction on personal liability, if any, assumed on the part of examiners for their actions in the course of performing their duties for OCIE.
- (36) OCIE management should make clear that it will support OCIE examiners in their pursuit of evidence in the course of an examination, even if pursuing that evidence requires con-

tacting customers or clients of the target of that examination.

- (37) When an auditor's independence is questioned in a tip or complaint, OCIE should report the information, if deemed credible, to the appropriate state board of accountancy and to the Public Company Accounting Oversight Board, if applicable, in addition to considering a referral to the SEC's Division of Enforcement or other government agency.

OCIE concurred with all 37 recommendations. The OIG informed OCIE that it plans to follow up to ensure that all 37 recommendations are implemented in full and report back to Congress on the status of these efforts. The OIG also indicated that it plans to conduct a follow-up audit to determine if the changes to OCIE's operations are having the desired and appropriate effect.

### **Program Improvements Needed Within the SEC's Division of Enforcement (Report No. 467)**

#### **Background**

The OIG conducted a review to identify programmatic issues from the OIG's investigation involving Bernard L. Madoff, that may prevent Enforcement from efficiently and effectively accomplishing its mission of enforcing the federal securities laws and protecting investors, and to obtain feedback from Enforcement staff regarding improvements needed in the Enforcement program. We conducted our review from June 2009 to September 2009.

On December 11, 2008, the SEC charged Madoff with securities fraud for a multi-billion dollar Ponzi scheme. Subsequently, the Commission learned that credible and specific

allegations regarding Madoff's financial wrongdoing, going back to at least 1999, had been repeatedly brought to the attention of SEC staff but no actions were ever recommended to the Commission. As a result, former Chairman Christopher Cox requested that the OIG conduct an investigation into the past allegations regarding Madoff and his firm and the reasons these allegations were not found to be credible. In June 2009, as a result of issues identified during this ongoing OIG investigation, the OIG launched a survey questionnaire to approximately 1,200 Enforcement staff and managers in headquarters as well as the regional offices. The questionnaire was designed to obtain feedback from Enforcement staff and managers on topics such as allocation of resources, performance measurement, case management procedures, communication, adequacy of policies and procedures, employee morale, and management efficiency and effectiveness.

On August 31, 2009, the OIG issued a comprehensive, 457-page investigative report, entitled, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." The investigation found that the SEC received more than ample information in the form of detailed and substantive complaints over a period of many years, to warrant a thorough and comprehensive examination and/or investigation of Madoff and his firm for operating a Ponzi scheme. However, despite three examinations and two investigations of Madoff, a thorough and competent investigation or examination was not performed, and the SEC never identified the Ponzi scheme that Madoff operated.

The investigation further found that in October 2005, Harry Markopolos (Markopolos) provided the SEC's Boston District Office with a third version of a complaint entitled "The World's Largest Hedge Fund is a Fraud." Markopolos' 2005 complaint detailed ap-

proximately 30 red flags indicating Madoff was operating a Ponzi scheme, a scenario Markopolos described as "highly likely." The red flags identified by Markopolos generally fell into one of three categories: (1) Madoff's obsessive secrecy; (2) the impossibility of Madoff's returns, particularly the consistency of those returns; and (3) the unrealistic volume of options Madoff was supposedly trading.

The SEC's Boston District Office referred the complaint to the Northeast Regional Office and an Enforcement investigation was initiated. However, we found that the focus of the Enforcement staff's investigation was much too limited. Markopolos' 2005 complaint primarily presented evidence that Madoff was operating a Ponzi scheme, calling that scenario "highly likely." However, most of the Enforcement staff's efforts during their investigation were directed at determining whether Madoff should register as an investment adviser or whether Madoff's hedge fund investors' disclosures were adequate. In fact, the Enforcement staff's investigative plan primarily involved comparing documents and information that Madoff had provided to the examination staff (which he fabricated) with documents that Madoff had sent his investors (which he also fabricated).

During the investigation, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on these inconsistencies. They rebuffed offers of additional evidence from the complainant, and were confused about certain critical and fundamental aspects of Madoff's operations. When Madoff provided evasive or contradictory answers to important questions in testimony, they simply accepted his explanations as plausible.

Although the Enforcement staff made attempts to seek information from independent third parties, they failed to follow up on these



requests. They reached out to the National Association of Securities Dealers and asked for information on whether Madoff had options positions on a certain date. However, when they received a report that there were in fact no options positions on that date, they did not take any further steps. An Enforcement staff attorney made several attempts to obtain documentation from European counterparties (another independent third party) and, although a letter was drafted, the Enforcement staff decided not to send it. Had any of these efforts been fully executed, they may have led to Madoff's Ponzi scheme being uncovered.

The Enforcement staff effectively closed the Madoff investigation in August 2006 after Madoff agreed to register as an investment adviser.

## Results

The OIG's review found that the Enforcement staff did not conduct a thorough review of a complaint brought to their attention in 2001 regarding Madoff. We determined that this failure illustrated the need for guidance and training on appropriate complaint-handling procedures. In particular, we found that no formal guidance existed within Enforcement to assist staff in determining what information was needed to assess adequately the legitimacy of a complaint, including, for example, what specific information should be gathered related to a potential Ponzi scheme. Additionally, there was no readily-available information regarding what procedures the Assistant Regional Director to whom the complaint was assigned performed in reviewing the complaint.

The review also found that the Enforcement staff did not sufficiently review the evidence that Markopolos provided to

them. Further, Enforcement staff rebuffed Markopolos' offers of additional information related to his complaint. This demonstrated a lack of due diligence in the handling of critical information regarding Madoff and the need for additional policies, procedures and training in Enforcement to ensure these types of issues do not reoccur.

While we noted that the SEC had begun the process to develop policies and procedures to improve the manner in which the agency evaluates tips and complaints, we determined that these procedures, when finalized, need to be tested to ensure they operate effectively.

We also found that the Enforcement staff assigned to the Madoff investigation team was inexperienced in investigating Ponzi schemes. We determined that this illustrated the need for Enforcement to ensure that investigations are assigned to a team where at least one individual on the team has specific and sufficient knowledge of the subject matter, and the team has access to at least one additional individual who also has such expertise or knowledge. Additionally, Enforcement should require Planning Memoranda to be prepared and approved by management during investigations that outline the steps to be taken to complete the investigation, identify other offices or particular individuals with requisite expertise that should be consulted during the investigation, and identify staffing resources needed and estimated timeframes to complete the work.

The review also found that the Enforcement staff did not always seek assistance from other divisions and offices as needed during its investigation of Madoff. Although the Enforcement staff had difficulty understanding some aspects of Madoff's operations, including his purported trading over-

seas, they did not sufficiently consult with other divisions and offices within the SEC.

The OIG survey regarding management effectiveness within Enforcement indicated that a certain percentage of the Enforcement staff did not feel they were receiving adequate support from SEC offices and divisions outside of Enforcement. Our survey polled Enforcement staff on whether they felt they received adequate support from external offices and divisions when requested. Out of 759 respondents to this question, 66 percent agreed that they received adequate support. However, 24 percent (180 respondents) disagreed that they received adequate support. Of those respondents that disagreed, many provided written comments expressing their concerns over the difficulty in obtaining timely guidance or information from other divisions and offices.

We determined that despite an individual's personal perception of whether seeking out assistance from other offices would be helpful or take too long, Enforcement staff should work on establishing more effective relationships with other divisions and offices and ensure they are consulted on matters within their areas of expertise.

We also found that the Madoff investigation suffered from a lack of supervision. The OIG found that there were questions about the level of supervision provided to the staff attorney on the Madoff investigation with regard to providing guidance on how to conduct the investigation. There were also concerns expressed about the lack of resources available to the Enforcement staff in connection with its Madoff investigation.

Further, we found in response to the OIG Enforcement survey that Enforcement staff had concerns about lack of resources and the

resulting administrative burdens they had to perform. More specifically, we surveyed Enforcement staff regarding their thoughts on resources by asking, "Do you have adequate resources to successfully perform your job?" Out of 776 respondents to this question, 54 percent stated they did not have adequate resources to successfully perform their job. Many of the Enforcement staff cited the lack of support resources (e.g., secretaries, paralegals and document clerks) as a major problem with investigations.

We also found that Enforcement failed to evaluate adequately additional troubling information received by the SEC after Madoff agreed to register as an investment advisor in August 2006, but before the investigation was officially closed in January 2008. In June 2007, Markopolos e-mailed the Enforcement Branch Chief on the Madoff investigation, stating that he had attached some very troubling documents that showed the Madoff fraud scheme was becoming even more brazen. Additionally, the e-mail stated that Madoff could not possibly be managing the billions of dollars in the strategy that he claimed. Despite the additional information, we found no documentation to show that any analysis was performed of the additional information or that Enforcement staff contacted Markopolos to follow up on the e-mail or attached documents. The Branch Chief testified that she did not recall whether the e-mail attachments were given significant analysis. Further, the staff attorney on the investigation opined that she did not believe the e-mail provided any new information. These events illustrated the need for Enforcement staff to evaluate complaints and tips thoroughly and encourage additional information from complainants even if an investigative matter is pending closure.

We further found that there were delays in completing administrative tasks related to opening and closing the Madoff investigation that impaired Enforcement's investigative efforts. We noted that Enforcement has begun to streamline processes related to the opening of investigations, and stated that Enforcement should also examine ways to streamline the case closing process and devote adequate resources to do so.

The review, through the OIG survey results that were not directly related to the Madoff investigation, also identified several additional areas in which opportunities existed for making programmatic improvements within Enforcement. We found that a troubling number of Enforcement staff stated that they felt they had been in situations where there was a lack of impartiality. Additionally, a large percentage of Enforcement staff stated that they did not know where to find information regarding requirements concerning impartiality in the performance of official duties (e.g., improper preferential treatment and external influences). We also found that while the majority of Enforcement staff believed that program priorities were clearly established and communicated, a large percentage expressed concern over workload priorities. In addition, while the majority of the feedback received from Enforcement staff with regard to Enforcement's case-handling processes was positive, a considerable number of staff expressed concerns about its case-selection process, as well as its methods of assigning resources to cases and rewarding employees for their work on cases. Finally, in addition to concerns over obtaining assistance from outside divisions and offices, we found that Enforcement staff did not always believe that different groups within the Division worked together effectively.

## Recommendations

The OIG issued a final report summarizing the results of its review on September 29, 2009. The report included 21 recommendations to help strengthen management controls in Enforcement to address the deficiencies identified and to help ensure the Enforcement program efficiently and effectively fulfills its mission.

These recommendations were as follows:

- (1) Enforcement should establish formal guidance for evaluating various types of complaints (e.g., Ponzi schemes) and train appropriate staff on the use of the guidance. The guidance should address the necessary steps and key information required to be collected when conducting preliminary inquiries of various types of complaints, specify what information should be documented, and list who should be consulted in other offices within the SEC with relevant expertise in various subject matters and other pertinent data.
- (2) Enforcement should ensure the SEC's tip and complaint-handling system provides for data capture of relevant information relating to the vetting process to document why a complaint was or was not acted upon and who made that determination.
- (3) Enforcement should require tips and complaints to be reviewed by at least two individuals experienced in the subject matter prior to deciding not to take further action.
- (4) Enforcement should establish guidance to require that all complaints that appear on the surface to be credible and compelling be probed further by in-depth interviews with

- the sources to assess the complaints' validity and to determine what issues need to be investigated. Such guidance should also require that staff obtain all relevant documentation related to such complaints.
- (5) Enforcement should provide training to staff to ensure they are aware of the pertinent guidelines contained in the Enforcement Manual and the SEC's regulations for obtaining information from media sources.
  - (6) Enforcement should annually review and test the effectiveness of its policies and procedures with regard to its new tip and complaint-handling system. Enforcement should also modify these policies and procedures, where needed, to ensure adherence and adequacy.
  - (7) Enforcement should put in place procedures to ensure that investigations are assigned to teams where at least one individual on the team has specific and sufficient knowledge of the subject matter (e.g., Ponzi schemes), and the team has access to at least one additional individual who also has such expertise or knowledge.
  - (8) Enforcement should train staff on what resources and information is available from the national specialized units and when and how assistance from these units should be requested.
  - (9) Enforcement should make it mandatory that Planning Memoranda be prepared during an investigation and that the plan includes a section identifying what type of expertise or assistance is needed from others within and outside the SEC. The plan should also be reviewed and approved by senior Enforcement personnel.
  - (10) Enforcement should require that after the Planning Memorandum is drafted, it is circulated to all team members assigned to the investigation, and all team members then should meet to discuss the investigation approach, methodology and any concerns team members wish to raise.
  - (11) Enforcement should establish procedures so that junior-level Enforcement attorneys who are having difficulty with obtaining timely assistance from outside offices are able to escalate their concerns to senior-level management within Enforcement.
  - (12) Enforcement should conduct periodic internal reviews of any newly-implemented policies and procedures related to information sharing with divisions and offices outside of Enforcement to ensure they are operating efficiently and effectively and necessary changes are made.
  - (13) Enforcement should require that the Planning Memorandum and associated scope, methodology and time-frames be routinely reviewed by an investigator's immediate supervisor to ensure investigations remain on track and to determine whether adjustments in scope, etc. are necessary.
  - (14) Enforcement should ensure that sufficient resources, both supervisory and support are dedicated to investigations upfront to provide for adequate and thorough supervision of cases and effective handling of the investigations.
  - (15) Enforcement should put in place policies and procedures or training mechanisms to ensure staff has an understanding of what types of information should be validated during investigations with independent parties such as the Financial Industry Regulatory Authority, Depository

- Trust Company, and Chicago Board Options Exchange.
- (16) Enforcement should include in its complaint-handling guidance proper procedures for ensuring complaints received, even if an investigation is pending closure, are properly vetted.
  - (17) Enforcement should conduct periodic internal reviews to ensure that investigations are opened in accordance with any newly-developed Commission guidance and examine ways to streamline the case closing process. Enforcement should also ensure staff has adequate time in which to complete these types of administrative tasks.
  - (18) Enforcement should put in place a process to remind staff periodically of their responsibilities regarding impartiality in the performance of official duties and instruct staff where they can find additional information regarding impartiality.
  - (19) Enforcement should establish or utilize an existing working group to analyze the OIG survey information regarding staff concerns over communication of program priorities and make recommended improvements to the Director of Enforcement.
  - (20) Enforcement should establish or utilize an existing working group to analyze the OIG survey information regarding staff concerns regarding case handling procedures within Enforcement and make recommended improvements to the Director of Enforcement.
  - (21) Enforcement should establish or utilize an existing working group to ana-

lyze the OIG survey information regarding staff concerns over working relationships within Enforcement and make recommended improvements to the Director of Enforcement.

Enforcement Management concurred with all 21 recommendations. The OIG informed Enforcement that it plans to follow up to ensure that all 21 recommendations are implemented in full and report back to the Congress on the status of these efforts. The OIG also indicated that it plans to conduct a follow-up audit to determine if the changes to Enforcement's operations are having the desired and appropriate effect.

### **The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs) (Report No. 458)**

#### **Background**

Due to the importance of credit rating agencies (CRAs) to the U.S. securities markets and the role they played in the recent credit crisis, the OIG conducted a limited review of the SEC's oversight of CRAs that have been designated as nationally recognized statistical rating organizations (NRSROs). A credit rating is an opinion issued by a CRA as of a specific date, of the creditworthiness, i.e., the ability to repay timely loan principal and interest, of an issuer or with respect to particular securities or money market instruments. Credit ratings are utilized in a variety of capacities in the U.S. financial system, e.g., to calculate bank capital requirements and to place limits on the types of investments that may be purchased by a particular type of investor such as a pension fund.

The Commission first incorporated reliance on credit ratings into its rules and regulations in 1975 in connection with the rule delineating how broker-dealers must compute their net capital. In that rule, the Commission specified that a broker-dealer, in computing its net capital, could take a lesser deduction from its net worth as to securities that were rated as having a comparatively low chance of default according to a CRA of national repute, or an NRSRO. Thereafter, the Commission incorporated the NRSRO concept into many rules and regulations issued under the Federal securities laws, and the term was also used in a number of federal, state and foreign laws and regulations.

Until the enactment of the Credit Rating Agency Reform Act of 2006 (Rating Agency Act), NRSROs were not required to file any formal application with the Commission. From 1975 to 2006, the Commission identified a total of seven NRSROs through the staff no-action letter process. Commission staff was criticized for not acting on some CRA no-action letter requests in a timely manner.

Beginning with the issuance of a concept release in 1994, the Commission considered, but did not adopt, rules that would have, among other things, defined the term NRSRO and formalized the NRSRO no-action letter process. The CRAs became subject to harsh criticism after Enron Corporation (Enron) filed for bankruptcy in 2001. In particular, a Senate committee staff report, on Enron's bankruptcy strongly criticized the CRAs for failing to warn the public of Enron's precarious financial situation until four days before it declared bankruptcy.

After Enron's bankruptcy, the Commission's Office of Compliance Inspections and Examinations (OCIE) undertook

examinations of the three largest NRSROs to aid the Commission in assessing whether it should continue to use credit ratings in its regulations and, if so, the categories of acceptable credit ratings and the appropriate level of oversight. OCIE's examinations revealed a number of significant concerns, including, among other things, difficulties encountered in obtaining relevant documents from the NRSROs, and the potential for conflict of interest created by the industry practice of issuers paying NRSROs for credit ratings and the NRSROs' marketing of other types of services, e.g., corporate consulting services, in addition to providing credit ratings. The Commission also held two public hearings in 2002 on a wide variety of issues impacting CRAs.

In addition, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) was enacted in response to several major corporate and accounting scandals, including Enron's bankruptcy, that shook the public's confidence in the U.S. financial markets. The Sarbanes-Oxley Act, among other things, required the Commission to prepare a report on the role and function of CRAs. The Commission issued the report required by the Sarbanes-Oxley Act in 2003, which identified a wide range of issues pertinent to CRAs that warranted further examination. Also in that report, the Commission stated its intent to publish another concept release and thereafter issue proposed rules. While the Commission subsequently issued a concept release in 2003 and then proposed a rule to define the term NRSRO, the Commission adopted no rules setting conditions on NRSRO designation, despite the findings surrounding Enron's bankruptcy, the problems revealed by the 2002 OCIE examinations and the results of the study required by the Sarbanes-Oxley Act.

In September 2006, the Rating Agency Act was enacted in an effort to improve the quality of credit ratings for the protection of investors by increasing accountability, transparency and competition in the CRA industry. The Rating Agency Act for the first time required a CRA to register formally with the Commission in order to qualify as an NRSRO. The Rating Agency Act established an application process for approval for a CRA to issue various classes of credit ratings as an NRSRO and required numerous pertinent disclosures in a CRA's application for NRSRO designation and in subsequent updates and annual certifications. The Rating Agency Act gave the Commission examination authority to ensure an NRSRO's compliance with its requirements and, since the fall of 2008, OCIE has been responsible for conducting these examinations. The Rating Agency Act, however, prohibited the Commission from regulating the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings.

The Rating Agency Act mandated that the Commission issue final rules and regulations necessary to carry out the Act's requirements within nine months after the date of enactment. The Commission adopted rules to implement the requirements of the Act in June 2007. Since the Rating Agency Act became effective, the Commission received 11 applications from a total of ten CRAs seeking NRSRO designation, all of which were approved.

The CRAs have once again come under criticism for the role they played in connection with the recent financial crisis. Specifically, the CRAs provided ratings on structured finance products that were based on risky or "subprime" mortgages. After home values decreased beginning in 2006, the market value of the mortgage securities declined, resulting

in write-downs of billions of dollars in the value of mortgage securities. Serious questions then arose as to whether the CRAs initially rated the structured products accurately and whether they should have subsequently reassessed their credit ratings.

The role played by CRAs in the recent financial crisis has led to numerous reports and proposed regulatory changes, including the SEC's adoption of NRSRO rule amendments in February 2009. Other proposed changes to the Commission's NRSRO rules, however, were not acted upon. In addition, both President Obama's Administration and Congress have recently proposed legislative reforms that would strengthen the SEC's oversight of NRSROs. Also, the Administration's legislative proposal would make registration with the Commission mandatory for all CRAs, not just those that choose to seek NRSRO designation.

The objective of our review was to identify improvements in the Commission's oversight of NRSROs and was limited in scope. The review focused primarily on the implementation of and compliance with the Rating Agency Act and Commission rules. We also reviewed the Commission's history with NRSROs to assess the Commission's efforts to oversee the NRSROs and to implement the Rating Agency Act's accountability, competition and transparency objectives. The OIG did not take any position on, or render any opinion, with regard to how many firms the Commission should approve as NRSROs and whether the larger CRAs should be favored over smaller CRAs.

## Results

Overall, our review found that, despite the importance of NRSROs to the U.S. securities

markets and the Commission's reliance on NRSROs in its rules and regulations, the Commission has historically been slow to act in this area, even after Enron's bankruptcy and a Senate staff report recommendation that the Commission set specific conditions on the NRSRO designation. While, beginning in 1994, the SEC issued concept releases, conducted examinations, issued reports, held hearings and proposed regulations, it adopted no regulations regarding NRSROs until required to do so after the Rating Agency Act was enacted in 2006. Further, our review identified certain instances of non-compliance with the requirements of the Rating Agency Act or Commission rules, as well as several areas in which we believe the SEC's oversight of NRSROs can be enhanced. The current SEC Chairman has, however, identified improving the quality of credit ratings as one of her priorities, directed the SEC staff to explore possible new NRSRO regulations and allocated additional resources to establish a branch of NRSRO examiners.

Most significantly, our review's compliance testing identified one NRSRO application that the Commission approved based upon the Division of Trading and Markets' (TM) recommendation, despite the fact that TM identified numerous significant concerns with the CRA's application. These included concerns about the adequacy of the CRA's managerial resources, suspicions regarding the accuracy of the financial information provided in its application, and concerns about the authenticity of a number of certifications required by the Rating Agency Act. Under the process established by the Rating Agency Act, within 90 days upon the filing of a CRA's application for NRSRO designation, the Commission must either approve the application or institute proceedings to determine whether the application should be denied, unless the applicant con-

sents to a longer time period. The Rating Agency Act provides that the Commission shall grant the application except under certain circumstances, including where the CRA does not comply with the statutory requirements and if the CRA lacks adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with their disclosed procedures and methodologies.

In its recommendation to the Commission, TM acknowledged that its concerns about the CRA's application were unresolved, but recommended that they be addressed in an examination of the firm to be conducted after the application was approved. Our review found that an examination of this firm was not initiated until ten months after the Commission approved its application and that this examination still has not been completed. Because the issues identified by TM were related to whether the firm had met the statutory eligibility requirements, our review concluded that in accordance with the provisions of the Rating Agency Act, TM should not have recommended that the Commission approve the CRA's application. Rather, TM should have recommended that the Commission institute proceedings to determine whether it should deny the application or have sought the CRA's consent to an additional period of time for the Commission to act on the application.

Our compliance testing also revealed that, while not to the same degree as with the application discussed above, TM identified numerous substantive concerns regarding the applications of several other CRAs. These included, among others, concerns about the financial condition of a CRA, the absence of required information regarding a CRA's process for rating structured products, and con-



cerns about some CRAs' procedures for handling material non-public information. Despite these numerous issues, which we believe raised questions as to whether the approval of these applications was in the public interest, TM recommended that the Commission approve the applications and stated that it would address the issues after the applications were approved. Our review found risks in this approach and concluded that all significant issues should be resolved before TM recommends that the Commission approve a CRA's application for NRSRO registration, to the extent consistent with the Rating Agency Act.

The compliance testing also disclosed several instances where TM did not comply with, or require firms to comply with, certain procedural requirements of the Rating Agency Act and the Commission's implementing rules. For example, in two instances, TM, acting on its own, granted NRSROs extensions of time to file required annual certifications or reports when the applicable statute and regulation required such extensions to be granted by the Commission. The compliance testing also revealed instances where TM received and accepted forms or reports from NRSROs that did not include a required financial statement or certifications.

We also identified several areas in which the effectiveness of OCIE's NRSRO examination program could be improved. In particular, our review found that the Commission's ability to determine whether a CRA applying for NRSRO registration has met the requirements of the Rating Agency Act would significantly be enhanced if examinations were conducted as part of the application review process, rather than after the application has been approved. If examinations had been conducted as part of the review process for the applications discussed above, it is likely that some of the significant issues TM identi-

fied with the applications could have been resolved before TM made a recommendation on those applications.

Our review also disclosed a number of policy issues involving NRSROs that the Commission should address in order to enhance NRSRO oversight and improve the quality of credit ratings. These included, among others: (1) imposing further restrictions on the consulting and advisory services that NRSROs perform for issuers, underwriters or obligors that have paid the NRSROs for credit ratings; (2) requiring NRSROs to monitor and appropriately revise credit ratings on a periodic basis; (3) implementing a credit rating analyst rotation requirement in order to reduce the risk of undue pressure on credit rating analysts; (4) requiring enhanced disclosures by NRSROs regarding the credit ratings process, including the key assumptions used in credit ratings methodologies and procedures and any shortcoming of or limitations on credit ratings; (5) evaluating whether the quality of credit ratings is being negatively impacted by the revolving door, i.e., credit rating analysts leaving to work for an issuer as to which the analyst previously provided a credit rating; (6) conducting an assessment of the potential effects on competition in the NRSRO industry of the proposed amendments regarding the disclosure of material non-public information to other NRSROs, but not to CRAs that do not have NRSRO designation; (7) recommending rules designed to address the problem of forum shopping for credit ratings, i.e., seeking a credit rating from multiple NRSROs and hiring the one that provides the highest credit rating, to reduce the potential harmful effects on the quality of credit ratings; and (8) soliciting and obtaining public comment on CRAs' applications for NRSRO designation. In addition, our review identified several areas in which the Commission's annual report to Congress, as

required by the Rating Agency Act, could be improved.

## Recommendations

The OIG issued its final report on August 27, 2009, which included a total of 24 recommendations for improvements that we believe are needed to ensure compliance with the Rating Agency Act and the Commission's implementing regulations and to enhance NRSRO oversight.

Specifically, we made several recommendations designed to ensure compliance with the NRSRO application approval process established by the Rating Agency Act. These included, among others, that TM (1) ensure that all significant issues identified in the application review process are resolved prior to TM recommending approval of the application by the Commission; (2) in consultation with the appropriate offices, evaluate whether action should be taken regarding the CRA that was granted NRSRO designation despite the numerous significant problems identified with the application; and (3) ensure that all pending issues previously identified during the NRSRO application process be resolved within six months of the date of the issuance of the OIG's report. We also recommended that TM, in consultation with other appropriate offices, request that the Office of General Counsel develop guidance to assist TM in deciding under what circumstances it should seek consent from an applicant to waive the 90-day statutory time period for Commission action on an NRSRO application, or recommend that the Commission institute proceedings to determine whether registration should be denied.

We further recommended, in order to achieve compliance with statutory and regula-

tory requirements pertaining to NRSROs, that TM: (1) ensure in the future that it seeks Commission orders regarding NRSROs when required by statute or the Commission's rules; and (2) ensure that CRAs applying for NRSRO registration and firms that are registered as NRSROs comply with the Commission's rules and requirements regarding the filing and certification of financial information.

In addition, our review made several recommendations designed to improve the effectiveness of OCIE's NRSRO examination program, including the seeking of legislative authority to conduct examinations of CRAs as part of the NRSRO application process, the inclusion of NRSROs in OCIE's pilot monitoring program, and obtaining an additional review of OCIE's NRSRO examination module by someone with industry expertise.

With regard to the numerous NRSRO policy issues that our review found the Commission should address to enhance its oversight of NRSROs, we made several recommendations pertaining to, among other things: (1) performing examination work regarding and assessing the adverse effect of the provision of consulting and advisory service on the quality of credit ratings; (2) implementing a comprehensive credit rating monitoring requirement for NRSROs; (3) performing examination work regarding and assessing undue influence on credit rating analysts and the benefits of an analyst rotation requirement; (4) recommending additional disclosures about the credit ratings process; (5) examining and assessing whether the revolving door problem is negatively impacting the quality of credit ratings; (6) assessing the potential effects on competition in the credit rating industry of proposed amendments regarding the disclosure of material non-public information to other NRSROs, but not to CRAs that do not

have NRSRO designation; (7) recommending rules to reduce the potential harmful effects of forum shopping on the quality of credit ratings; and (8) incorporating the seeking and consideration of public comments into the NRSRO oversight process. Finally, we made several suggestions for including additional concepts identified by our review in the Commission's annual report to Congress regarding NRSROs.

The Office of the Chairman and OCIE concurred with the 13 recommendations directed to these offices. TM fully or partially concurred with 12 of the 13 recommendations directed to that Division. On September 17, 2009, the Commission voted to take several rulemaking actions to bolster oversight of CRAs by enhancing disclosure and improving the quality of credit ratings, thereby addressing several of the issues identified by the OIG.

### **Review of the SEC's Compliance with the Freedom of Information Act (Report No. 465)**

#### **Background**

The OIG contracted with Elizabeth A. Bunker to conduct a review of the SEC's Freedom of Information Act (FOIA or Act) processes and procedures. The review was conducted from March 2009 to July 2009. The objectives of the review were to assess the SEC's FOIA/Privacy Act (FOIA/PA) Office's compliance with applicable laws and regulations, to assess the coordination with FOIA/PA Office liaison staff throughout the SEC, select field offices, and the Office of General Counsel (OGC), and to review the SEC's compliance with prior OIG audit recommendations.

The Act was enacted in 1966, and was codified in Title 5 of the United States Code

(U.S.C.), Section 552. It generally provides that any person has a right of access to agency records, with certain exceptions. Agency records that are not available to the public through "reading rooms," may be made available in response to FOIA requests. All U.S. government agencies are required to disclose their records, or portions of the records, upon receiving a written request, except when the records are protected from disclosure under one or more of the FOIA's nine exemptions. Pursuant to the Act, the right of access is enforceable in court. The Act also generally requires agencies to respond to FOIA requests within 20 working days and to notify requesters of their right to appeal a response denying access to records.

In FY 2007, the FOIA/PA Office had approximately 28 full-time personnel, total FOIA processing costs were \$3.78 million, and the SEC collected \$140,106 in fees, representing about 3.7 percent of its actual processing costs. In FY 2008, the FOIA/PA Office had 27 full-time personnel, its processing costs were \$4.29 million, and the office collected \$62,466 in fees, or 1.45 percent of the FY's processing costs. During FY 2007 through 2008, the SEC's FOIA/PA Office's achievements were noteworthy. Overall, the FOIA/PA Office met and exceeded the backlog goals that were established in its "Program Action Plan." The "Program Action Plan" was required by Executive Order 13392, and was submitted to the Department of Justice. These results were accomplished with no significant changes in the FOIA/PA Office's staffing levels and overall costs. While other divisions within the SEC had its staff and resources increased to proactively make information readily available to the public, the FOIA/PA Office reduced its backlog and responded to new FOIA requests though neither its staff nor budget were increased.

## Results

The OIG's review found that the manner in which the SEC's Chief FOIA Officer functioned was not in compliance with the requirements of Executive Order 13392, or the OPEN Government Act. Prior to our review of the FOIA program in connection with this report, the SEC had not defined any explicit authorities, responsibilities, or reporting duties for the Chief FOIA Officer. During the course of the review, the SEC took steps to fill the Chief FOIA Officer position and to address deficiencies identified in the position.

Further, we reviewed data that measured the SEC's compliance with the FOIA and found that in all FOIA request disposition categories, the SEC's overall rate was significantly lower when compared to all other federal agencies. Specifically, we found that the SEC's FOIA process denied the disclosure of information due to exemption (b)(7)(A), "Interference with Law Enforcement Proceedings," in 67 percent of all FOIA denials in FY 2007 and 66 percent in FY 2008. This exemption is most frequently applied to requests for records from the Division of Enforcement's (Enforcement) investigative caseload. We determined that the deficiencies in the SEC's method of processing FOIA requests may account for the frequent use of the FOIA exemption (b)(7)(A).

We also analyzed the SEC's search process for responsive records pursuant to the FOIA and found that in many cases, this search process actually prevented the discovery of information that was responsive to FOIA requests. Repeated studies issued by the GAO identified ongoing deficiencies and weaknesses in Enforcement's information systems, such as inadequate integration with other systems for data entry and case record updates. The Enforcement's FOIA liaison, corroborated by a GAO review, established that a weakness in its

systems is that even though a number of investigative cases may no longer be active, they have not been officially closed in the databases. The effect of this weakness is that Enforcement investigations, which for all intents and purposes are closed, appear in the databases as open. Therefore, the initial decision, determining if any responsive information is available, can be faulty because searches are conducted using databases that have incomplete and inaccurate information. Thus, searches of these systems show that an Enforcement investigation is open when it is in fact essentially closed, so the requested FOIA information relating to that investigation could actually be produced.

We also found that a second deficiency contributing to the inappropriate application of FOIA exemption (b)(7)(A) was the SEC staff's judgment, without the visual inspection of documents, that the disclosure of any information relating to an investigation (including information available publically) constitutes "interference with law enforcement proceedings." There was no well-documented process for reviewing documents to segregate potentially responsive documents that could be disclosed and, thus, the search may not be sufficient, particularly to justify an all-inclusive denial that is based on FOIA exemption (b)(7)(A). Many decisions concerning the responsiveness of the records were inferred broadly from the recorded narratives in the inaccurate SEC systems and not by reviewing actual documents.

Notwithstanding Enforcement's recent efforts to close cases that are inactive, we found that cases labeled as "open" that show some investigative activity in its systems were most often presumed to be exempt from disclosure unless the Enforcement FOIA liaison could determine that a case was pending payments (e.g., penalties or disgorgements) and that re-

sponsive information could be disclosed. Thus, instead of actually reviewing relevant documents relating to the investigation that is the subject of the FOIA request, the FOIA liaison relied upon a database that did not fully have accurate information and made the decision to withhold any and all potential responsive documents in their entirety. Also, we determined that insufficient time and attention was paid to determining if a partial FOIA release could be made.

The third obstacle that we found regarded the volume and organization of documents that needed to be reviewed, segregated, and redacted by the Enforcement FOIA liaisons and the FOIA/PA Office staff to properly process the information that is subject to FOIA exemption (b)(7)(A). Consultations with information management staff from Enforcement revealed that the volume of information increased beyond the capabilities of the available staff to address FOIA requests. The result was that case records, whether closed, open and inactive, or open and active, were not consistently reviewed for information that might be responsive to FOIA requests, because an exhaustive search to segregate releasable documents was often judged not to be feasible. While the volume of records was never stated as a basis for a denial, the expense and time that was needed to review the documents effectively deprived the requester of a legitimate response.

We also found evidence that the OGC supported and defended the practice of limited and perfunctory document review. We examined 19 FOIA appeal case files that were closed during FY 2007 and FY 2008. Our sample of 19 appeal files included 16 appeals from commercial requestors, two from media requestors, and a disputed fee charge from an individual requestor. Based on our review, we

found ten examples of legal memoranda prepared by OGC attorneys that contained standardized, boilerplate legal explanations upholding the SEC's routine application of FOIA exemption (b)(7)(A).

Some appeal case files that OIG examined for this review contained notes and copies of e-mails that documented OGC attorneys' attempt to verify the status of a case that was presumed to be "open," prior to the appeal being decided. However, there was no record or any affidavit confirming a document review was completed, or verifying that responsive records were withheld "which, if released, could reasonably be expected to interfere with Enforcement's proceedings," neither at the time of the initial FOIA response, nor at the time of the appeal.

In our review, we found many cases where no efforts were made to segregate portions of records for disclosure purposes. Accordingly, the effect was a practical presumption in favor of withholding information, rather than the presumption of disclosure required by the FOIA. We found that when an initial FOIA decision was appealed, while a thorough review of responsive documents was still not performed, OGC personnel would at least contact the staff attorney assigned to the investigation that was the subject of the FOIA request and obtain oral confirmation of the status of the investigation. However, because only a small percentage of requestors challenged the initial denial by filing an appeal, the majority of requestors were deprived of this additional step taken by OGC attorneys.

We further found that the practice of the SEC not conducting a document-by-document review had been challenged and resulted in censure by the courts on two recent occasions. These court decisions revealed the

SEC's consistent pattern of non-disclosure and exposed the SEC to the costs of litigation and negative publicity. We determined that the current SEC practice and policy disregarded the intent of the FOIA to maximize disclosure and, more importantly, negated the principle of openness in government that is embodied by the FOIA.

In addition, we found that the SEC had not established comprehensive management, supervisory, or personnel practices for staff who were responsible for FOIA processing. SEC management needed to improve the skill set of FOIA liaison staff by providing them with FOIA training opportunities, updating position descriptions, and revising FOIA liaison staff's performance standards to include FOIA liaison duties. We also determined that inefficient retrieval systems, voluminous paper and electronic records, and documents that were not organized for efficient FOIA review contributed to delays in processing FOIA requests. Finally, we found that a March 2007 OIG audit report recommendation that FOIA liaisons have access to a tracking system, FOIAXpress, had not been fully implemented. We found that only three of 19 designated FOIA liaisons in OGC and the Division of Corporation Finance reported that they had read-only access to the FOIA database and used FOIAXpress regularly to check the FOIA cases that are assigned to them. Other liaisons we interviewed stated they did not know they had access to the FOIAXpress and did not know how they would use the information in that system to facilitate FOIA work.

## Recommendations

The OIG issued its final report on September 25, 2009, containing ten recommendations designed to strength the SEC's FOIA

processes. Our report recommended that the Chairman's Office ensure the Chief FOIA Officer has sufficient SEC-wide support to fulfill the responsibilities outlined in the OPEN Government Act and should affirm the importance of the FOIA to the SEC's mission. We further recommended that the Chairman's Office direct the Chief FOIA Officer to ensure that accurate searches are made for responsive information that go beyond information available in the databases and, in the event of a denial of a FOIA request, documented evidence is provided to certify that a document-by-document review to segregate responsive records has been conducted.

We recommended that OGC provide and enforce a clear policy of the separation of its roles and responsibilities and stipulate that OGC lawyers who provide advice and counsel regarding any initial FOIA request shall not participate in the appeal process.

We also recommended that the Chairman's Office direct the Chief FOIA Officer to ensure that sufficient legal expertise is available to the FOIA/PA Operations staff to process FOIA requests in compliance with the FOIA, to correctly apply the exemptions, and to provide legal support to SEC staff regarding the Act.

We also made recommendations concerning training opportunities for SEC staff appropriate for their level of FOIA responsibilities, and specifically to fully implement the productive and suitable use of the FOIAXpress tracking and document management system.

The Chairman's Office concurred with the eight recommendations addressed to that Office, and the OGC partially concurred with the two remaining recommendations. We ex-

pressed our concern that the OGC did not fully concur with the recommendation that when the SEC denies a request under the FOIA, documented evidence should be provided to certify that there was a document-by-document review to segregate responsive materials. We noted the OGC acknowledged in its comments to our report that a Federal court rejected its position that if an agency establishes categories of documents, a document-by-document review is not necessary. We also expressed disappointment that the OGC was unwilling to enforce a clear separation of roles and responsibilities under the FOIA, and will continue its practice of having the same personnel who counsel staff during the initial FOIA request process later evaluate the appeal decision, notwithstanding the conflict. We fear that continuing this practice will compromise the FOIA process and deprive FOIA requesters from receiving an impartial and unbiased review during an appeal.

### **Audit of the Office of Acquisitions' Procurement and Contract Management Functions (Report No. 471)**

#### **Background**

The OIG contracted with Regis and Associates, PC (Regis) to conduct an audit of the SEC's contract management processes and functions covering Fiscal Years 2006 to 2008. Regis conducted the audit during January and February 2009. The objectives of the audit were to identify the population of contracts and other procurement vehicles administered by the Office of Administrative Services (OAS); determine if cost-reimbursable type contracts have been properly closed in accordance with the Federal Acquisition Regulation (FAR) and if the costs were allowable, alloc-

able, and reasonable; and determine if procurement activities in the regional offices are effectively managed and whether individuals performing procurement activities are properly trained.

#### **Results**

The audit found that OAS's Office of Acquisitions (OA) did not maintain accurate records and data on their procurement and contracting activities. We requested a list of open and closed contracts from OA and the Office of Financial Management (OFM) to verify the universe of all SEC contracts. OA provided us with a consolidated spreadsheet, which consisted of its open contracts that were developed based on data maintained and tracked by three different contracting officers. We found that these three contracting officers maintained the contracts under their purview differently. Our review of the consolidated spreadsheet further found that 14 of 50 data fields on the spreadsheet were blank. The contracting officers' spreadsheets are the main instruments that OA uses to track its procurement and contracting data for the SEC's headquarters offices/divisions and select regional offices. Yet, OA did not have policies or standard operating procedures to identify the acquisition data that should be tracked and how its contracting officers should maintain contracting data. We also found that OA's consolidated spreadsheet could not be reconciled with OFM's records. Furthermore, we found that OA was unable to provide requested data on contracting activities that originated from the regional offices.

The audit also found that contracting data reported in the Federal Procurement Data System (FPDS) was not accurate. We found the data OA reported to FPDS did not include

all of the SEC's procurement activities, such as modifications and information regarding procurement contracts for the regional offices. We further found that a significant number of personnel did not understand all of their job functions and did not know how to use the FPDS.

The audit further found that OA did not adequately oversee and monitor regional offices' contract activities or training of personnel. An OIG survey found that OA granted 16 personnel in the regional offices limited warrant authority to enter into contracts for Enforcement. However, OA did not establish a process by which its contracting officers would have oversight or knowledge of these contracts, and the regional office personnel were not required to submit monthly, quarterly, or even annual reports on contract activities to OA. We also found that some of these regional office personnel were unfamiliar and not in compliance with applicable federal and SEC regulations.

We also found in the audit that OA did not have an adequate migration plan for its new automated procurement system, PRISM, they were not adequately supporting payments on time-and-materials and labor-hour contracts, and they have not been conducting contract close-out procedures in compliance with SEC and FAR regulations.

The audit found that these deficiencies resulted from the absence of comprehensive data that is needed to manage operations and report on performance, inconsistent operational processes, performance of contractual functions by inadequately trained personnel at the regional offices, noncompliance with FAR and SEC procurement and contracting policies, and the lack of adequate policies and

procedures governing the management of OA's procurement and contracting function.

## Recommendations

On September 25, 2009, we issued the final audit report containing ten recommendations to help strengthen management controls with respect to the SEC's procurement and contract management functions. These recommendations included the development of: (a) record-keeping standard operating procedures to track procurement and contracting activities; (b) a periodic internal review process to ensure that the newly-developed record-keeping standards are followed; (c) an internal process to ensure procurement data is accurately and fully reported in the FPDS for both the headquarters and regional offices/divisions; (d) an acquisition training plan to ensure all headquarters and regional offices/divisions acquisition workforce performing procurement and contracting duties have requisite acquisition training that complies with the applicable Office of Federal Procurement Policy training requirements; and (e) an internal review process and checklist to further ensure compliance with the FAR contract close-out procedures. In addition, the audit recommended that the SEC determine the universe of active and open contracts and the corresponding value of the contracts, provide regional offices with appropriate oversight, and provide for revisions to OA's data migration plan and the reeducation of the acquisition workforce on the FAR requirements that are related to time-and-materials, and labor-hour contracts.

Management concurred with all ten OIG recommendations.



## **Management Alert - Microsoft Premier Support Services Contract (Report No. 469)**

### **Background**

The OIG conducted a limited-scope review of the Commission's sole-source contract for Microsoft Premier Support Services as a result of an anonymous complaint received through the GAO. The complaint raised concerns regarding the method that was used to award the contract and the Commission's subsequent issuance of contract modifications that the complainant believed were outside the scope of the original contract. The review was conducted during April and May 2009.

On March 27, 2006, Microsoft provided OA with a proposal pertaining to the acquisition of software support services (termed Microsoft Premier Support Services), based on its understanding of OA's requirements and its past experience in working with the SEC. On April 27, 2006, the SEC's Office of Information Technology (OIT) and OA approved a justification and approval (J&A) for other than full and open competition and awarded the Microsoft Premier Support Services, contract SECHQ1-06-P-0176, to Microsoft, citing as statutory authority, "41 U.S.C. 253(c)(1) [Federal Acquisition Regulation (FAR)] 6.302-1(a)(2) – Only one responsible source." On that same day, OA publicized its intent to award the sole-source contract for Microsoft software support services to Microsoft on the Federal Business Opportunities (FedBizOpps) website. While this notice was not a request for quotations, interested contractors were allowed to submit their capabilities and qualifications to perform the effort in writing to OA by May 4, 2006. On May 5, 2006, OA awarded a contract to Microsoft for \$227,400 for the software support services. The award document stated that the period of performance consisted of a base year (from

June 1, 2006 to May 31, 2007) and three option years. The total contract value, including all option years, amounted to \$1,009,643.

On May 10, 2007, OA issued a modification to exercise and fully fund Option Year 1 of the contract. On May 22, 2008, the SEC issued a modification to exercise and fully fund Option Year 2 of the contract, which also incorporated an attached amendment. The amendment expanded the scope of the contract by enhancing the existing software support options, adding consulting services to the contract's scope on a Firm Fixed Price Indefinite Delivery Indefinite Quantity basis, and including language to incorporate 96 agencies that are members of the Federal Small Independent Agency (FSIA) Chief Information Officer Council as "affiliates" to the contract.

### **Results**

The review identified five significant practices related to the award of the Microsoft contract that are problematic. First, we found that OA's J&A did not support purchasing the Microsoft Premier Support Services directly from Microsoft as opposed to obtaining those services from Microsoft resellers. Additionally, the OIG determined that any future SEC procurement for Microsoft Premier Support Services should allow Microsoft resellers to compete for the contract. By sole sourcing the requirement for these services, we found that OA excluded resellers, many of which are small businesses.

Second, we found that the J&A for the Microsoft contract was not approved by the appropriate level of contracting official. FAR 6.304, Approval of the Justification, requires justifications for other than full and open competition for proposed contract actions

over \$550,000, but not exceeding \$11,500,000, to be approved by the competition advocate designated pursuant to FAR 6.501, or an official described in paragraph a(3) or a(4) of FAR 6.304. FAR 6.502, Duties and Responsibilities, states that one of the duties of a competition advocate is to review the contracting operation of the agency and identify and report to the agency senior procurement executive “[a]ny condition or action that has the effect of unnecessarily restricting the acquisition of commercial items or competition in the contract actions of the agency . . . .” In a memorandum for Chief Acquisition Officers and Senior Procurement Executives from Paul A. Denett, Subject: Enhancing Competition in Federal Acquisition, dated May 31, 2007, the Administrator of the Office of Federal Procurement Policy requested that agencies “reinvigorate the role of the competition advocate.” We found that the April 27, 2006 J&A erroneously reflected only the base year contract value of \$228,100 and was not signed by the competition advocate, although the total contract value was in excess of \$1,000,000. The contract file contained a proposal that Microsoft had provided to OIT on March 27, 2006, which showed a proposed total contract price of \$1,009,643, consisting of a base year and three option years. The J&A, however, only contained the dollar amount for the base year and was signed only by the contracting officer. Had the J&A been signed by the competition advocate as required by the FAR, this individual may have discovered the aforementioned deficiencies regarding the sole source statutory authority before the contract was awarded.

Third, we determined that the type of contract vehicle that was used to procure the Microsoft Premiere Support Services was improper. The contract was awarded using Optional Form 347, Order for Supplies and Serv-

ices, and was marked on its face as a delivery order, although it was referred to elsewhere in the document as a contract. The requirement was then reported to the Federal Procurement Data Center as a purchase order. Further, the award was only signed by the contracting officer and not by a Microsoft representative. Accordingly, we found it questionable whether the award even constituted a properly executed and binding contract.

Fourth, we found that OA improperly expanded the scope of the original contract when it exercised Option Year 2, essentially violating the FAR’s competition requirements. FAR Part 5, Publicizing Contract Actions, requires any contract actions for additional supplies or services outside the existing contract scope to be publicized to the Government-wide point of entry (GPE) in order to increase competition, broaden industry participation in meeting Government requirements, and to assist small business concerns in obtaining contracts and subcontracts. The GPE may be accessed via the Internet at <http://www.fedbizopps.gov>.

On May 22, 2008, OA modified the original Microsoft contract by exercising Option Year 2 and amending the terms and conditions of the contract. The amendments, which were drafted by Microsoft, clearly expanded the scope of the contract by: (1) enhancing existing software support options (Premier Support Services by Microsoft); (2) adding consulting services to the scope of the contract on a Firm Fixed Price Indefinite Delivery Indefinite Quantity basis; and (3) including language to add 96 agencies that are members of the FSIA Chief Information Officer Council as affiliates to the contract. Despite Microsoft’s clear intent to expand its services to the SEC and to provide a vehicle under which other agencies could order the

same expanded services under the SEC's contract, we found no documentation in the contract file to show that OA recognized or acknowledged that the amendment Microsoft provided was outside the scope of the original contract. Accordingly, the contract action was not publicized on FedBizOpps as required by the FAR, and no J&A was prepared to cover the additional consulting services. Further, by naming other agencies as affiliates to the contract, OA may have opened the SEC up to unexpected contractual and legal implications. Accordingly, we determined that it appeared that OA violated the FAR's competition requirements and provided a vehicle for other agencies to do the same. Additionally, we did not believe the SEC had authority to enter into this type of multi-agency contract agreement without first obtaining approval from the Office of Federal Procurement Policy.

Fifth, we noted that the price reasonableness determination for the original contract award cited FAR 13.106, Soliciting Competition, Evaluation of Quotations or Offers, Award and Documentation, as the basis for determining that Microsoft's price was fair and reasonable. FAR, Part 13, Simplified Acquisition Procedures, however, pertains to price reasonableness under simplified acquisition procedures. Because the value of the Microsoft contract was in excess of \$100,000, simplified acquisition procedures were not applicable in this situation.

### **Recommendations**

OIG issued the Management Alert memorandum to OAS managers on August 10, 2009, to make them aware of the OIG's concerns. The memorandum requested that management respond within five business days and identify what actions would be taken to address the five significant areas related to the

award of the Microsoft contract and subsequent modification. Management issued a response on August 17, 2009, in which it agreed with the findings, stated it would take action to remedy the deficiencies identified, and promised to ensure that future procurements are conducted appropriately and in accordance with the regulations.

## **PENDING AUDITS AND EVALUATIONS**

### **Review of the Commission's Processes for Selecting Investment Advisers and Investment Companies for Examination**

We will be shortly issuing our final report in connection with the SEC's failure to uncover Madoff's Ponzi scheme. Previously, we issued a 457-page investigative report, as well as two audit reports providing recommendations for both Enforcement and OCIE to improve their operations based on our investigative findings. These reports are described in detail in the Investigations and Inquiry Conducted and the Audits and Evaluations Conducted sections of this report, respectively.

The investigative report chronicled in detail how the SEC Enforcement staff effectively closed the Madoff investigation in August 2006, after Madoff agreed to register as an investment adviser. The investigative report found that the SEC Enforcement lawyers believed that this was a "beneficial result" because, once he registered, "he would have to have a compliance program, and he would be subject to an examination by [the Investment Adviser] team." Further, the Branch Chief on the Enforcement investigation stated that "one of the reasons that registration felt really important to [them] was to – keep opening him to extra regulatory scrutiny, you know, in case there was something that [they] just weren't able to find." However, we found that no ex-

amination was ever conducted of Madoff after he registered as an investment adviser.

As a consequence of the findings discussed above, we are performing a review to analyze the circumstances surrounding the failure of OCIE's investment adviser program to conduct an examination of Madoff. The specific objectives of this review are to determine the SEC's rationale for not performing an examination of Madoff's investment advisory business soon after the firm registered as an investment adviser in 2006, and to make recommendations to improve OCIE's process for selecting which investment advisers and investment companies it examines. In this review, we will analyze Madoff's filings with the Commission as a result of his investment adviser registration, as well as OCIE's processes for identifying risks related to investment advisers, and for rating and examining investment advisers.

### **Assessment of Interagency Acquisition Agreements to Improve Efficiency**

The OIG is continuing its audit of the SEC's interagency agreements and acquisitions. Government agencies use interagency agreements and acquisitions to take advantage of contracts, expertise and experience in other government agencies that they might not have internally. They can also use interagency agreements and acquisitions to provide services to other agencies. Interagency agreements provide government agencies with convenient access to commonly-needed goods and services. Using these types of acquisitions can provide an agency with improved efficiency and convenience through a streamlined procurement process. However, interagency agreements must be effectively managed. In 2005, the GAO designated the management of interagency contracting as a high-risk area. Also, a recent risk assessment survey of the

SEC's contracting activities identified a number of potential risk areas that could affect the management of its interagency agreements.

We are finalizing our audit to assess whether the SEC obtains, manages, and closes interagency agreements and acquisitions in accordance with applicable requirements. We expect to issue the audit report shortly.

### **Audit of the SEC's Information Technology Investment Process**

We have also commenced an audit of the SEC's approval process for major IT investments. The audit will examine whether procedures exist to ensure that major IT investments are properly approved by the appropriate IT boards as outlined in the SEC's Capital Planning and Investment Control (CPIC) bylaws. We will determine whether the CPIC structure, approval processes and procedures adhere to governing Commission policy and applicable Federal laws and regulations. We will further assess whether major IT investment projects are properly approved by the appropriate agency committees or boards.

The OIG will also survey the SEC's offices and divisions to assess whether all major IT investments are properly controlled throughout the agency.

### **2009 Federal Information Security Management Act Assessments**

The OIG has contracted with the Command, Control, Communications, Collaborate, Combat and Intelligence Corporation (C5i) to perform an independent review of the SEC's IT systems, in accordance with the Federal Information Security Management Act. C5i will independently evaluate and report on how the SEC has implemented its

mandated information security requirements regarding the following components:

- Security management structure;
- Risk management process;
- System security plans;
- Certification and accreditation process;
- Computer incident response capability;
- Contingency planning process and procedures;
- Security awareness environment;
- Life-cycle management of security and management of personnel security; and
- Privacy.

C5i will also conduct an assessment of two major SEC security programs, encryption and privacy, and determine whether the programs meet the Office of Management and Budget's and the National Institute of Standards and Technology's requirements.

### **U.S. Securities and Exchange Commission's FY 2009 Financial Statements**

The GAO conducts the SEC's financial statement audit. In support of the SEC's FY 2009 financial statement audit, the OIG will

conduct testing and work in the areas of sensitive payments and contract and consulting services (described in more detail below). The OIG will also determine whether the SEC's special-purpose financial statements, and the accompanying notes, fairly present the agency's financial position in all material respects. We will further test the intragovernmental and other related parties activity balances, render an opinion, transmit the SEC's financial statements and legal representation letter, and complete the agreed-upon procedural requirements.

### **FY 2009 Assessment of Sensitive Payments**

The OIG is performing an assessment of the SEC's sensitive payment areas in support of the GAO's audit of the SEC's FY 2009 financial statements. Specifically, the OIG will assess the effectiveness of management controls over sensitive payments and contract and consulting services for senior executive salaries and bonuses, official entertainment, consulting services, speaking honoraria and gifts, executive perquisites, etc., to ensure compliance with applicable requirements and to detect fraud, waste or mismanagement. We will test the sensitive payment areas to ensure that the SEC's senior executives adhere to established policies and procedures over sensitive payments and to determine whether inappropriate acts or misconduct have occurred.





# SEMIANNUAL REPORT TO CONGRESS

## INVESTIGATIONS

### OVERVIEW

The OIG's Office of Investigations responds to allegations of violations of statutes, rules and regulations, and other misconduct by SEC staff and contractors. The misconduct investigated ranges from criminal wrongdoing and fraud to violations of SEC rules and policies and the Government-wide standards of conduct. The OIG receives complaints through the OIG Hotline, an office electronic mailbox or by mail, facsimile or telephone.

The most common way complaints were received during this reporting period continued to be through the OIG Hotline, which consists of both telephone and web-based complaint mechanisms. Complaints may be made anonymously by calling the Hotline, which is staffed and answered 24 hours a day, seven days a week. Complaints may also be made to the Hotline through an Online Complaint Form, which is accessible through the OIG's website. In addition to a mechanism for the receipt of complaints, the OIG's website also provides the public with an overview of the work of the Office of Investigations, as well as links to investigative memoranda issued by the Office.

The Office of Investigations conducts thorough and independent investigations in accordance with the Quality Standards for Investigations of the Council of the Inspectors General on Integrity and Efficiency. In instances where it is determined that something less than a full investigation is appropriate, the Office of Investigations conducts a preliminary inquiry into the allegation. If the information obtained during the inquiry indicates that a full investigation is warranted, the Office of Investigations will commence an investigation of the allegation.

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

of confidentiality to potential witnesses who have expressed a reluctance to come forward.

Where allegations of criminal conduct are involved, the Office of Investigations notifies and works with the Department of Justice, including the FBI, as appropriate. The OIG also obtains necessary investigative assistance from the SEC's Office of Information Technology (OIT), including the prompt retrieval of employee e-mail accounts as requested by the OIG investigators and forensic analysis of computer hard drives. The OIG investigative staff meets with the Inspector General frequently to review the progress of ongoing investigations. The OIG investigative unit also meets periodically with the Commission's Ethics Counsel to coordinate activities.

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

## **INVESTIGATIONS AND INQUIRIES CONDUCTED**

### **Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme**

#### **Opening of the Investigation**

On December 17, 2008, the OIG opened an investigation after a request was made the previous evening by former SEC Chairman Christopher R. Cox that the OIG investigate allegations made to the SEC regarding Bernard L. Madoff (Madoff), who had just confessed to operating a multi-billion dollar Ponzi scheme, and the reasons why the SEC had found these allegations to be not credible.

#### **Initial Investigatory Efforts**

On December 17, 2008, the OIG initiated its first request for e-mail records from the SEC's OIT. Over the course of the investigation, the OIG made numerous requests from OIT for e-mails, including: (1) all e-mails of former Office of Compliance Inspections and Examinations (OCIE) employee Eric Swanson during his tenure with the SEC; (2) all e-mails of six staff members who were involved in the SEC's investigation of the Madoff firm that was initiated in 2006 for the period from January 2006 through January 2008; (3) all e-mails for SEC Headquarters, New York Regional Office (NYRO) and Boston Regional Office (BRO) staff members from January 1, 1999 through December 11, 2008, that contained the word "Madoff"; (4) additional e-mails for approximately 68 current and former SEC employees for various time periods relevant to the investigation, ranging from 1999 to 2009. In all, we estimate that we ob-



tained and searched approximately 3.7 million e-mails during the course of our investigation.

On December 24, 2008, we sent comprehensive document requests to both the Division of Enforcement (Enforcement) and OCIE, specifying the documents and records we required to be produced for the investigation. We followed up with memoranda to OCIE in April, May and June of 2009. We also had follow-up communications with Enforcement on January 21, 2009 and July 22, 2009. We further had numerous e-mail and telephonic communications with both OCIE and Enforcement regarding the scope and timing of the document requests and responses, as well as meetings to clarify and expand the document requests as was necessary.

We collected all the information produced in response to our document production requests. We then carefully reviewed and analyzed the investigative records of all SEC investigations conducted relating to Madoff, Madoff's firms, members of Madoff's family, and Madoff's associates from 1975 to the present.

During the investigation, we also reviewed the workpapers and examination files of nine SEC examinations of Madoff's firms from 1990 to December 11, 2008. Where documents from the examinations were not available, we sought testimony and conducted interviews of current and former SEC personnel who had worked on the examinations.

We also sought information and documentation from third parties in order to undertake our own analysis of Madoff's trading records. During the course of the OIG investigation, we requested and obtained records from: (1) the Depository Trust Company (DTC) relating to position reports for Madoff's firms; (2) the National Securities

Clearing Corporation (NSCC) relating to clearing data records for executions effected by Madoff's firms; and (3) the Financial Industry Regulatory Authority (FINRA) for Order Audit Trail System (OATS) data submitted by Madoff's firms for six National Association of Securities Dealers Automated Quotations (NASDAQ)-listed stocks and the NASDAQ Automated Confirmation of Transactions (ACT) database for a trading period in March 2005.

### **Retention of Experts**

In order to assist us in the Madoff investigation, we retained two sets of outside consultants. In February 2009, we retained FTI Consulting, Inc. (FTI Engagement Team) to assist with the review of the examinations of Madoff and his firms that were conducted by the SEC. Members of the FTI Engagement Team included Charles R. Lundelius, Jr., Senior Managing Director, Forensic and Litigation Consulting; Simon Wu, Managing Director, Forensic and Litigation Consulting; John C. Crittenden III, Managing Director, Corporate Finance Group; and James Conversano, Director, Forensic and Litigation Consulting. Each individual member of the FTI Engagement Team brought a unique and specialized experience to the analyses that the FTI Engagement Team conducted, including expertise in complex financial fraud investigations, securities-related inspections and examinations, hedge fund operations, cash flow analysis and valuations, market regulation rules, market structure issues, accounting fraud, investment suitability, the underwriting process and compliance and due diligence practices.

At our direction, the FTI Engagement Team conducted a thorough review of all relevant workpapers and documents associ-

ated with the OCIE examinations of Madoff's firm, scrutinized the conduct of the Madoff-related SEC examinations and investigations, and analyzed whether the SEC examiners overlooked red flags that could have led to the discovery of Madoff's Ponzi scheme. The FTI Engagement Team also replicated aspects of the OCIE cause examinations of Madoff to determine whether the SEC sought the appropriate information in the examinations and analyzed that information correctly.

In addition, OIT advised us during the course of our investigation that there were substantial gaps in the e-mails we were seeking to review as part of our investigation because of failures to backup tapes, hardware or software failures during the backup process, and/or lost, mislabeled or corrupted tapes. In order to ensure that we were able to conduct a thorough and comprehensive investigation, in June 2009, we retained the services of First Advantage Litigation Consulting Services (First Advantage) to assist us in the restoration and production of relevant electronic data. First Advantage's team had significant experience in leading numerous large-scale electronic discovery consulting projects, as well as assisting with highly sensitive and confidential investigations for corporations and the FBI.

In connection with its retention on the Madoff investigation, First Advantage provided consulting and technical support to the OIG and the SEC, and was able to successfully preserve and restore potentially relevant data within the universe of electronic data we had requested from OIT. As a result, we were able to review additional Madoff-related e-mails that were pertinent to our investigation.

## **Testimony and Interviews Conducted in the Madoff Investigation**

We also conducted 140 testimonies under oath or interviews of 122 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Madoff and his firms. We interviewed all current or former SEC employees who had played any significant role in the SEC's significant examinations and investigations of Madoff and his firms over a period spanning approximately 20 years.

## **Issuance of the Report of Investigation**

On August 31, 2009, we issued to the Chairman of the SEC a comprehensive report of investigation (ROI) in the Madoff matter containing 457 pages of analysis. The complete public version of the report is available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>. The ROI detailed the SEC's response to all complaints it received regarding the activities of Madoff and his firms, and traced the path of these complaints through the Commission from their inception, reviewing the investigative or examination work that was conducted with respect to the allegations. Further, the ROI assessed the conduct of examinations and/or investigations of Madoff and his firms by the SEC and analyzed whether the SEC examiners or investigators overlooked red flags (which other entities conducting due diligence identified) that could have led to a more comprehensive examination or investigation and the discovery of Madoff's Ponzi scheme.

Our ROI also analyzed the allegations of conflicts of interest arising from relationships between any SEC officials or staff and members of the Madoff family. This included an

examination of the role that former SEC OCIE Assistant Director Eric Swanson, who eventually married Madoff's niece Shana Madoff, may have played in the examination or other work conducted by the SEC with respect to Madoff or related entities, and whether such role or relationship in any way affected the manner in which the SEC conducted its regulatory oversight of Madoff and any related entities.

We have also considered the extent to which the reputation and status of Madoff and the fact that he served on SEC Advisory Committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials, may have affected Commission decisions regarding investigations, examinations, and inspections of his firms.

### **Summary of Findings in the Report of Investigation**

The OIG investigation did not find evidence that any SEC personnel who worked on an SEC examination or investigation of Bernard L. Madoff Investment Securities, LLC (BMIS) had any financial or other inappropriate connection with Bernard Madoff, or the Madoff family, that influenced the conduct of their examination or investigatory work. The OIG also did not find that former SEC Assistant Director Eric Swanson's romantic relationship with Bernard Madoff's niece, Shana Madoff, influenced the conduct of the SEC examinations of Madoff and his firms. Further, we did not find that senior officials at the SEC directly attempted to influence examinations or investigations of Madoff or his firms, nor was there evidence any senior SEC official interfered with the staff's ability to perform its work.

The OIG investigation did find, however, that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008, when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent returns.

The first complaint, brought to the SEC's attention in 1992, related to allegations that an unregistered investment company was offering "100%" safe investments with high and extremely consistent rates of return over significant periods of time to "special" customers. The SEC actually suspected the investment company was operating a Ponzi scheme and learned in its investigation that all of the investments were placed entirely through Madoff and consistent returns were claimed to have been achieved for numerous years without a single loss.

The second complaint was very specific and different versions were provided to the SEC in May 2000, March 2001 and October 2005. The complaint submitted in 2005 was entitled "The World's Largest Hedge Fund is a Fraud," and detailed approximately 30 red flags indicating that Madoff was operating a

Ponzi scheme, a scenario it described as “highly likely.” The red flags included the impossibility of Madoff’s returns, particularly the consistency of those returns and the unrealistic volume of options Madoff represented to have traded.

In May 2003, the SEC received a third complaint from a respected Hedge Fund Manager identifying numerous concerns about Madoff’s strategy and purported returns, questioning whether Madoff was actually trading options in the volume he claimed, noting that Madoff’s strategy and purported returns were not duplicable by anyone else, and stating Madoff’s strategy had no correlation to the overall equity markets in over ten years. According to an SEC manager, the Hedge Fund Manager’s complaint laid out issues that were “indicia of a Ponzi scheme.”

The fourth complaint was part of a series of internal e-mails of another registrant that the SEC discovered in April 2004. The e-mails described the red flags that a registrant’s employees had identified while performing due diligence on their own Madoff investment using publicly-available information. The red flags identified included Madoff’s incredible and highly unusual fills for equity trades, his misrepresentation of his options trading and his unusually consistent, non-volatile returns over several years. One of the internal e-mails provided a step-by-step analysis of why Madoff must be misrepresenting his options trading. The e-mail clearly explained that Madoff could not be trading on an options exchange because of insufficient volume and could not be trading options over-the-counter because it was inconceivable that he could find a counterparty for the trading. The SEC examiners who initially discovered the e-mails viewed them as indicating, “some suspicion as to whether Madoff is trading at all.”

The fifth complaint was received by the SEC in October 2005 from an anonymous informant and stated, “I know that Madoff [sic] company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale. And they have been doing it for a long time.” The informant also stated, “After a short period of time, I decided to withdraw all my money (over \$5 million).”

The sixth complaint was sent to the SEC by a “concerned citizen” in December 2006, advising the SEC to look into Madoff and his firm as follows:

Your attention is directed to a scandal of major proportion which was executed by the investment firm Bernard L. Madoff . . . . Assets well in excess of \$10 Billion owned by the late [investor], an ultra-wealthy long time client of the Madoff firm have been “co-mingled” with funds controlled by the Madoff company with gains thereon retained by Madoff.

In March 2008, the SEC Chairman’s office received a second copy of the previous complaint, with additional information from the same source regarding Madoff’s involvement with the investor’s money, as follows:

It may be of interest to you to that Mr. Bernard Madoff keeps two (2) sets of records. The most interesting of which is on his computer which is always on his person.

The two 2001 journal articles also raised significant questions about Madoff’s unusually consistent returns. One of the articles noted his “astonishing ability to time the market and move to cash in the underlying securities before

market conditions turn negative and the related ability to buy and sell the underlying stocks without noticeably affecting the market.” This article also described that, “experts ask why no one has been able to duplicate similar returns using [Madoff’s] strategy.” The second article quoted a former Madoff investor as saying, “Anybody who’s a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naïve.”

The complaints all contained specific information and could not have been fully and adequately resolved without thoroughly examining and investigating Madoff for operating a Ponzi scheme. The journal articles should have reinforced the concerns about how Madoff could have been achieving his returns.

As noted above, the OIG retained an expert in connection with its investigation to analyze both the information the SEC received regarding Madoff and the examination work conducted. According to the OIG’s expert, the most critical step in examining or investigating a potential Ponzi scheme is to verify the subject’s trading through an independent third party.

The OIG investigation found the SEC conducted two investigations and three examinations related to Madoff’s investment advisory business based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff’s trading through an independent third party, and in fact, it never actually conducted a Ponzi scheme examination or investigation of Madoff.

The first examination and first Enforcement investigation were conducted in

1992 after the SEC received information that led it to suspect that a Madoff associate had been conducting a Ponzi scheme. Yet, the SEC focused its efforts on Madoff’s associate and never thoroughly scrutinized Madoff’s operations, even after learning that the investment decisions were made by Madoff and being apprised of the remarkably consistent returns over a period of numerous years that Madoff had achieved with a basic trading strategy. While the SEC ensured that all of Madoff’s associate’s customers received their money back, they took no steps to investigate Madoff. The SEC focused its investigation too narrowly and seemed not to have considered the possibility that Madoff could have taken the money that was used to pay back his associate’s customers from other clients for which Madoff may have had held discretionary brokerage accounts. In the examination of Madoff, the SEC did not seek records from the Depository Trust Company (DTC) (an independent third party), but sought copies of such records from Madoff himself. Had they sought records from DTC, there is an excellent chance that they would have uncovered Madoff’s Ponzi scheme in 1992.

In 2004 and 2005, the SEC’s examination unit, OCIE, conducted two parallel cause examinations of Madoff based upon the Hedge Fund Manager’s complaint and the series of internal e-mails that the SEC discovered. The examinations were remarkably similar. There were initial significant delays in the commencement of the examinations, notwithstanding the urgency of the complaints. The teams assembled were relatively inexperienced, and there was insufficient planning for the examinations. The scopes of the examination were in both cases too narrowly focused on the possibility of front-running, with no significant attempts made to analyze the numerous red flags about Madoff’s trading and returns.

During the course of both examinations, the examination teams discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them. Even when Madoff's answers were seemingly implausible, the SEC examiners accepted them at face value.

In both examinations, the examiners made the surprising discovery that Madoff's mysterious hedge fund business was making significantly more money than his well-known market-making operation. However, no one identified this revelation as a cause for concern.

Astoundingly, both examinations were open at the same time in different offices without either knowing the other one was conducting an identical examination. In fact, it was Madoff himself who informed one of the examination teams that the other examination team had already received the information they were seeking from him.

In the first of the two OCIE examinations, the examiners drafted a letter to the National Association of Securities Dealers (NASD) (another independent third party) seeking independent trade data, but they never sent the letter, claiming that it would have been too time-consuming to review the data they would have obtained. The OIG's expert opined that had the letter to the NASD been sent, the data would have provided the information necessary to reveal the Ponzi scheme. In the second examination, the OCIE Assistant Director sent a document request to a financial institution that Madoff claimed he used to clear his trades, requesting trading done by or on behalf of particular Madoff feeder funds during a specific time period, and received a response that there was no transaction activity in

Madoff's account for that period. However, the Assistant Director did not determine that the response required any follow-up and the examiners testified that the response was not shared with them.

Both examinations concluded with numerous unresolved questions and without any significant attempt to examine the possibility that Madoff was misrepresenting his trading and operating a Ponzi scheme.

The investigation that arose from the most detailed complaint provided to the SEC, which explicitly stated it was "highly likely" that "Madoff was operating a Ponzi scheme," never really investigated the possibility of a Ponzi scheme. The relatively inexperienced Enforcement staff failed to appreciate the significance of the analysis in the complaint, and almost immediately expressed skepticism and disbelief. Most of their investigation was directed at determining whether Madoff should register as an investment adviser or whether Madoff's hedge fund investors' disclosures were adequate.

As with the examinations, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on these inconsistencies. They rebuffed offers of additional evidence from the complainant, and were confused about certain critical and fundamental aspects of Madoff's operations. When Madoff provided evasive or contradictory answers to important questions in testimony, they simply accepted his explanations as plausible.

Although the Enforcement staff made attempts to seek information from independent third parties, they failed to follow up on these requests. They reached out to the NASD and asked for information on whether Madoff had options positions on a certain date, but when

they received a report that there were in fact no options positions on that date, they did not take any further steps. An Enforcement staff attorney made several attempts to obtain documentation from European counterparties (other independent third parties) and, although a letter was drafted, the Enforcement staff decided not to send it. Had any of these efforts been fully executed, they would have led to Madoff's Ponzi scheme being uncovered.

The OIG also found that numerous private entities conducted basic due diligence of Madoff's operations and, without regulatory authority to compel information, came to the conclusion that an investment with Madoff was unwise. Specifically, Madoff's description of both his equity and options trading practices immediately led to suspicions about Madoff's operations. With respect to his purported trading strategy, many simply did not believe that it was possible for Madoff to achieve his returns using a strategy described by some industry leaders as common and unsophisticated. In addition, there was a great deal of suspicion about Madoff's purported options trading, with several entities not believing that Madoff could be trading options in such high volumes where there was no evidence that any counterparties had been trading options with Madoff.

The private entities' conclusions were drawn from the same red flags in Madoff's operations that the SEC considered in its examinations and investigations, but ultimately dismissed.

We also found that investors who may have been uncertain about whether to invest with Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud.

Moreover, we found that Madoff proactively informed potential investors that the SEC had examined his operations. When potential investors expressed hesitation about investing with Madoff, he cited the prior SEC examinations to establish credibility and allay suspicions or investor doubts that may have arisen while due diligence was being conducted. Thus, the fact the SEC had conducted examinations and investigations and did not detect the fraud, lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him.

A more detailed description of the circumstances surrounding the five major investigations and examinations that the SEC conducted of Madoff and his firms is provided below. In June 1992, several customers of an investment firm known as Avellino & Bienes approached the SEC conveying concerns about investments they had made. The SEC was provided with several documents created by Avellino & Bienes that indicated they were offering "100%" safe investments, which they characterized as loans, with high and extremely consistent rates of return over significant periods of time. Not everyone could invest with Avellino & Bienes, as this was a "special" and exclusive club, with some special investors getting higher returns than others.

As the SEC began investigating the matter, they learned that Madoff had complete control over all of Avellino & Bienes' customer funds and made all investment decisions for them and, according to Avellino, Madoff had achieved these consistent returns for them for numerous years without a single loss. Avellino described Madoff's strategy for these extraordinarily consistent returns as very basic: investing in long-term Fortune 500 securities with hedges of the Standard & Poor's (S&P) index.

The SEC suspected that Avellino & Bienes was operating a Ponzi scheme and took action to ensure that all of Avellino & Bienes' investors were refunded their investments. Yet, the OIG found that the SEC never considered the possibility that Madoff could have taken the money that was used to pay back Avellino & Bienes' customers from other clients as part of a larger Ponzi scheme.

The SEC actually conducted an examination of Madoff that was triggered by the investigation of Avellino & Bienes, but assembled an inexperienced examination team. The examination team conducted a brief and very limited examination of Madoff, but made no effort to trace where the money that was used to repay Avellino & Bienes' investors came from. In addition, although the SEC examiners did review records from DTC, they obtained those DTC records from Madoff, rather than going to DTC itself to verify if trading occurred. According to the lead SEC examiner, someone should have been aware of the fact that the money used to pay back Avellino & Bienes' customers could have come from other investors, but there was no examination of where the money that was used to pay back the investors came from. Another examiner said such a basic examination of the source of the funds would have been "common sense." In addition, although the SEC's lead examiner indicated that the investment vehicle offered by Avellino & Bienes had numerous "red flags" and was "suspicious," no effort was made to look at the investment strategy and returns.

Instead, the SEC investigative team, which was also inexperienced, brought a limited action against Avellino & Bienes for selling unregistered securities, not fraud, and did not take any further steps to inquire into Madoff's firms. The SEC lawyers working on the matter were aware of the questionable returns

and the fact that all the investment decisions were made by Madoff, but the focus of the investigation was limited to whether Avellino & Bienes was selling unregistered securities or operating an unregistered investment firm. A trustee and accounting firm were retained to ensure full distribution of the assets, but their jurisdiction was limited, and they did not take any action to independently verify account balances and transaction activity included in Madoff's financial and accounting records. Even after the accounting firm was unable to audit Avellino & Bienes' financial statements and uncovered additional red flags, such as Avellino & Bienes' failure to produce financial statements or have the records one would have expected from such a large operation, no further efforts were made to delve more deeply into either Avellino & Bienes' or Madoff's operations.

The result was a missed opportunity to uncover Madoff's Ponzi scheme 16 years before Madoff confessed. The SEC had sufficient information to inquire further and investigate Madoff for a Ponzi scheme back in 1992. There was evidence of incredibly consistent returns over a significant period of time without any losses, purportedly achieved by Madoff using a basic trading strategy of buying Fortune 500 stocks and hedging against the S&P index. Yet, the SEC seemed satisfied with closing Avellino & Bienes down, and never even considered investigating Madoff, despite knowing that Avellino & Bienes invested all of its clients' money exclusively with Madoff. The SEC's lead examiner said Madoff's reputation as a broker-dealer may have influenced the inexperienced team not to inquire into Madoff's operations.

In May 2000, Harry Markopolos provided the SEC's Boston District Office (BDO) with an eight-page complaint questioning the legitimacy of Madoff's reported returns. The



2000 complaint posited the following two explanations for Madoff's unusually consistent returns: (1) that "[t]he returns are real, but they are coming from some process other than the one being advertised, in which case an investigation is in order;" or (2) "[t]he entire fund is nothing more than a Ponzi scheme." Markopolos' complaint stated that Madoff's returns were unachievable using the trading strategy he claimed to employ, noting Madoff's "perfect market-timing ability." Markopolos also referenced the fact that Madoff did not allow outside performance audits.

Markopolos explained his analysis presented in the 2000 complaint at a meeting at the SEC's BDO and encouraged the SEC to investigate Madoff. Both Markopolos and an SEC staff accountant testified that after the meeting, it was clear that the BDO's Assistant District Administrator did not understand the information presented. Our investigation found that this was likely the reason that the BDO decided not to pursue Markopolos' complaint or even refer it to the SEC's Northeast Regional Office (NERO).

In March 2001, Markopolos provided the BDO with a second complaint, which supplemented his previous 2000 complaint with updated information and additional analysis. Markopolos' 2001 complaint included an analysis of Madoff's returns versus the S&P 500, showing that he had only three down months versus the market's 26 down months during the same period, with a worst down month of only -1.44% versus the market's worst down month of -14.58%. Markopolos concluded that Madoff's "numbers really are too good to be true." Markopolos' analysis was supported by the experience of two of his colleagues, Neil Chelo and Frank Casey, both of whom had substantial experience with and knowledge of investment funds.

Although this time the BDO did refer Markopolos' complaint, NERO decided not to investigate the complaint only one day after receiving it. The matter was assigned to an Assistant Regional Director in Enforcement for initial inquiry, who reviewed the complaint, determined that Madoff was not registered as an investment adviser, and the next day, sent an e-mail stating, "I don't think we should pursue this matter further." The OIG could find no explanation for why Markopolos' complaint, which the Enforcement attorney and the former head of NERO acknowledged was "more detailed than the average complaint," was disregarded so quickly.

Just one month after NERO decided not to pursue Markopolos' second submission to the SEC, in May 2001, MARHedge and Barron's both published articles questioning Madoff's unusually consistent returns and secretive operations. The MARHedge article, written by Michael Ocrant and entitled, "Madoff tops charts; skeptics ask how," stated how many were "baffled by the way [Madoff's] firm has obtained such consistent, non-volatile returns month after month and year after year," and described the fact Madoff "reported losses of no more than 55 basis points in just four of the past 139 consecutive months, while generating highly consistent gross returns of slightly more than 1.5% a month and net annual returns roughly in the range of 15.0%." The MARHedge article further discussed how industry professionals "marvel at [Madoff's] seemingly astonishing ability to time the market and move to cash in the underlying securities before market conditions turn negative and the related ability to buy and sell the underlying stocks without noticeably affecting the market." It further described how "experts ask why no one has been able to duplicate similar returns using [Madoff's] strategy."

The Barron's article, written by Erin Arvedlund and entitled, "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum," discussed how Madoff's operation was among the three largest hedge funds, and has "produced compound average annual returns of 15% for more than a decade," with the largest fund "never [having] had a down year." The Barron's article further questioned whether Madoff's trading strategy could have been achieving those remarkably consistent returns.

The OIG found that the SEC was aware of the Barron's article when it was published in May 2001. On May 7, 2001, an Enforcement Branch Chief in the BDO followed up with NERO regarding Markopolos' 2001 complaint and the Barron's article, and asked the Director of NERO if he wanted a copy of the article. However, the decision not to commence an investigation was not reconsidered and there is no evidence the Barron's article was ever even reviewed. In addition, we found that former OCIE Director Lori Richards reviewed the Barron's article in May 2001 and sent a copy to an Associate Director in OCIE shortly thereafter, with a note on the top stating that Arvedlund is "very good" and, "This is a great exam for us!" However, OCIE did not open an examination, and there is no record of anyone else in OCIE reviewing the Barron's article until several years later.

In May 2003, OCIE's investment management group in Washington, D.C. received a detailed complaint from a reputable Hedge Fund Manager, in which he laid out the red flags that his hedge fund had identified about Madoff while performing due diligence on two Madoff feeder funds. The Hedge Fund Manager attached four documents to his complaint, including performance statistics for three Madoff feeder funds and the

MARHedge article.

The Hedge Fund Manager's complaint identified numerous concerns about Madoff's strategy and purported returns. According to the Hedge Fund Manager's complaint, while Madoff purported to trade \$8-\$10 billion in options, he and his partner had checked with some of the largest brokers and did not see the volume in the market. Further, the Hedge Fund Manager explained in his complaint that Madoff's fee structure was suspicious because Madoff was foregoing the significant management and performance fees typically charged by asset managers. The complaint also described specific concerns about Madoff's strategy and purported returns such as the fact that the strategy was not duplicable by anyone else, there was no correlation to the overall equity markets (in over ten years), accounts were typically in cash at month end, the auditor of the firm was a related party to the principal, and Madoff's firms never had to face redemption.

According to an SEC supervisor, the Hedge Fund Manager's complaint implied that Madoff might be lying about his options trading and laid out issues that were "indicia of a Ponzi scheme." One of the senior examiners on the team also acknowledged that the Hedge Fund Manager's complaint could be interpreted as alleging that Madoff was running a Ponzi scheme.

The OIG's expert concluded that based upon issues raised in the Hedge Fund Manager's complaint, had the examination been staffed and conducted appropriately and basic steps taken to obtain third-party verifications, Madoff's Ponzi scheme should and would have been uncovered.

However, we found that OCIE did not staff or conduct the examination adequately

and, thus, missed another opportunity to uncover Madoff's fraud. The complaint was immediately referred to OCIE's broker-dealer examination group even though the complaint mainly raised investment management issues. The broker-dealer group decided not to request investment adviser staff support for the examination even though the examiners testified that such support could have been arranged whether or not Madoff was registered as an investment adviser. The OIG was informed that, at that time, the two OCIE groups rarely collaborated on examinations.

The broker-dealer examination team assigned to the examination was inexperienced. According to an examiner, at the time of the Madoff examination, OCIE "didn't have many experienced people at all," noting that OCIE was "expanding rapidly and had a lot of inexperienced people" conducting examinations. Another OCIE examiner stated that "there was no training," "this was a trial by fire kind of job," and there were a lot of examiners who "weren't familiar with securities laws." The team was composed entirely of attorneys, who, according to one member, did "not have much experience in equity and options trading" but "rather, their experience was in general litigation." As noted above, the complaint included issues typically examined by investment adviser personnel, such as verification of purported investment returns and account balances, but the group assigned to the examination had no significant experience conducting examinations of these issues.

In addition, notwithstanding the serious issues raised in the Hedge Fund Manager's complaint, the start of the examination was delayed for seven months, until December 2003. No reason was given for this delay.

The OIG investigation also found that the complaint was poorly analyzed and the focus of the examination was much too limited. The examination focused solely on front-running, notwithstanding the numerous other "red flags" raised in the complaint, and failed to analyze how Madoff could have achieved his extraordinarily consistent returns, which had no correlation to the overall markets. When asked why the other issues in the Hedge Fund Manager's complaint and the two 2001 articles were not investigated, the Associate Director stated he focused on front-running because "that was the area of expertise for my crew."

A Planning Memorandum for the examination was prepared, but it failed to address several critical issues from the complaint, including the unusual fee structure; the inability to see the volume of options in the marketplace; the remarkable returns; the fact that Madoff's trading strategy was not duplicable; the returns had no correlation to actual equity markets; the accounts were in cash at month's end; there were no third-party brokers; and the auditor of Madoff's firms was a related party.

In addition, courses of action outlined in the Planning Memorandum that involved verification of trading with independent third parties should have been carried out, but were not. For example, the staff drafted a letter to the NASD (an independent third party), which was critical to any adequate review of the complaint because the data and information from the NASD would have assisted in independently verifying trading activity conducted at Madoff's firms. However, the letter was never sent, with the explanation given by staff that it would have been too time-consuming to review the information they would have obtained. According to the

OIG's expert, had the letter been sent out, the NASD would have provided order and execution data that would have indicated that Madoff did not execute the significant volume of trades for the discretionary brokerage accounts that he represented to the examiners, and the data would likely have provided the information necessary to reveal the Ponzi scheme.

During the course of the examination, the examination team discovered suspicious information and evidence, but failed to follow up on numerous "red flags." Responses by Madoff to the document requests contradicted the Hedge Fund Manager's complaint and the 2001 articles. For example, Madoff's claim that his firms did not manage or advise hedge funds was contradicted by the articles that reported Madoff was managing billions of dollars in assets. In addition, although known for advanced technology, Madoff claimed not to have e-mail communications with clients. However, the examiners did not follow up on these red flags.

We also found that Madoff's responses to the examiners' document requests should have raised suspicions because the information provided appeared incomplete and, at times, inconsistent when compared to other information provided. For example, Madoff's account statements only included average prices during each day without the actual prices for each transaction. According to the OIG's expert, based on the questions raised by the examination team with regard to differing trade patterns for certain clients, there should have been significant suspicions as to whether or not Madoff was implementing the strategy as claimed.

The examiners also made the surprising discovery that Madoff's mysterious hedge fund business was making significantly more

money than his well-known market-making operation. However, this was not identified as a cause for concern. When the examination team contacted Madoff to discuss their open questions, his answers failed to clarify matters and he again claimed not to act as an investment adviser. In February 2004, the examination was expanded to analyze the question of whether Madoff was acting as an investment adviser. Legal memoranda were drafted to seek guidance on this issue, but never sent. In a subsequent draft of a supplemental document request to Madoff, the examiners sought detailed audit trail data, including the date, time, and execution price for all of his trades in 2003. However, the examiners removed the request for this critical data from the supplemental request before it was sent out. The reason given was that they were generally hesitant to get audit trail data "because it can be tremendously voluminous and difficult to deal with" and "takes a ton of time" to review. No requests were made from independent third parties for any data, although an OCIE examiner acknowledged obtaining such data should not have been difficult.

Although there were numerous unresolved questions in the examination, in early April 2004, the examiners were abruptly instructed to shift their focus to "mutual funds" projects, placing the Madoff examination on the "backburner." We found that it was not unusual at that time to shift attention to high priority projects in OCIE and leave some projects incomplete.

As the examination of Madoff in Washington, D.C. was shelved, in NERO, a nearly identical examination of Madoff was just beginning. In April 2004, a NERO investment management examiner had been conducting a routine examination of an unrelated registrant when the examiner discovered internal e-mails from November and December 2003 that

raised questions about whether Madoff was involved in illegal activity involving managed accounts. These internal e-mails described the red flags the registrant's employees identified while performing due diligence using widely available information on their Madoff investment. The red flags the registrant had identified included Madoff's: (1) incredible and highly unusual fills for equity trades; (2) misrepresentation of his options trading; (3) secrecy; (4) auditor; (5) unusually consistent and non-volatile returns over several years; and (6) fee structure.

Crucially, one of the internal e-mails provided a step-by-step analysis of why Madoff must be misrepresenting his options trading. The e-mail explained that Madoff could not be trading on an options exchange because of insufficient volume and could not be trading options over-the-counter because it was inconceivable he could find a counterparty for the trading. For example, the e-mail explained that because customer statements showed that the options trades were always profitable for Madoff, there was no incentive for a counterparty to continuously take the other side of those trades since it would always lose money. These findings raised significant doubts that Madoff could be implementing his trading strategy. The internal e-mails included the statement that the registrant had "totally independent evidence" that Madoff's executions were "highly unusual."

The investment management examiner who initially discovered the e-mails and his supervisors viewed them as indicating the registrant's employees were clearly "trying to find out where exactly the trades were taking place" and the e-mails evidenced that "there's some suspicion as to whether Madoff is trading at all." They indicated they would have

followed up on the allegation in the e-mails about "whether Madoff was actually trading."

As with the examination, in Washington, D.C., there was a significant delay before the examination was commenced. Although the e-mails were discovered in April 2004 and immediately referred to the NERO broker-dealer examination program, a team was not assembled until December 2004.

The team assembled in NERO consisted of an Associate Director, an Assistant Director and two junior examiners in the broker-dealer examination program. A branch chief, whose role would be to oversee and assist the junior examiners, was not assigned to the examination. One of the junior examiners assigned to the examination in 2004 graduated from college in 1999 and joined the SEC as his first job out of school. The other examiner had worked as an equity trader for a few years before coming to the SEC. He had worked on approximately four examinations before being assigned to the Madoff examination.

Once again, no consideration was given to performing a joint examination with investment management examiners, despite the fact that the internal e-mails raised suspicions about Madoff's performance and returns. An examiner stated that each of the examination programs in NERO was a "silo," and they almost never worked together.

In late March 2005, approximately ten months after receiving the referral, the NERO broker-dealer examination team began performing background research in preparation for an on-site examination of Madoff to begin in April. Unlike the OCIE examination team, the NERO examination team did not draft a Planning Memorandum laying out the scope of the examination. The examiners recalled

that, at the time of the examination, NERO did not have a practice of writing Planning Memoranda.

Once again, although the e-mails raised significant issues about whether Madoff was engaging in trading at all, the decision was made to focus exclusively on front-running. The NERO Associate Director stated that despite identifying Madoff's returns as an issue, he did not necessarily have "an expectation" that the examiners would analyze Madoff's returns because portfolio analysis was not a strength of broker-dealer examiners.

To the extent that the NERO examiners did examine issues outside of front-running, they conducted their examination by simply asking Madoff about their concerns and accepting his answers. With respect to the significant concerns about Madoff's options trading, they asked Madoff about this issue, and when Madoff said he was no longer using options as part of his strategy, they stopped looking at the issue, despite the fact that Madoff's representation was inconsistent with the internal e-mails, the two 2001 articles, and the investment strategy Madoff claimed to employ. As to why Madoff did not collect fees like all other hedge fund managers, they accepted his response that he was not "greedy" and was happy with just receiving commissions.

Several issues, including the allegation in the internal e-mails that Madoff's auditor was a related party, were never examined at all. Yet, after Madoff confessed to operating a Ponzi scheme, a staff attorney in NERO's Division of Enforcement was assigned to investigate Madoff's accountant, David Friehling, and within a few hours of obtaining the workpapers, the staff attorney determined that no audit work had been done.

In addition, although one of the NERO examiners placed a "star" next to the statement in the internal e-mails about having "totally independent evidence" that Madoff's executions were "highly unusual," NERO never followed up with the registrant to inquire about or obtain this evidence. The NERO examiners explained that it was not their practice to seek information from third parties when they conducted examinations.

When the examiners began their on-site examination of Madoff, they learned Bernard Madoff would be their primary contact and Madoff carefully controlled to whom they spoke at the firm. On one occasion, when a Madoff employee was speaking to the NERO examiners at Madoff's firm, after a couple of minutes, another Madoff employee rushed in to escort her from the conversation, claiming she was urgently needed. When the examiners later asked Madoff the reason for the urgency, Madoff told them her lunch had just arrived, even though it was 3:00 p.m.

Madoff made efforts during the examination to impress and even intimidate the junior examiners from the SEC. Madoff emphasized his role in the securities industry during the examination. One of the NERO examiners characterized Madoff as "a wonderful storyteller" and "very captivating speaker" and noted that he had "an incredible background of knowledge in the industry." The examiner said he found it "interesting" but also "distracting" because they were there "to conduct business."

The other NERO examiner noted that "[a]ll throughout the examination, Bernard Madoff would drop the names of high-up people in the SEC." Madoff told them that Christopher Cox was going to be the next Chairman of the SEC a few weeks prior to Cox being officially named. He also told them

that Madoff himself “was on the short list” to be the next Chairman of the SEC. When the NERO examiners sought documents Madoff did not wish to provide, Madoff became very angry, with an examiner recalling that Madoff’s “veins were popping out of his neck” and he was repeatedly saying, “What are you looking for? . . . Front running. Aren’t you looking for front running,” and “his voice level got increasingly loud.”

Throughout the examination, the NERO examiners “had a real difficult time dealing with” Madoff as he was described as growing “increasingly agitated” during the examination, and attempting to dictate to the examiners what to focus on in the examination and what documents they could review. Yet, when the NERO examiners reported back to their Assistant Director about the pushback they received from Madoff, they received no support and were actively discouraged from forcing the issue.

One effort was made to verify Madoff’s trading with an independent third party, but even after they received a very suspicious response, there was no follow-up. The Assistant Director sent a document request to a financial institution that Madoff claimed he used to clear his trades, requesting records for trading done by or on behalf of particular Madoff feeder funds during a specific time period. Shortly thereafter, the financial institution responded, stating there was no transaction activity in Madoff’s account for that period. Yet, the response did not raise a red flag for the Assistant Director, who merely assumed that Madoff must have “executed trades through the foreign broker-dealer.” The examiners did not recall ever being shown the response from the financial institution, and no further follow-up actions were taken.

At one point in the NERO examination, the examiners were planning to confront Madoff about the many contradictory positions he was taking, particularly as they related to Madoff’s changing stories about how many advisory clients he had. However, when the NERO examiners pushed Madoff for documents and information about his advisory clients, he rebuffed them, pointing out that he had already provided the information to the Washington, D.C. staff in connection with their examination. The NERO examiners were taken aback, since they were unaware that the D.C. office of OCIE had been conducting a simultaneous examination of Madoff on the identical issues they were examining.

When the NERO examiners asked the Washington, D.C. examiners about Madoff’s claim, they first learned about the Washington, D.C. examination, which, by that time, had been dormant for months. There were a couple of brief conference calls between the two offices about their examinations, but relatively little sharing of information. One of the few points that was made in a conference call between the offices was a comment by a senior-level Washington, D.C. examiner reminding the junior NERO examiners that Madoff “was a very well-connected, powerful, person,” which one of the NERO examiners interpreted to raise a concern about pushing Madoff too hard without having substantial evidence. While the Washington, D.C. examination team decided not to resume their examination and sent their workpapers to NERO, the NERO examiners reported conducting only a cursory review of the workpapers and did not recall even reviewing the Hedge Fund Manager’s detailed complaint that precipitated the D.C. examination. Further, they appear to have never discussed the D.C. examiners’ open questions about Madoff’s representations and trading, and did

not compare the list of clients Madoff produced to them with the list he produced to the D.C. team.

Meanwhile, as the NERO examination continued, Madoff was failing to provide the NERO examiners with requested documents, and the examiners continued to find discrepancies in the information Madoff did provide. As the examiners continued to review the documents Madoff produced, their confusion and skepticism grew. While the NERO examiners had significant questions about Madoff's trade executions and clearance, as well as Madoff's claim that he used his "gut feel" to time the market based on "his observations of the trading room," Madoff was pushing them to finish the examination.

As had been the case with the Washington, D.C. examination, the NERO examiners learned that Madoff's well-known market-making business would be losing money without the secretive hedge fund execution business. Although they described this revelation as "a surprising discovery," the issue was once again never pursued.

Although the NERO examiners determined Madoff was not engaged in front-running, they were concerned about issues relating to the operation of his hedge fund business, and sought permission to continue the examination and expand its scope. Their Assistant Regional Director denied their request, telling them to "keep their eyes on the prize," referring to the front-running issue. When the examiners reported that they had caught Madoff in lies, the Assistant Director minimized their concerns, stating "it could [just] be a matter of semantics." The examiners' request to visit Madoff feeder funds was denied, and they were informed that the time for the Madoff examination had expired. The explanation given was that "field work

cannot go on indefinitely because people have a hunch or they're following things."

Thus, the NERO cause examination of Madoff was concluded without the examination team ever understanding how Madoff was achieving his returns and with numerous open questions about Madoff's operations. Many, if not most, of the issues raised in both the Hedge Fund Manager's complaint that precipitated the Washington, D.C. examination and the internal e-mails that triggered the NERO examination had not been analyzed or resolved. In September 2005, NERO prepared a closing report for the examination that relied almost entirely on information verbally provided by Madoff to the examiners for resolution of numerous red flags. One of the two primary examiners on the NERO examination team was later promoted based on his work on the Madoff examination.

Only a month after NERO closed its examination of Madoff, in October 2005, Markopolos provided the SEC's BDO with a third version of his complaint entitled, "The World's Largest Hedge Fund is a Fraud." Markopolos' 2005 complaint detailed approximately 30 red flags indicating Madoff was operating a Ponzi scheme, a scenario Markopolos described as "highly likely." Markopolos' 2005 complaint discussed an alternative possibility – that Madoff was front running – but characterized that scenario as "unlikely." The red flags identified by Markopolos were similar to the ones previously raised in the Hedge Fund Manager's complaint and the internal e-mails that led to the two cause examinations of Madoff, although somewhat more detailed. They generally fell into one of three categories: (1) Madoff's obsessive secrecy; (2) the impossibility of Madoff's returns, particularly the consistency of those returns; and (3) the unrealistic vol-



ume of options Madoff was supposedly trading.

The BDO found Markopolos credible, having worked with him previously, and took his 2005 complaint seriously. While senior officials with the BDO considered Markopolos' allegation that Madoff was operating a Ponzi scheme worthy of serious investigation, they felt it made more sense for NERO to conduct the investigation because Madoff was in New York and NERO had already conducted an examination of Madoff. The BDO made special efforts to ensure that NERO would "recognize the potential urgency of the situation," which was evidenced by the Director of the BDO e-mailing the complaint to the Director of NERO personally, and by following up to ensure the matter was assigned within NERO.

While the Madoff investigation was assigned within NERO Enforcement, it was assigned to a team with little to no experience conducting Ponzi scheme investigations. The majority of the investigatory work was conducted by a staff attorney who recently graduated from law school and only joined the SEC 19 months before she was given the Madoff investigation. She had never previously been the lead staff attorney on any investigation, and had been involved in very few investigations overall. The Madoff assignment was also her first real exposure to broker-dealer issues.

The NERO Enforcement staff, unlike the BDO, failed to appreciate the significance of the evidence in the 2005 Markopolos complaint and almost immediately expressed skepticism and disbelief about the information contained in the complaint. The Enforcement staff claimed that Markopolos was not an insider or an investor and, thus, immediately

discounted his evidence. The Enforcement staff also questioned Markopolos' motives, indicating concerns that "he was a competitor of Madoff's" who "was looking for a bounty." These concerns were particularly misplaced because in Markopolos' complaint, he described that it was "highly likely" that Madoff was operating a "Ponzi scheme," and acknowledged that if he were correct, he would not be eligible for a bounty. Moreover, even after the Branch Chief assigned to the Madoff Enforcement investigation spoke with a Senior Official at the BDO, who vouched for Markopolos' credibility, she remained skeptical of him throughout the investigation.

The OIG investigation also found the Enforcement staff was skeptical about Markopolos' complaint because Madoff did not fit the "profile" of a Ponzi scheme operator, with the Branch Chief on the Madoff investigation noting that there was "an inherent bias towards [the] sort of people who are seen as reputable members of society."

The NERO Enforcement staff also received a skeptical response to Markopolos' complaint from the NERO examination team who had just concluded their examination. Even though the NERO examination had focused solely on front-running, the NERO examination team downplayed the possibility that Madoff was conducting a Ponzi scheme, saying that "these are basically some of the same issues we investigated" and that Markopolos "doesn't have the detailed understanding of Madoff's operations that we do which refutes most of his allegations." In testimony before the OIG, the examiners acknowledged that their examination "did not refute Markopolos' allegations regarding a Ponzi scheme" and that the examiners' reaction may have given the impression their examination had a greater focus than it did. Indeed, since the

NERO examination had ruled out front-running, the NERO examiners should have encouraged the Enforcement staff to analyze Markopolos' more likely scenario, the Ponzi scheme. Yet, that scenario was never truly analyzed.

The Enforcement staff delayed opening a matter under inquiry (MUI) for the Madoff investigation for two months, which was a necessary step at the beginning of an Enforcement investigation for the staff to be informed of other relevant information that the SEC received about the subject of the investigation. As a result of the delay in opening a MUI, the Enforcement staff never learned of another complaint sent to the SEC in October 2005 from an anonymous informant stating, "I know that Madoff [sic] company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale. And they have been doing it for a long time." The informant also stated, "After a short period of time, I decided to withdraw all my money (over \$5 million)." As a result, there was no review or analysis of this complaint.

In addition, as was the case with the SEC examinations of Madoff, the focus of the Enforcement staff's investigation was much too limited. Markopolos' 2005 complaint primarily presented evidence that Madoff was operating a Ponzi scheme, calling that scenario "highly likely." However, most of the Enforcement staff's efforts during their investigation were directed at determining whether Madoff should register as an investment adviser or whether Madoff's hedge fund investors' disclosures were adequate. In fact, the Enforcement staff's investigative plan primarily involved comparing documents and

information that Madoff had provided to the examination staff (which he fabricated) with documents that Madoff had sent his investors (which he also fabricated).

Yet, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations. An initial production of documents the Enforcement staff obtained from a Madoff feeder fund demonstrated Madoff had lied to the examiners in the NERO examination about a fundamental component of his claimed trading activity. Specifically, while Madoff told the examiners he had stopped using options as part of his strategy after they scrutinized his purported options trading, the Enforcement staff found evidence from the feeder funds that Madoff was telling his investors that he was still trading options during that same time period. Yet, the Enforcement staff never pressed Madoff on this inconsistency. After an interview with an executive from a Madoff feeder fund, the Enforcement staff noted several additional "discrepancies" between what Madoff told the examiners in the NERO examination and information they received in the interview. The Enforcement staff also discovered that the feeder fund executive's testimony had been scripted and he had been prepped by Madoff.

As the investigation progressed, in December 2005, Markopolos approached the Enforcement staff to provide them additional contacts and information. However, the Branch Chief assigned to the Madoff Enforcement investigation took an instant dislike to Markopolos and declined to even pick up the "several inch thick file folder on Madoff" that Markopolos offered. One of the Enforcement staff described the relationship between Markopolos and the Branch Chief as "adversarial."

In February 2006, the Enforcement staff contacted the SEC's Office of Economic Analysis (OEA) seeking assistance in analyzing Madoff's trading. OEA failed to respond to the request for two and a half months. In April 2006, the Enforcement staff went back to OEA, but failed to provide OEA with a copy of Markopolos' 2005 complaint. An expert on options trading in OEA did review certain documents that OEA received from the Enforcement staff and, based upon a 20-minute review, concluded Madoff's split-strike conversion strategy "was not a strategy that would be expected to earn significant returns in excess of the market." However, this analysis was not conveyed to the Enforcement staff. In addition, the OEA options trading expert told the OIG that if he had been made aware of the amount of assets that Madoff had been claiming to manage, he would have ruled out "front-running" as a possible explanation for Madoff's returns. In the end, the Enforcement staff never obtained any useful information or analysis from OEA.

Throughout the Enforcement staff's investigation, the Enforcement staff was confused about certain critical and fundamental aspects of Madoff's operations. They had trouble understanding Madoff's purported trading strategy, basic custody of assets issues and, generally, how Madoff's operation worked. Despite the Enforcement staff's confusion, after their unsuccessful attempt to seek assistance from OEA, they never consulted the SEC's own experts on broker-dealer operations, the SEC's Division of Trading and Markets (formerly the Division of Market Regulation), who could have facilitated inquiries with independent third parties such as the NASD and DTC. Similarly, after Madoff claimed his purported trading activity took place in Europe, the Enforcement staff did not seek help from the SEC's Office of International Affairs (OIA). Had they simply sought

assistance from OIA on matters within its area of expertise, the Enforcement staff should have discovered that Madoff was not purchasing equities from foreign broker-dealers and that he did not have over-the-counter (OTC) options with European counterparties.

At a crucial point in their investigation, the Enforcement staff was informed by a senior-level official from the NASD that they were not sufficiently prepared to take Madoff's testimony, but they ignored his advice. On May 17, 2006, two days before they were scheduled to take Madoff's testimony, the Enforcement staff attorney contacted the Vice President and Deputy Director of the NASD Amex Regulation Division to discuss Madoff's options trading. The NASD official told the OIG that he answered "extremely basic questions" from the Enforcement staff about options trading. He also testified that, by the end of the call, he felt the Enforcement staff did not understand enough about the subject matter to take Madoff's testimony. The NASD official also recalled telling the Enforcement staff that they "needed to do a little bit more homework before they were ready to talk to [Madoff]," but that they were intent on taking Madoff's testimony as scheduled. He testified that when he and a colleague who was also on the call hung up, "we were both, sort of, shaking our heads, saying that, you know, it really seemed like some of these [options trading] strategies were over their heads." Notwithstanding the advice, the Enforcement staff did not postpone Madoff's testimony.

On May 19, 2006, Madoff testified voluntarily and without counsel in the SEC's investigation. During Madoff's testimony, he provided evasive answers to important questions, provided some answers that contradicted his previous representations, and provided some information that could have been used to discover that he was operating a Ponzi scheme.

However, the Enforcement staff did not follow up with respect to the critical information that was relevant to uncovering Madoff's Ponzi scheme.

For example, when Enforcement staff asked the critical question of how he was able to achieve his consistently high returns, Madoff never really answered the question but, instead, attacked those who questioned his returns, particularly the author of the Barron's article. Essentially, Madoff claimed his remarkable returns were due to his personal "feel" for when to get in and out of the market, stating, "Some people feel the market. Some people just understand how to analyze the numbers that they're looking at." Because of the Enforcement staff's inexperience and lack of understanding of equity and options trading, they did not appreciate that Madoff was unable to provide a logical explanation for his incredibly consistent returns. Each member of the Enforcement staff accepted as plausible Madoff's claim that his returns were due to his perfect "gut feel" for when the market would go up or down.

During his testimony, Madoff also told the Enforcement investigators that the trades for all of his advisory accounts were cleared through his account at DTC. He testified further that his advisory account positions were segregated at DTC and gave the Enforcement staff his DTC account number. During an interview with the OIG, Madoff stated that he had thought he was caught after his testimony about the DTC account, noting that when they asked for the DTC account number, "I thought it was the end game, over. Monday morning they'll call DTC and this will be over . . . and it never happened." Madoff further said that when Enforcement did not follow up with DTC, he "was astonished."

This was perhaps the most egregious failure in the Enforcement investigation of Madoff: that they never verified Madoff's purported trading with any independent third parties. As a senior-level SEC examiner noted, "clearly if someone . . . has a Ponzi and, they're stealing money, they're not going to hesitate to lie or create records" and, consequently, the "only way to verify" whether the alleged Ponzi operator is actually trading would be to obtain "some independent third party verification" like "DTC."

A simple inquiry to one of several third parties could have immediately revealed the fact that Madoff was not trading in the volume he was claiming. The OIG made inquiries with DTC as part of our investigation. We reviewed a January 2005 statement for one Madoff feeder fund account, which alone indicated that it held approximately \$2.5 billion of S&P 100 equities as of January 31, 2005. On the contrary, on January 31, 2005, DTC records show that Madoff held less than \$18 million worth of S&P 100 equities in his DTC account. Similarly, on May 19, 2006, the day of Madoff's testimony with the Enforcement staff, DTC records show that Madoff held less than \$24 million worth of S&P 100 equities in his DTC account. On August 10, 2006, the day Madoff agreed to register as an investment adviser and the Enforcement staff effectively ended the Madoff investigation, DTC records showed that Madoff held less than \$28 million worth of S&P 100 equities in his DTC account. Had the Enforcement staff learned this information during the course of their investigation, they would have immediately realized that Madoff was not trading in anywhere near the volume that he was showing on the customer statements. When Madoff's Ponzi scheme finally collapsed in 2008, an SEC Enforcement attorney testified that it took only "a few days" and "a phone

call ... to DTC” to confirm that Madoff had not placed any trades with his investors’ funds.

Our investigation found that the Enforcement staff made attempts to seek information from independent third parties; however, they failed to follow up on these requests. On May 16, 2006, three days before Madoff’s testimony, the Enforcement staff reached out to the Director of the Market Regulation Department at the NASD and asked her to check a certain date on which Madoff had purportedly held S&P 100 index option positions. She reported back that they had found no reports of such option positions for that day. Yet, the Enforcement staff failed to make any further inquiry regarding this remarkable finding. The Enforcement staff also failed to scrutinize information obtained in the NERO cause examination when the examination staff had attempted to verify Madoff’s claims of trading OTC options with a financial institution and found that “no relevant transaction activity occurred during the period” requested. Finally, although the Enforcement staff attorney attempted to obtain documentation from U.S. affiliates of European counterparties and one of Madoff’s purported counterparties was in the process of drafting a consent letter asking Madoff’s permission to send the Enforcement staff the documents from its European account, the inexplicable decision was made not to send the letter and to abandon this effort. Had any of these efforts been pursued by the Enforcement staff, they would have uncovered Madoff’s Ponzi scheme.

The Enforcement staff effectively closed the Madoff investigation in August 2006 after Madoff agreed to register as an investment adviser. They believed that this was a “beneficial result” as, once he registered, “he would have to have a compliance program, and he would be subject to an examination by our

[Investment Adviser] team.” However, no examination was ever conducted of Madoff after he registered as an investment adviser.

A few months later, in December 2006, the Enforcement staff received another complaint from a “concerned citizen,” advising the SEC to look into Madoff and his firm:

Your attention is directed to a scandal of major proportion which was executed by the investment firm Bernard L. Madoff . . . . Assets well in excess of \$10 Billion owned by the late [investor], an ultra-wealthy long time client of the Madoff firm have been “co-mingled” with funds controlled by the Madoff company with gains thereon retained by Madoff.

In investigating this complaint, the Enforcement staff simply asked Madoff’s counsel about it, and accepted the response that Madoff had never managed money for this investor. This statement turned out to be false. When news of Madoff’s Ponzi scheme broke, it became evident not only that Madoff managed this investor’s money, but also that he was actually one of Madoff’s largest individual investors.

Shortly after the Madoff Enforcement investigation was effectively concluded, the staff attorney on the investigation received the highest performance rating available at the SEC, in part, for her “ability to understand and analyze the complex issues of the Madoff investigation.”

Markopolos also tried again in June 2007, sending an e-mail to the Enforcement Branch Chief on the Madoff investigation, attaching “some very troubling documents that show the Madoff fraud scheme is getting even more

brazen” and noting ominously, “When Madoff finally does blow up, it’s going to be spectacular, and lead to massive selling by hedge fund, fund of funds as they face investor redemptions.” His e-mail was ignored.

After Madoff was forced to register as an investment adviser, the Enforcement investigation was inactive for 18 months before being officially closed in January 2008. A couple of months later, in March 2008, the Chairman’s office received additional information regarding Madoff’s involvement with the investor’s money from the same source. The previous complaint was re-sent, and included the following information:

It may be of interest to you to that Mr. Bernard Madoff keeps two (2) sets of records. The most interesting of which is on his computer which is always on his person.

This updated complaint was forwarded to the Enforcement staff who had worked on the Madoff investigation, but it was immediately sent back, with a note stating, in pertinent part, “[W]e will not be pursuing the allegations in it.”

### **Recommendations in the Report of Investigation**

The OIG recommended that the SEC Chairman carefully review the ROI and share with OCIE and Enforcement management, the portions of the ROI that related to the performance failures by those employees who still worked at the SEC, so that appropriate action (which may include performance-based action, as appropriate) is taken, on an employee-by-employee basis, to ensure that future examinations and investigations are

conducted in a more appropriate manner and the mistakes and failures outlined in this ROI are not repeated.

As of the end of the semiannual reporting period, the OIG has not been informed of any disciplinary or performance-based actions taken as a result of the investigation.

### **Disclosures and Assurances Given in Connection with Acquisition of Investment Bank**

On October 17, 2008, the OIG opened an investigation based upon an anonymous complaint alleging that a Senior Officer in the SEC’s Division of Enforcement improperly disclosed non-public information to a senior executive of a large investment bank who was a former SEC Senior Official. The complaint alleged that the Senior Officer gave the former Senior Official assurances with respect to ongoing Enforcement investigations of another investment bank that was being acquired by the former Senior Official’s employer. The Senior Officer and the former Senior Official had worked closely together while the latter was at the SEC and the Senior Officer had been promoted by the former Senior Official. The complaint further alleged the Senior Officer failed to consult with Enforcement staff about the matter, contrary to a policy instituted by the Senior Officer.

The OIG interviewed and/or took sworn testimony of thirty-six former and/or current SEC employees, including the Senior Officer (who is no longer employed at the SEC) and the former Senior Official. In addition, the OIG obtained and reviewed thousands of e-mails of relevant SEC staff, as well as numerous other documents related to the matter.

On September 30, 2009, the OIG issued its report of investigation in this matter, find-

ing that the Senior Officer had communications with the former Senior Official and the former Senior Official did seek assurances from Enforcement staff that his investment bank would not be sued for the actions of the investment bank it was acquiring. We found that while the former Senior Official did not receive the broad assurances for the acquiring investment bank that he sought, he did receive some assurances with respect to ongoing and potential investigations related to the pre-acquisition conduct of the target investment bank.

The OIG investigation also disclosed that while at least one staff member had the impression that cases related to the investment bank were “essentially over,” there was no evidence that any specific investigation was stopped as a result of the communications or assurances given. We did find that there are senior staff within Enforcement who perceive that former high-level officials such as the former Senior Official have undue access and influence within Enforcement.

We also found that the Senior Officer did not consult with any other Enforcement staff about decisions made regarding ongoing Enforcement cases, as alleged in the complaint. While the OIG did not find that the Senior Officer’s actions directly violated a policy about external communications, we found that the inclusion of other staff in the deliberative process or the communications would have helped avoid an appearance of impropriety stemming from the relationship of the Senior Officer and former Senior Official.

The OIG investigation also found that a letter written by the Enforcement staff to the acquiring investment bank technically disclosed non-public information because it confirmed there were ongoing investigations of the target investment bank. The OIG found

that the SEC rules and policies regarding disclosure of non-public information by the staff allow for senior staff to exercise discretion about such disclosure. However, the OIG found a lack of clarity with respect to the agency’s rules and guidelines relating to the disclosure of non-public information and the appropriate role of the Commissioners in approving such disclosure.

Further, we found that the Senior Officer and the OGC did not obtain formal Commission approval before making critical determinations about the viability of future Enforcement investigations, although we did not find any SEC rule or policy that mandated formal Commission approval.

The OIG recommended clarification of the Commission’s policies on the disclosure of non-public information, including: (1) what constitutes non-public information related to the existence, or non-existence, of investigations; and (2) what are the parameters for discretionary releases by senior staff of non-public information. In addition, the OIG’s report recommended clarification of the Commission’s policies regarding under what circumstances the staff is obligated to seek formal approval before making decisions that may bind the Commission.

As the OIG’s report of investigation was issued just prior to the end of the semiannual reporting period, no action has yet been taken by management with respect to the OIG’s recommendations.

### **Violations of Standards of Ethical Conduct With Regard to Official Government Travel by Managers in the Fort Worth Regional Office**

On July 24, 2008, the OIG opened an investigation into an allegation of violations of

the Federal Travel Regulations by a Fort Worth Regional Office (FWRO) Senior Official. Specifically, it was alleged that the FWRO Senior Official arranged for herself and three other FWRO staff to stay overnight at a bed & breakfast in Kansas, owned by the FWRO Senior Official's brother and sister-in-law, during official government travel in July 2007. It was also alleged that the FWRO Senior Official had misused government resources in September 2006 by unnecessarily sending several FWRO employees to New York City as a "reward" and spending excess FY 2006 travel funds.

The OIG reviewed the travel vouchers, and took the sworn, on-the-record testimony from the FWRO Senior Official and the three other Kansas trip participants. Similarly, the OIG reviewed the travel vouchers and time and attendance records of all eight FWRO employees who traveled to New York City in September 2006, and took the sworn, on-the-record testimony from the FWRO Senior Official and the seven other trip participants. The OIG also consulted with the SEC's Ethics Counsel.

The OIG found that in connection with a government meeting in Kansas, the FWRO Senior Official made arrangements for herself and three other FWRO staff to stay overnight at a bed & breakfast, owned by the FWRO Senior Official's brother and sister-in-law. The bed & breakfast was approximately 50 miles from the place where the group was scheduled to have a meeting the next day, and in fact, the group was late getting to the meeting due to its distance from the bed & breakfast. Two of the staff members who took the trip testified that the FWRO Senior Official made the arrangements for them and they did not feel that they could make alternate arrangements, despite feeling uncomfortable staying at the bed & breakfast owned by the

relative of an SEC manager. In light of these investigative findings, the OIG found, after consultation with the SEC Ethics Counsel, that the FWRO Senior Official violated 5 C.F.R. § 2635.702 by using her public office for her family members' private gain.

With respect to the allegations about the New York City trip, the OIG found no evidence of misuse of government time on this trip, as the record showed that the participants were engaged in SEC-related activities during their duty hours.

The OIG issued its report of investigation to management on September 25, 2009, and recommended that management take disciplinary action against the FWRO Senior Official. As the report of investigation was issued just prior to the end of the semiannual reporting period, no action has yet been taken by management with respect to the OIG's recommendation.

### **Retaliation by Senior Officers in a Regional Office**

On July 24, 2008, the OIG opened an investigation upon receipt of a written complaint sent by a former Branch Chief in an SEC Regional Office. The former Branch Chief alleged that he suffered retaliation by two Senior Officers following his submission of a memorandum to SEC senior management in Washington, DC, disclosing what he believed to be mismanagement of the examination program and mistreatment of his immediate supervisor. The former Branch Chief asserted that following his submission to SEC senior management, the two Senior Officers engaged in a series of retaliatory personnel actions consisting of performance management counseling, abusive daily monitoring, and a Letter of Reprimand. After the OIG initiated its investigation, the former



Branch Chief voluntarily resigned his employment with the SEC.

Subsequent to the former Branch Chief's complaint, his immediate supervisor, the Assistant Director, also made a complaint to the OIG alleging that the same two Senior Officers retaliated against her because she was not supporting a new examination program, known as the Broker-Dealer Risk Assessment Verification Examinations (RAVEs) program. Specifically, the Assistant Director alleged that she was excluded from the RAVEs program, mistreated by these two Senior Officers during meetings, issued a retaliatory Letter of Reprimand, and involuntarily transferred to non-supervisory duties.

The OIG interviewed ten current or former employees of the Regional Office, three employees from OCIE, and three current or former employees of the SEC Office of Human Resources (OHR). The OIG also reviewed four years of relevant employee performance records, the letters of reprimand issued to the former Branch Chief and the Assistant Director, the counseling memorandum given to the former Branch Chief, and applicable agency policy and laws.

With respect to the former Branch Chief, the OIG found that the performance counseling memorandum, daily monitoring, and the Letter of Reprimand were issued shortly after he complained about his supervisors and, in fact, his letter of reprimand actually cited his memorandum to senior SEC officials in describing his inappropriate conduct. In addition, the OIG found that the former Branch Chief's memorandum to senior SEC officials would constitute disclosures to authorities in a position to correct improper activity, which would be a prerequisite for a finding of retaliation against a whistleblower. The former Branch Chief filed a grievance based upon his

claim that his Letter of Reprimand was retaliatory in nature and, in a settlement with the SEC, the letter of reprimand was rescinded.

In connection with the claims of the Assistant Director, the OIG investigation found that the Assistant Director and one of the Senior Officers had a history of conflict well before the introduction of the RAVEs program. We also found that this conflict was exacerbated by the Assistant Director's opposition to the RAVEs program and the manner in which the Assistant Director expressed that opposition, which could be described as hostile. Accordingly, in light of the Assistant Director's reaction to the RAVEs program, the OIG found that the decision to exclude the Assistant Director from that program was not inappropriate or an abuse of authority.

With respect to certain meetings in which the Assistant Director alleged she was mistreated, the OIG found that the two Senior Officers were somewhat harsh in these meetings. However, the OIG found that the Assistant Director was not a whistleblower per se, as there was no evidence that she made actionable disclosures beyond her supervisors in the Regional Office.

However, the OIG determined that both the former Branch Chief's and the Assistant Director's complaints about their supervisors and the RAVEs program improperly led to actions taken against them. While the OIG found that the manner in which the former Branch Chief and the Assistant Director expressed their complaints may have also been an appropriate factor in the actions taken against them, we determined that the complaints themselves were a more significant contributing factor in the disciplinary actions.

The OIG issued its report of investigation to management on September 15, 2009, and recommended that management consider performance-based or disciplinary action against the two Senior Officers. As the report of investigation was issued just prior to the end of the semiannual reporting period, no action has yet been taken by management with respect to the OIG's recommendations.

### **Misuse of Position, Government Resources, and Official Time in a Regional Office and Headquarters**

On July 30, 2009, the OIG opened an investigation after the SEC Ethics Counsel forwarded to the OIG a copy of a FOIA request that an SEC SK-16 Regional Office attorney had sent to another Federal agency. The FOIA request included the attorney's official title, SEC phone number and SEC fax number, and stated that he was a lawyer with an SEC Regional Office and a FOIA Liaison in that Office. An Assistant General Counsel for Ethics (Assistant General Counsel) for the agency that received the request notified the SEC's Ethics Counsel of the request and provided a copy of it. The Assistant General Counsel of the recipient agency also notified the SEC Ethics Counsel that the SEC attorney had contacted a regional office of that agency, indicating that he was calling for the SEC concerning additional requests for information.

Upon opening its investigation, the OIG contacted the Assistant General Counsel at the agency that had received the SEC attorney's FOIA request. OIG staff then conducted interviews of five current or former employees of that agency who had contacts with the SEC attorney or possessed information regarding his requests for information. The OIG also interviewed or communicated by e-mail with two officials

from other Federal or state agencies who had been contacted by the SEC attorney. In addition, the OIG obtained and searched the SEC attorney's e-mails for the month of July 2009. The OIG took the sworn, on-the-record testimony of the SEC attorney, as well as another lower-level employee who assisted the attorney with his FOIA request, and interviewed other SEC employees, including the supervisors of both the attorney and the lower-level employee who assisted the attorney.

The OIG issued a detailed report of investigation to management on September 30, 2009. The OIG's investigation disclosed substantial evidence that the SEC Regional Office attorney had repeatedly misused his SEC position and SEC resources to assist his girlfriend, a former government contractor, in connection with ongoing litigation with her insurance company. In particular, we found evidence that the SEC attorney was using his position and SEC resources to assist her with an upcoming hearing regarding allegations that she had submitted false documents during the course of the litigation.

Specifically, we found evidence of at least seven concrete instances when the SEC attorney misused his position in an effort to assist his girlfriend. First, as noted above, the attorney sent a FOIA request to another Federal agency that sought information pertinent to his girlfriend's litigation with her insurance company and included his official title and SEC telephone number and fax number. He also plainly stated in its opening sentences that he was a lawyer with an SEC Regional Office and a FOIA liaison in that Office. This request raised serious questions with one agency official to whom it was sent for processing, who in particular questioned why the SEC would be involved in the case.

Second, the SEC attorney left a voicemail message for a paralegal of the Federal agency to whom he had sent his FOIA request, seeking procurement-related information for use in his girlfriend's litigation. The SEC attorney also had a follow-up conversation with an attorney of this agency in which he again identified himself as an SEC attorney and sought information relating to the agency's procurement program. The attorney from the other agency stated that the SEC attorney informed him that the request related to a contract that was being investigated, leading him to believe that the SEC attorney's request pertained to an official SEC matter.

Third, the SEC attorney contacted by telephone a former agency procurement official who was the purported author of a letter that his girlfriend was accused of fabricating. The former official stated that the SEC attorney indicated that he was from the SEC in a message he left for the former official, and the SEC attorney admitted that he most likely called the former official from his SEC phone. The former official indicated that he wondered what the SEC had to do with this private individual who had been a contractor for the official's former agency.

Fourth, another employee of the same agency to which the SEC attorney had submitted his FOIA request informed us that the SEC attorney had left him a voicemail message, in which he clearly stated that he was calling from the SEC and was calling on behalf of a private individual (his girlfriend).

Fifth, the SEC attorney sent an e-mail from his SEC e-mail account to the director of a district office of another Federal agency, in which he stated he was making an inquiry on behalf of his girlfriend, a former government contractor.

Sixth, the SEC attorney admitted disclosing the fact he worked at the SEC in conversations with a state insurance commissioner in an effort to convince the division of insurance to undertake a proceeding that might assist his girlfriend. In fact, the SEC attorney noted that he used his relationship with the state securities commissioner as an entrée to meet with the insurance commissioner.

Seventh, the SEC attorney used his SEC e-mail account to communicate with a state senior assistant attorney general who was working on behalf of the division of insurance in connection with the girlfriend's petition for a declaratory order. This official stated that after he learned that the SEC attorney worked at the SEC, he wondered whether the SEC attorney was acting in an official capacity and requested clarification as to the SEC attorney's role in the matter. According to this official, the SEC attorney informed him that he was working at the SEC and was helping the girlfriend in her insurance claims process and otherwise, but was not acting as her counsel.

In addition to the numerous instances in which he misused his official SEC position, the OIG's investigation disclosed that the SEC attorney improperly sought and obtained the assistance of a lower-level SEC staff person in an effort to obtain information on how to best draft the FOIA request he eventually submitted to another Federal agency. The investigation concluded that the SEC attorney violated SEC policies and the government-wide standards of ethical conduct by misusing SEC resources, and SEC e-mail in particular, to assist his girlfriend with her litigation. Our investigation revealed that he frequently used SEC e-mail in connection with her litigation, often during work hours, and in a volume that could not be considered de minimis (approximately 180 e-mails in one month and several with lengthy attachments).

While the SEC attorney repeatedly claimed that he did nothing wrong, the OIG investigation concluded that his numerous contacts to current and former government officials to obtain information for his girlfriend's litigation were, in fact, an improper use of his public office in a manner that was intended to coerce or induce a benefit for his girlfriend, and clearly violated the government-wide standards of conduct.

The OIG's investigation also found that a lower-level SEC employee, in response to a request for a favor from the SEC attorney, sent an e-mail to another Federal agency to obtain information on how the SEC attorney could file a FOIA request with this other agency. Despite it being clear to the lower-level employee that the SEC attorney was requesting information for a friend and that it was not an official SEC request, she sent the request from her SEC e-mail account, during her work hours, and stated that she worked in an SEC office. While the lower-level employee indicated that she did not think there was any problem with her e-mail at the time she sent it, she testified that she now clearly sees there is a problem. The OIG investigation also found that the lower-level employee reviewed a draft of the SEC attorney's private FOIA request using her official time. The OIG investigation concluded that it was improper for her to use her official position and time to assist the SEC attorney with a private matter.

The SEC attorney's contacts to other Federal agencies on behalf of his girlfriend appeared to violate 18 U.S.C. § 205, which prohibits an officer or employee of the United States, other than in the proper discharge of official duties, from acting as agent or attorney for anyone before any department or agency in connection with any covered matter in which the United States is a party or has a di-

rect and substantial interest. Accordingly, the OIG referred the matter to the U.S. Attorney's Office for the District of Columbia for consideration of criminal prosecution. That Office provided a declination of prosecution in lieu of appropriate administrative action.

In consideration of the attorney's egregious and repeated misuse of his official SEC position and title to assist a private individual, we recommended that disciplinary action be taken against him, up to and including dismissal. We also recommended that management consider taking disciplinary action against the lower-level employee and suggested that she be provided with ethics training. As the report of investigation was issued just prior to the end of the semiannual reporting period, no action has been taken as of yet by management with respect to the OIG's recommendations.

### **Possession of a Weapon Inside SEC Headquarters**

On March 27, 2009, the OIG opened this investigation after receiving information from the SEC's Security Branch concerning a potential threat allegedly made by an Enforcement Accountant against his supervisor. On March 20, 2009, the Enforcement Accountant sent his supervisor an e-mail related to a disagreement over a professional matter that contained language that could have been interpreted as threatening. On March 25, 2009, the supervisor met with representatives of the SEC Security Branch and the Office of Human Resources (OHR). During this meeting, the supervisor stated that he had heard from other SEC employees that the Enforcement Accountant routinely brought a "large buck knife" to work.

On April 1, 2009, the OIG interviewed the Enforcement Accountant concerning the allegation that he routinely brought a large knife to his SEC office and discovered that the Enforcement Accountant was carrying a folding knife with a 3½ to 4-inch blade. Immediately after this discovery, an OIG investigator accompanied the Enforcement Accountant to his office and discovered two other similar knives in a backpack. The Enforcement Accountant's knives were immediately confiscated by the OIG investigator and turned over to the Security Branch for safekeeping. That same day, the Enforcement Accountant was placed in a non-duty status with pay (administrative leave), effective immediately. The notice of his administrative leave stated that he was not allowed access to the worksite and must immediately surrender his building pass and SEC identification card.

Subsequently, the OIG reviewed the Enforcement Accountant's personnel files, reports prepared by the SEC Security Branch, e-mails between the Enforcement Accountant and his supervisor or other SEC personnel, a memorandum to the Enforcement Accountant's file from his supervisor regarding a March 25, 2009 meeting with the Enforcement Accountant, and an National Crime Information Center criminal background report for the Enforcement Accountant. The OIG also took sworn, on-the-record testimony of the Enforcement Accountant, his supervisor, and four other SEC employees and interviewed three other SEC employees.

The OIG found that the Enforcement Accountant violated Title 18 U.S.C. § 930 of the Federal criminal code by knowingly carrying dangerous weapons into a federal facility. Specifically, the OIG found that on April 1, 2009, the Enforcement Accountant knowingly possessed at least three "dangerous weapons" in a "federal facility," as those terms are de-

finied in 18 U.S.C. § 930(g), and had routinely been in possession of dangerous weapons within the SEC building for several years despite his own admission that he knew it was unlawful to do so. On April 21, 2009, the OIG referred its factual findings to the U.S. Attorney's Office for the District of Columbia for its consideration of a possible criminal prosecution of the Enforcement Accountant under 18 U.S.C. § 930(a). The U.S. Attorney issued a declination of prosecution stating that the matter was more appropriately suited for an administrative proceeding.

In the course of this investigation, the OIG also discovered evidence suggesting that the Enforcement Accountant was not completely truthful in his testimony before the OIG and in his previously-submitted Declaration for Federal Employment regarding his prior criminal conviction and probation for driving while intoxicated.

The OIG issued its report of investigation to management on July 9, 2009, and recommended disciplinary action against the Enforcement Accountant, up to and including dismissal. As of the end of the semiannual reporting period, management had proposed removal of the Enforcement Accountant, but disciplinary action had not been finalized.

### **Participation in Fraudulent Scheme by Contract Employee Using SEC Resources**

On July 1, 2009, the OIG opened an investigation after being advised by the FBI of a criminal investigation being conducted jointly with other law enforcement agencies into an illegal scheme to defraud the United States in connection with accounts receivables finance companies (factoring companies) that purchased accounts receivables from government contractors. The targets of the investigation

included an employee of an SEC contractor who was working in the Office of Administrative Services and two other individuals. The SEC contract employee was alleged to have falsely portrayed himself as a U.S. Army Contracting Officer in furtherance of the scheme to defraud.

Upon opening its investigation, the OIG contacted the Personnel Security and Records Branch of OHR for information pertinent to the employee's clearance to work as an SEC contract employee. We reviewed the file pertaining to his background investigation and learned that the employee was authorized to have access to SEC facilities and computer systems on April 3, 2009, based upon a favorable suitability determination. We further found that this favorable suitability determination was made, notwithstanding knowledge of prior criminal and court-martial proceedings being instituted against the employee, based upon perceived mitigating factors.

The OIG requested and obtained the employee's building access records for the period in which he had been employed as an SEC contractor. The OIG also obtained the contract employee's SEC e-mails for that time period. The OIG then uncovered documents that the contract employee had scanned and e-mailed using SEC equipment that appeared to be in furtherance of the scheme to defraud involving the factoring companies. The OIG found that the contract employee fraudulently signed several of these documents as a U.S. Army Contracting Officer while he was employed as a contractor at the SEC. The OIG's review of the subject's e-mails also revealed an excessive amount of personal e-mails sent and received during work hours, as well as e-mails sent pertaining to a private business in violation of the SEC's policies and rules regarding

the use of SEC office equipment and computer resources.

The OIG also assisted in coordinating the arrest of the contract employee. Specifically, the OIG provided information necessary for the arrest to occur, and an OIG Special Agent worked closely with other Federal agents to facilitate the subject's arrest on July 23, 2009. The subject was apprehended while en route to the SEC facility where he worked. As a result of the subject's arrest, his contract employment with the SEC was terminated immediately, his SEC access card was deactivated and he was banned from entry on SEC property.

Subsequent to the contract employee's arrest, the OIG continued to coordinate with the FBI regarding the criminal investigation into the fraudulent scheme. Specifically, the OIG obtained and searched additional e-mails of the subject, as well as files maintained on his computer hard drive and the SEC network. The OIG then provided additional pertinent documents to the FBI, including a resume containing false information about the subject's employment with the SEC.

On August 24, 2009, the contract employee and two other individuals were indicted in Federal district court based upon a scheme to defraud the United States by falsely representing to factoring companies that the defendants' business entities had obtained legitimate multi-million dollar government contracts. The indictment alleged, among other things, that the SEC contract employee falsely held himself out as a U.S. Army Contracting Officer in order to convince the factoring companies that the defendants' companies had genuine government contracts and that government payments would be made to the factoring companies. The contract employee

was charged with seven counts of wire fraud, and forfeiture of over \$4 million was sought against the defendants.

On September 30, 2009, the OIG issued a report of investigation that set forth the pertinent facts uncovered during the investigation and discussed in detail the assistance provided to and coordination with the FBI and other agencies involved in the investigation. Because the contract employee no longer works at the SEC due to his arrest and subsequent indictment, the OIG did not recommend administrative action. However, the OIG provided its report to management for informational purposes and suggested that management exercise greater caution in making suitability determinations concerning proposed contract employees in the future. Management informed the OIG that it is remedying a processing error that occurred in this case and is continuing to review the matter.

### **Assistance with the Operation of a Ponzi Scheme by Former SEC Employee Using SEC Resources**

On November 4, 2008, the OIG opened an investigation as a result of information received from the Securities Division of the Arizona Corporation Commission (ACC). The ACC advised the OIG that a Supervisor in the SEC's Office of Administrative Services had been allegedly assisting with the operation of a Ponzi scheme orchestrated by an Arizona man. According to an ACC investigator, one of the investors who had cooperated with the ACC's investigation of this Ponzi scheme perpetrator provided the ACC with e-mails that the Supervisor sent from her SEC computer regarding sending funds on his behalf. The ACC investigator also informed the OIG that several other witnesses in the ACC investigation had identified the Supervisor as the per-

son who handled money for this Ponzi scheme perpetrator and his companies.

Shortly after the OIG investigation began, the Supervisor retired from the SEC pursuant to the SEC's Voluntary Early Retirement Authority (VERA) and Voluntary Separation Incentive Payment (VSIP) authority. As a result, the Supervisor received full retirement benefits and a \$25,000 buyout.

The OIG obtained and reviewed the Supervisor's SEC e-mails for the relevant period. The OIG reviewed those e-mails to determine the nature of the Supervisor's involvement with the Ponzi scheme perpetrator and his companies. The OIG provided the ACC with the Supervisor's approximately 2,300 e-mails that were related to the Ponzi scheme perpetrator and his companies. The OIG also requested that the SEC's Office of Information Technology examine the Supervisor's computer hard drive and logs for any indication that she used SEC resources in addition to her e-mail account to support the activities of the Ponzi scheme perpetrator and his companies. Additionally, the OIG contacted the Ethics Office to determine whether the Supervisor had sought ethics advice in connection with the matter under investigation. Finally, the OIG took the sworn testimony of the person to whom the Supervisor reported during the relevant period.

The OIG found that on May 11, 2009, the Ponzi scheme perpetrator consented to the ACC's entry of an Order to Cease and Desist, Order for Restitution, Order for Administrative Penalties and Consent to Same by Respondents (ACC Order). In the ACC Order, he admitted to violating the Arizona securities laws.

According to the ACC Order, the Ponzi scheme perpetrator presented himself as "an

international numerologist and spiritual financial adviser who could predict the future utilizing numerology.” He purportedly provided services as “a life coach” to individuals who paid to join his “VIP coaching program” and told the members of this program that “they could, through the use of numerology concepts, improve their financial well-being by investing in futures and commodities and/or enhance their spiritual awareness.” Eventually, he began soliciting members of his life-coaching program for funds that he claimed would be invested on their behalf in copper futures using numerology principles to time the futures market. In fact, none of the investors’ funds were ever invested, but instead were deposited in the checking accounts of his companies and used for his own personal benefit. His scheme raised approximately \$430,000 from 65 investors.

The OIG discovered that during the period in question, the Supervisor used her SEC e-mail account to conduct business on behalf of the Ponzi scheme perpetrator and his companies on virtually a daily basis. The OIG found that the Supervisor was extensively involved in handling the payments to and from his victims, and used her SEC e-mail account to communicate directly with those victims.

The OIG did not find any evidence that the Supervisor knew that this individual was operating a Ponzi scheme. The ACC did not take any action against the Supervisor and she is not mentioned in the ACC Order. However, the OIG did find that the Supervisor violated Commission rules and policies on the use of SEC office equipment, as well as the Standards of Ethical Conduct for Employees of the Executive Branch by using the SEC’s e-mail system, her SEC computer, and other SEC resources to assist the Ponzi scheme perpetrator operate his companies, whether or not she knew those companies were a Ponzi

scheme. During the course of its investigation, the OIG referred this matter to the SEC’s Division of Enforcement for investigation and the U.S. Department of Justice (DOJ) Criminal Division for possible criminal prosecution. The DOJ declined prosecution of the matter.

The OIG issued its report of investigation to management on September 30, 2009. In its report, the OIG stated that had the Supervisor not retired shortly after the OIG investigation began, the OIG would have recommended serious disciplinary action against her, including termination. In light of her conduct, the OIG recommended that the SEC pursue revocation of the VERA and VSIP benefits the Supervisor received, including the \$25,000 payment. As the report of investigation was issued just prior to the end of the semiannual reporting period, no action has been taken as of yet by management with respect to the OIG’s recommendation.

### **Allegations of Failure to Conduct Timely Investigation in the Fort Worth Regional Office**

The OIG opened an investigation in response to specific anonymous complaints that the SEC’s FWRO improperly “stood down” in its investigation of Robert Allen Stanford (Stanford) at the request of another government agency and failed to diligently pursue the Stanford investigation until the Madoff Ponzi scheme collapsed in December 2008. The SEC’s Stanford investigation ultimately resulted in a civil complaint, filed on February 17, 2009, in the U.S. District Court for the Northern District of Texas against Stanford for allegedly operating a Ponzi scheme.

The SEC’s February 17, 2009 civil complaint alleged that Stanford and his co-



defendants orchestrated a \$8 billion fraud based on false promises of guaranteed returns related to “certificates of deposit” (CDs) issued by the Antigua-based Stanford International Bank (SIB). The SEC alleged that SIB sold approximately \$8 billion of CDs to investors by promising improbable and unsubstantiated high interest rates of return. Pursuant to the SEC’s request for emergency relief, the Court immediately issued a temporary restraining order, froze the defendants’ assets, and appointed a receiver to marshal those assets. After reviewing documents obtained from the court-appointed receiver, the SEC filed an amended complaint on February 27, 2009, further alleging that Stanford had conducted a Ponzi scheme.

The OIG conducted numerous interviews of officials in the SEC’s FWRO regarding their investigation of Stanford and the resulting civil action. In addition, the OIG reviewed many documents related to the investigation of, and the litigation against, Stanford, including: (1) a March 14, 2005 referral from the SEC’s Office of Compliance Inspections and Examinations; (2) a copy of the Action Memorandum Seeking Formal Order Authority dated October 11, 2006, (3) the Formal Order of Investigation dated October 26, 2006; (4) a Memorandum to the DOJ regarding the criminal referral dated April 22, 2008; and (5) information from the SEC Division of Enforcement’s case tracking systems.

The OIG issued its report of investigation to management on June 19, 2009. In its report, the OIG found that the SEC did decide to effectively halt its Stanford investigation in or about April 2008. However, we did not find that the SEC breached its obligations to vigorously pursue allegations of wrongdoing in the Stanford matter, as the SEC’s decision to halt its investigation was made in a response

to a specific request from the DOJ, which was involved in a criminal investigation.

The report also found that the FWRO was actively investigating Stanford well before the December 2008 revelations about Madoff’s Ponzi scheme, although immediately after Madoff confessed, the Stanford investigation became more urgent for the FWRO and, after ascertaining that the DOJ investigation was in its preliminary phase, the FWRO staff asked DOJ if it could move forward with the Stanford investigation. After DOJ gave the FWRO staff the approval to move forward, the FWRO staff gathered more evidence of certain fraudulent marketing practices by Stanford. That evidence allowed the SEC to file a civil action against Stanford on February 17, 2009.

We also found that the FWRO staff’s efforts to pursue its suspicions of a Ponzi scheme in the Stanford investigation were hampered by a lack of cooperation on the part of Stanford and his counsel, certain jurisdictional obstacles and, according to a June 19, 2009 DOJ indictment, criminal obstruction of the FWRO’s Stanford investigation by several individuals including the head of Antigua’s Financial Services Regulatory Commission.

### **Misuse of Government Computer Resources**

On December 1, 2008, the OIG opened an investigation as a result of information received from the Office of Information Technology Security group. This information showed that a Supervisor in an SEC Regional Office had used his SEC-assigned computer to access Internet pornography.

The OIG reviewed certain computer records, including an Internet history log, related to the Supervisor and the results of a forensic analysis of his SEC computer hard drive. The OIG also reviewed the Supervisor's Official Personnel Folder and time and attendance records. Finally, the OIG took the Supervisor's sworn, on-the-record testimony.

The OIG investigation revealed that while using his SEC computer during seven working days, the Supervisor received approximately 196 access denials for Internet websites classified by the Commission's Internet filter as "Pornography." The Supervisor's SEC computer hard drive also contained numerous pornographic images. The Supervisor admitted under oath that he accessed pornographic and sexually explicit websites from his SEC computer during work hours. He also admitted that he had frequently viewed pornography at work on his SEC computer for about a year.

The OIG found that the Supervisor violated Commission rules and policies on the use of SEC office equipment as well as the Government-wide Standards of Ethical Conduct. The OIG also found that two video files discovered on the Supervisor's computer hard drive potentially contained child pornography. Therefore, the OIG referred the matter to the FBI.

The OIG issued its report of investigation to management on July 9, 2009, and recommended that the SEC take appropriate disciplinary action against the Supervisor, up to and including dismissal. Management proposed a five-day suspension for the Supervisor, but disciplinary action had not been finalized by the end of the reporting period.

## **Allegation of Unauthorized Disclosure of Non-Public Information**

The OIG opened an investigation on August 8, 2008, after it was notified by senior staff in the Office of Compliance Inspections and Examinations (OCIE) that a non-public draft of the SEC's report on certain issues related to credit rating agencies was apparently leaked to the Wall Street Journal (WSJ). An August 2, 2008 WSJ article included non-public information contained in the draft report.

The report was the product of an SEC examination of three Nationally Recognized Statistical Rating Organizations (NRSROs). The report was a collaborative effort by OCIE, the Division of Trading and Markets (TM), the Office of Economic Analysis (OEA), and the Office of Risk Assessment (ORA). The focus of the report was the NRSROs' activities in rating subprime residential mortgage-backed securities and associated collateralized debt obligations.

In the process of writing the report, the staff produced a number of drafts that were circulated among various SEC divisions and offices for comment. The SEC ultimately released a redacted version of the final report to the public. The public version of the report did not identify the NRSROs that were examined, but did include the SEC's findings that were critical of those firms.

During the course of this investigation, the OIG reviewed numerous drafts of the NRSRO Report; the individual examination reports of the three examined NRSROs; the Action Memorandum jointly submitted to the Commission by OCIE, TM and OEA seeking authorization to publicly release the report; the WSJ article; and correspondence from one of the NRSROs and its outside counsel to

OCIE regarding the impact of the WSJ article. The OIG also identified the SEC staff members on the report's distribution list and other staff members involved in the preparation and review of the report. For those 37 SEC staff members, the OIG obtained and reviewed approximately 134,000 e-mails for the relevant period. The OIG also took sworn, on-the-record testimony of 25 SEC staff members who were involved in the preparation and review of the report.

The OIG issued its report of investigation to management on September 30, 2009. In the report, we determined that there was no evidence that any SEC staff member provided non-public information to the WSJ.

### **Allegation of Conflict of Interest by Senior SEC Official**

On May 9, 2008, after initially conducting a preliminary inquiry, the OIG opened an investigation into an anonymous allegation that an SEC Senior Officer was involved in the decision to hire a company with whom he had a past relationship, even though the contractor was not the lowest bidder in the procurement process.

The OIG reviewed relevant contract documents and interviewed the Senior Officer as well as several other witnesses. On April 21, 2009, the OIG issued its report of investigation to management summarizing its investigative work. The OIG investigation found the Senior Officer had no improper conflict of interest with the company at issue. The OIG's investigation revealed that the Senior Officer made the final decision to select the company after the selection panel recommended a different company, but there was no evidence that this decision was improper per se. The OIG did find that better communication could have been used with respect to the selec-

tion of the company so that staff could more fully understand why the selection had been made.

### **Allegation of Abuse of Authority**

On December 1, 2008, the OIG opened an investigation as a result of a complaint from the subject of an SEC Enforcement investigation and civil action. The complainant alleged that two SEC attorneys from an SEC Regional Office abused their authority and demonstrated a bias against Native Americans during the investigation and civil litigation against the complainant.

The SEC civil action was filed on September 13, 2006 in the U.S. District Court for the Northern District of California against the complainant and a public company for which the complainant was the Chief Executive Officer. The SEC alleged that the defendants had made fraudulent statements in press releases and SEC filings. The court granted the SEC summary judgment against the complainant and default judgment against his corporate co-defendant on June 30, 2008. The court permanently enjoined the complainant from future violations of the relevant federal securities laws; barred him from acting as an officer or director of a public company or from participating in the offering of any penny stock; and ordered him to pay in disgorgement, pre-judgment interest and a civil penalty. The corporate co-defendant was ordered to pay a civil penalty. The SEC also filed an administrative action against the corporate co-defendant on September 13, 2006, seeking revocation of its securities. The administrative law judge granted the SEC summary judgment in the matter on January 12, 2007.

The OIG took on-the-record, sworn testimony of the complainant and the two SEC attorneys. In addition, the OIG reviewed numerous documents related to the investigation of, and litigation against, the complainant and his company, including: (1) the SEC's subpoenas, voluntary requests for documents, and related correspondence from the complainant, and (2) the judicial decisions granting the SEC summary judgment in the civil action against the complainant and his corporate co-defendant and the administrative proceeding against that corporate co-defendant.

During the OIG's investigation, the complainant offered no evidence to support his vague and conclusory allegations of discrimination by the two SEC attorneys. In fact, he conceded during his testimony that no one employed by the SEC had made any type of racist comments or discriminatory comments to him.

Moreover, the OIG found that two judges had specifically rejected the complainant's allegations of discrimination by the SEC staff. In the civil action against him, the complainant raised an "unclean hands" defense based on the same allegations of discrimination made to the OIG. The court rejected the complainant's defense, finding:

[T]he complainant's allegations [of discrimination on the basis of race] have been vague and conclusory. He has provided no specific facts or evidence to support his allegations and he has pointed to no conduct on the part of the government that has resulted in any actual prejudice with respect to [the complainant's] defense in this action.

Similarly, the OIG found that in the SEC's administrative action against the corporate co-defendant, the complainant had also asserted generalized allegations of discrimination and selective prosecution. The administrative law judge dismissed those allegations as well.

The OIG issued its report of investigation to management on June 24, 2009. In its report, the OIG concluded that it had found no evidence of discriminatory bias on the part of the SEC staff in pursuing the actions against the complainant and the corporate co-defendant.

### **Other Inquiries Conducted**

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

The OIG conducted a preliminary inquiry after information received in the course of another OIG investigation disclosed that an Enforcement Assistant Director was sending and receiving an excessive amount of personal e-mails. During its inquiry, the OIG conducted a thorough review of the Assistant Director's e-mails for the months of March and April 2008 that had been obtained from the OIT. The OIG's review disclosed that the Assistant Director spent an excessive amount of time sending and reading personal e-mails using his SEC account during these two months. For example, during March and April 2008, the Assistant Director received a total of approximately 1,100 personal e-mails from two individuals outside the SEC alone. During the same two-month period, the Assistant Director sent approximately 1,700 personal e-mails to those two individuals. Virtually all of this personal correspondence occurred during

business hours, and much of it was quite lengthy. In addition, a large number of e-mails exchanged between the Assistant Director and various SEC employees during these two months did not relate to SEC business.

To determine whether the Assistant Director's excessive use of his SEC computer during business hours for personal correspondence was ongoing, the OIG requested and obtained from OIT his e-mails for the month of April 2009. A review of those e-mails indicated that the Assistant Director's practice of using his SEC e-mail account during business hours for excessive personal correspondence continued.

The OIG issued a memorandum report on June 24, 2009, finding that the Assistant Director's excessive use of SEC e-mail for personal purposes violated the SEC's policy and rules on use of office equipment. The OIG recommended that Enforcement consider taking appropriate disciplinary action against the Assistant Director. Enforcement took no formal disciplinary action against the Assistant Director, but issued a memorandum reminding him of the computer resources training he had completed and to limit his use of personal e-mail to non-duty hours.

The OIG also conducted inquiries during the reporting period into the misuse of SEC computer resources to view pornography by two SEC employees and four contract personnel. In each of these matters, the OIG reviewed and analyzed the individuals' Internet access logs for the available time period, as well as images found on the individuals' computer hard drives where applicable.

In one matter involving a Headquarters Enforcement employee, the evidence showed that the employee had received 406 access re-

quest denials for Internet websites classified by the Internet filter as pornography in a nearly two-month period. Many of these denials occurred during normal SEC work hours. Information provided by OIT also revealed additional instances in which the employee successfully accessed numerous sexually-explicit Internet websites. The OIG issued a memorandum report on June 5, 2009, and referred the matter to management for consideration of disciplinary action. Based on the OIG's report, the employee was suspended for three calendar days for use of government resources for unauthorized purposes and misuse of official time.

In the other matter involving an SEC employee, the information provided by OIT showed that an Enforcement Regional Office Branch Chief had received 271 access request denials for websites classified as pornography in a nearly two-month period, many of which occurred during normal SEC work hours. The OIG issued a memorandum report on June 8, 2009, and referred the matter to management for consideration of disciplinary action. Management has proposed a one-day suspension of the attorney for attempting to access pornographic websites using SEC computer resources.

In three of the matters involving contract personnel, the information provided by OIT demonstrated that each of these individuals received between approximately 175 and 250 access request denials for websites classified as pornography during periods of about two months in length. Moreover, a review of the information provided by OIT revealed additional instances in which two of these contractors successfully accessed sexually-explicit or sexually-suggestive Internet websites from their government-assigned computers. The OIG issued memorandum reports in all three matters, one dated June 15, 2009, and two

dated June 16, 2009. In response to the OIG's reports, one of these individuals, who had previously received a verbal warning for similar conduct, was removed from the SEC contract, and the other two individuals were provided warning letters. In the fourth matter involving a contractor employee, the information provided by OIT revealed several hundred access denial requests for Internet websites classified as Internet pornography, all of which occurred over a ten-hour period. The OIG referred the matter verbally to management for appropriate follow-up.

The OIG also completed inquiries into whether two separate employees were using SEC resources and official time to conduct private businesses. Both of these matters arose out of information received in the context of an investigation conducted during a prior reporting period. The OIG obtained from OIT the e-mails for both employees for the months of January 2008 to March 2009, and conducted a thorough review of these e-mails. The OIG also reviewed documents located on these employees' computer hard drives.

In one matter, the OIG's inquiry disclosed that the employee had violated Commission policy and rules, as well as the Government-wide Standards of Ethical Conduct (Standards of Conduct), by using his SEC computer and official time to manage rental property. The OIG also found that this employee had used SEC e-mail in connection with a gun auction website in violation of SEC policy. In the other matter, the OIG found evidence that the employee had violated SEC policy and rules, as well as the Standards of Conduct, by using her SEC computer for her personal makeup business. The OIG issued memorandum reports to management on July 1, 2009 and August 5, 2009, respectively, recommending consideration of disciplinary ac-

tion against the employees. In response to the OIG's reports, management issued counseling memoranda to both employees regarding their use of SEC computer equipment in a manner that may conflict with the SEC's policies and in violation of ethical standards. These memoranda cautioned the employees that their failure to heed the counseling memoranda could result in more severe disciplinary action.

In another inquiry conducted during the reporting period, the OIG reviewed a complaint that an OIT contract employee was allegedly misusing SEC resources and time by conducting a private computer services business during working hours. During its review, the OIG requested and obtained from OIT the contract employee's e-mails for the months of January to June 2009. The OIG found evidence that the employee violated SEC policy and rules by using his SEC computer and time to manage his private business. Prior to the completion of the OIG inquiry, the contracting firm suspended and subsequently removed the employee for violations of internal company policies. The OIG issued a memorandum report to management on September 30, 2009, setting forth the evidence that the contract employee had misused his SEC computer and e-mail to conduct business matters pertaining to his computer services business.

The OIG also conducted an inquiry into two OIG Hotline complaints received from anonymous sources that alleged that a senior SEC Enforcement official (who has now left the SEC) regularly received calls from former high-level Enforcement officials employed by investment banks or law firms to discuss investigative matters. While the receipt of these calls would not necessarily violate any policies, rules or regulations, they could lead to improper external communications, favorable treatment or disclosure of non-public

information. During its inquiry, the OIG obtained and reviewed the Enforcement official's e-mails for a three-week period pertinent to the allegations in the complaint. The OIG's review of these e-mails found no evidence to substantiate the complaints' allegations that the Enforcement official's contacts with the former SEC officials violated any SEC policies or regulations. Accordingly, the OIG concluded that the complaints did not warrant further investigation.

The OIG reviewed allegations contained in a complaint received from an attorney that SEC Regional Office Enforcement staff had failed to act appropriately in response to the attorney's complaint that a competitor of his client was in violation of the Federal securities laws. During its review, the OIG interviewed the Regional Office Branch Chief who had reviewed the attorney's allegations and found them to be without merit. The OIG also reviewed several pertinent judicial decisions, as well as a report by the Inspector General of the U.S. Export-Import Bank that had found the attorney's allegations to be without merit. The OIG determined, based on its review, that no further action was required in the matter.

The OIG also performed an inquiry into a complaint received from a consultant to a former hedge fund, alleging that the staff of an SEC Regional Office had closed an investigation without recommending any enforcement action due to improper political pressure. During its inquiry, the OIG reviewed documentation pertaining to the Enforcement investigation and took the sworn on-the-record testimony of the complainant. During that testimony, the complainant retracted his allegation that the investigation was impacted by undue political influence, stating that he had not intended to convey that impression in this complaint. The complainant

further admitted that he had no evidence to support the assertion made in his complaint. As a result, the OIG determined that no further action was necessary in this matter.

## **PENDING INVESTIGATIONS**

### **Allegation of Conflict of Interest in an Enforcement Investigation**

The OIG has opened an investigation at the request of the Honorable Elijah E. Cummings, Member, U.S. House of Representatives, into the circumstances surrounding an Enforcement action brought against a prominent banking institution. The OIG intends to investigate whether there was a conflict of interest in the decisions made by the Enforcement staff regarding their investigation of, and recommendation of penalties against, the banking institution because of a previous acquisition made by the financial institution and the role the U.S. Government may have played in the encouragement of that acquisition.

### **Allegations of Numerous Procurement Violations**

During the reporting period, the OIG opened an investigation as a result of information received from anonymous complaints through the OIG's Hotline. The complaints alleged that managers in an SEC headquarters office have been awarding contracts to their friends.

Additionally, the OIG received a complaint regarding an SEC manager in the same office for disclosing non-public procurement information relating to contract bids to an SEC contractor. The SEC contractor then allegedly shared that information with an employee of one of the contracting companies

involved in the solicitation. The OIG has taken the sworn, on-the-record testimony of multiple witnesses and the subjects in this investigation. In addition, the OIG has reviewed documentation regarding the contracts and is in the process of finalizing its findings in this investigation.

### **Allegations of Unauthorized Disclosure by Former Employee and Improper Enforcement Investigation**

The OIG has completed its investigative work in this matter and has begun writing a report of investigation into allegations made in a published book, including an allegation that a former SEC attorney may have taken confidential investigative materials when he left the SEC and provided those materials to a company for which he went to work as a lobbyist. It was also alleged in the book that the SEC settlement with the company was inadequate given the evidence of the company's fraud the author had provided to the SEC.

In this investigation, we took the testimony and conducted interviews of a dozen former and current SEC employees, including the testimony of both examiners who conducted the relevant examination of the company at issue. We took the testimony of the staff attorneys responsible for related investigations, conducted telephone interviews with the former Enforcement attorney who is alleged to have engaged in wrongdoing, and took testimony of Senior Officers with responsibilities related to the examination and investigation of the company at issue. In addition, we took the testimony of the book's author and his counsel about allegations related to the SEC's action against the company outlined throughout the book, and obtained and reviewed the several detailed complaints the author had submitted to the SEC. We also obtained and reviewed the relevant examination workpapers, volumi-

nous e-mails of former and current employees, and various Enforcement documents concerning related investigations.

The OIG plans to issue its report of investigation prior to the end of the next semiannual reporting period.

### **Allegations of Failure to Vigorously Enforce Securities Laws**

The OIG continued its investigation into a complaint alleging that Enforcement failed to properly and vigorously enforce the Federal securities laws in an investigation of a publicly-traded corporation, resulting in substantial losses to shareholders. The OIG requested and reviewed the entire investigative file and numerous other relevant documents.

Further, during the semiannual reporting period, the OIG took the testimony of the Enforcement attorneys who handled the underlying investigation. The OIG plans to complete its investigation during the next reporting period.

### **Complaint of Investigative Misconduct by Various Enforcement Attorneys**

The OIG is continuing to investigate a complaint received from counsel for a defendant in an SEC Enforcement action, alleging numerous instances of misconduct by Enforcement attorneys during the course of the investigation. The OIG obtained thousands of e-mails during the reporting period and carefully reviewed these e-mails for information relevant to the investigation. The OIG also reviewed substantial documents relating to the allegations in the complaint.

Further, the OIG scheduled testimony for numerous individuals with information perti-



ment to the investigation for shortly after the reporting period ended, and plans to take additional testimony within the next few weeks. The OIG intends to finalize its investigation and issue a report during the next semiannual reporting period.

### **Allegation of Abusive Behavior and Other Improper Conduct**

During the reporting period, the OIG continued its investigation into allegations that an SEC manager engaged in a pattern of unprofessional and disruptive behavior while conducting SEC inspections of outside entities and that he provided unethical instructions to his staff. During the reporting period, the OIG interviewed numerous additional staff members, and took the sworn, on-the-record testimony of several witnesses. The OIG plans to conduct a few additional interviews and complete its investigatory work prior to the end of the next semiannual reporting period.

### **Allegation of Procurement Violations**

The OIG opened an investigation into allegations that a senior management official awarded a contract to a company without following proper procedures and, as a result, the system purchased from that company does not function as intended. The OIG has taken the sworn testimony of the complainant and obtained relevant documents. The OIG plans to take the testimony of the senior management official and others related to this matter.

### **Allegation of Failure to Maintain Active Bar Membership**

The OIG is conducting an investigation into a complaint that the state bar license of

an SEC Headquarters attorney had been suspended, but that this individual continues to work as an SEC attorney. The OIG has obtained pertinent information from state court officials regarding the attorney's bar status. In addition, the OIG has obtained e-mails for the relevant time period. The OIG plans to take testimony of relevant parties and complete this investigation during the next reporting period.

### **Allegations of Conflict of Interest and Investigative Misconduct**

The OIG is continuing its investigation into allegations that a supervisory SEC Enforcement attorney participated in an investigation notwithstanding a personal conflict of interest that required his recusal from the investigation and that various misconduct occurred during the course of the investigation and subsequent litigation. During this semiannual reporting period, the OIG continued to search and review e-mails of the attorneys who worked on the matter for the relevant time period. The OIG also obtained and reviewed additional materials provided by the complainant. In addition, the OIG conducted interviews of three former Enforcement attorneys who had supervisory responsibility over the matter. The OIG plans to take the testimony of the subjects and complete the investigation during the next reporting period.

### **Complaint Concerning Unauthorized Disclosure of Non-Public Information Obtained from a Commission Database**

The OIG continued its investigation into a complaint that two Regional Office SEC Enforcement attorneys repeatedly, and in violation of agency policy, disclosed non-public information about SEC Enforcement

investigations obtained from an internal SEC database. The information in question was allegedly disclosed to a corrupt FBI agent and short seller, who were subsequently tried and convicted of several criminal violations, including fraud, theft, racketeering, and conspiracy in connection with a stock short selling operation.

During this reporting period, the OIG completed all the testimony in this investigation and finalized its review of the record of the underlying proceeding and thousands of pages of additional documentary evidence. Having completed its investigatory work, the OIG has drafted a comprehensive report of investigation summarizing its findings and the results of its investigatory analysis. The OIG plans to finalize the report of investigation and issue it shortly.

### **Complaint Concerning Obstruction of Justice**

The OIG opened this investigation after receiving information that an SEC employee may have offered to obstruct an SEC investigation. The OIG obtained and reviewed relevant documents from the SEC and relevant outside entities, and worked with other federal law enforcement agencies in the course of this investigation. The source of the information has recanted his story. The OIG has completed its investigative work and plans to issue its report of investigation prior to the end of the next semiannual reporting period.

### **Allegations of Failure to Investigate**

The OIG has opened an investigation into complaints from an investor alleging that the SEC failed to investigate instances of market manipulation and other misconduct in connection with the review, and eventual non-

approval, of a developmental drug. The investor also has alleged that the SEC failed to investigate a recent bear raid on the stock of the company that developed the drug, causing a severe plunge in the stock price. The OIG has reviewed several hundred pages of documents, including numerous e-mails and attachments provided by the complainant. The OIG expects to complete its investigation and issue a report of investigation in the next reporting period.

### **Allegation of Negligence in the Conduct of an Enforcement Investigation**

During this reporting period, the OIG continued its investigation into a complaint that Enforcement committed acts of negligence in the conduct of an insider trading investigation. The complaint was based upon recently-discovered information that purports to demonstrate that Enforcement had access to specific evidence that insider trading had occurred prior to Enforcement closing its investigation. The OIG has reviewed documents provided by the complainant, as well as additional documents in its possession. The OIG took the sworn, on-the-record testimony of the complainant and plans to take additional testimony and continue its investigation of the allegations.

### **Whistleblower Allegation of Falsification of Contract Documents**

The OIG continued its joint investigation with another Federal agency's Office of Inspector General and a U.S. Attorney's Office (USAO) into allegations made by a whistleblower that a contractor manipulated data in order to increase the millions of dollars of award fees it had obtained from the SEC over a period of several years.

During this reporting period, the OIG worked extensively with the other Federal Office of Inspector General to further the investigative efforts in this matter. We developed a detailed outline of the investigative work completed to date, including the extensive e-mail review and witness interviews, to assist the USAO in its efforts in the matter. We also conducted further interviews of witnesses.

After the OIG had numerous discussions and consultations with the USAO about the additional investigative work, the USAO, after weighing the evidence in the case, decided to decline prosecution of the matter. The OIG will continue to investigate issues within its jurisdiction, including whether SEC employees adequately supervised the contract employees and oversaw the contract.

### **Allegation of Retaliatory Investigation**

The OIG continued its investigation of an allegation that SEC staff engaged in retaliation against a company after it publicly complained about naked short selling in the com-

pany's stock. During this reporting period, the OIG took the sworn testimony of the staff attorney who worked on the matter and reviewed numerous relevant documents. The OIG has completed its investigative work and plans to issue its report of investigation prior to the end of the next semiannual reporting period.

### **Allegation of Misuse of Resources and Official Time**

During the reporting period, the OIG opened an investigation into a complaint that an SEC employee had been using SEC e-mail resources and official time to run a nonprofit business. The OIG obtained and reviewed the employee's e-mails for an eleven-month period. The OIG took the sworn, on-the-record testimony of a witness and the subject in this investigation. The OIG has completed its investigative work and plans to issue its report of investigation prior to the end of the next semiannual reporting period.





# SEMIANNUAL REPORT TO CONGRESS

## REVIEW OF LEGISLATION AND REGULATIONS

During the reporting period, the OIG reviewed legislation and proposed and final rules and regulations relating to the programs and operations of the SEC, pursuant to Section 4(a)(2) of the Inspector General Act.

In particular, the OIG reviewed statutes, rules, regulations and requirements, and their impact on Commission programs and operations, within the context of audits, evaluations, and reviews conducted during the period. For example, in the review performed of the SEC's role regarding and oversight of Nationally Recognized Statistical Rating Organizations (NRSROs), the OIG comprehensively examined the provisions of the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, and noted several areas in which additional legislative authority might be sought. During this review, the OIG also closely analyzed numerous proposed and final rules pertaining to the SEC's oversight of NRSROs and identified several policy issues that could be addressed through additional rulemaking.

In connection with its review of the agency's compliance with the Freedom of

Information Act (FOIA), 5 U.S.C. § 552, as amended by Pub. L. No. 104-231, the OIG carefully reviewed and analyzed the provisions of the FOIA, as well as Executive Order 13392, Improving Agency Disclosure of Information, and the Openness Promotes Effectiveness in our National Government Act of 2007 (OPEN Government Act), Pub. L. No. 110-175. Among other things, the OIG's review recommended that the agency address its existing practices to ensure compliance with the OPEN Government Act.

During the period, the OIG also reviewed, tracked and provided comments and views on pending legislation that would impact the SEC. This legislation included H.R. 682, the Stop Trading on Congressional Knowledge Act, and H.R. 2798, the Support Investment Protection for Customers Reform Act of 2009. The IG testified at a hearing on H.R. 682 on July 13, 2009, before the Subcommittee on Oversight and Investigations of the House of Representatives Committee on Financial Services (see Appendix B). In addition, on June 30, 2009, the IG provided a letter to the Honorable Paul E. Kanjorski (D-Pennsylvania), Chairman of the Subcommit-

tee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services that contained several suggestions for possible legislative revisions arising out of the OIG's investigation of the SEC's failure to uncover Bernard Madoff's Ponzi scheme. Additional information concerning these legislative suggestions is contained in the section of this Report on Congressional Testimony, Briefings and Requests.

In coordination with the Legislation Committee of the Council of the Inspectors General on Integrity and Efficiency and the IGs from several other Federal financial regulatory agencies, the OIG closely reviewed, tracked and provided views on various legislation of interest to the IG community and, in particular, the financial regulatory agency IGs. This legislation included, among other provisions, H.R. 885, the Improved Financial and

Commodity Markets Oversight and Accountability Act, and a similar Senate bill, S. 1354; S. 1508, the Improper Payments Elimination and Recovery Act of 2009; S. 976, a bill amending provisions of the Paperwork Reduction Act, 44 U.S.C. § 3518(c); and proposed technical and conforming amendments to the Inspector General Reform Act of 2008, Pub. L. No. 110-409. On July 7, 2009, the SEC IG, jointly with the IGs of the Commodity Futures Trading Commission, the National Credit Union Administration, the Pension Benefit Guaranty Corporation and the Board of Governors of the Federal Reserve System, provided letters to Senator Joseph I. Lieberman (D-Connecticut), Chairman, and Senator Susan M. Collins (R-Maine), Ranking Member, of the Senate Committee on Homeland Security and Government Affairs, setting forth their views on S. 1354, which, like H.R. 885, would require Presidential appointments and Senate confirmations for these IGs.



# SEMIANNUAL REPORT TO CONGRESS

## **STATUS OF RECOMMENDATIONS WITH NO MANAGEMENT DECISIONS**

Management decisions have been made on all audit reports issued before the beginning of this reporting period.

## **REVISED MANAGEMENT DECISIONS**

No management decisions were revised during the period.

## **AGREEMENT WITH SIGNIFICANT MANAGEMENT DECISIONS**

The Office of Inspector General agrees with all significant management decisions regarding audit recommendations.

## **INSTANCES WHERE INFORMATION WAS REFUSED**

During this reporting period, there were no instances where information was refused.





## Table 1 List of Reports: Audits and Evaluations

Audit / Evaluation Number	Title	Date Issued
458	<b>The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)</b>	Aug 27, 2009
465	<b>Review of the SEC's Compliance with the Freedom of Information Act</b>	Sep 25, 2009
467	<b>Program Improvements Needed Within the SEC's Division of Enforcement</b>	Sep 29, 2009
468	<b>Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC</b>	Sep 29, 2009
469	<b>Management Alert - Microsoft Premier Support Services Contract</b>	Aug 10, 2009
471	<b>Audit of the Office of Acquisitions' Procurement and Contract Management Functions</b>	Sep 25, 2009



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

	Number of Reports	Value
A. REPORTS ISSUED PRIOR TO THIS PERIOD		
For which no management decision had been made on any issue at the commencement of the reporting period	2	\$391,550.00
For which some decisions had been made on some issues at the commencement of the reporting period	1	\$129,336.00
B. REPORTS ISSUED DURING THIS PERIOD	1	\$25,000.00
TOTAL OF CATEGORIES A AND B	4	\$545,886.00
C. For which final management decisions were made during this period	0	\$0.00
D. For which no management decisions were made during this period	4	\$545,886.00
E. For which management decisions were made on some issues during this period	0	\$0.00
TOTAL OF CATEGORIES C, D AND E	4	\$545,886.00



## Table 3 Reports With Recommendations on Which Corrective Action Has Not Been Completed

RECOMMENDATIONS OPEN 180 DAYS OR MORE

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
365 - IT Capital Investment Decision-Making Follow-Up	03/29/2004	Publish a charter for the Information Officers Council.
412 - Oversight of the PCAOB	09/28/2006	Review the Public Company Accounting Oversight Board's (PCAOB) disaster contingency plan.
		Develop procedures for several PCAOB oversight issues.
421 - Investment Company Disclosure Initiatives	09/25/2007	Develop outcome-based performance indicators for disclosure initiatives.
428 - Electronic Documents Program	07/25/2007	Issue program guidance.
		Develop written procedures for loading data work from the regional offices.
		Consider a larger forensics lab.
430 - Contract Ratifications	09/25/2007	Reevaluate procurement in the regional offices.
		Develop procurement procedures and provide training for the regional offices.
433 - Corporation Finance Referrals	09/30/2008	Develop a centralized tracking system for Divisions of Enforcement and Corporation Finance (CF) staff regarding non-delinquent filer referrals.

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
		Enhance CF's gatekeeper role once outcome information becomes more available.
437 - Security Enhancements in Station Place Parking Garage	10/22/2007	Install cameras in Station Place parking garage.
438 - SRO Rule Filing Process	03/31/2008	Enhance the Self Regulatory Organization Rule Tracking System by identifying comment letters, improving speed, retaining proposed rule changes in inbox, and ensuring upload of all comment letters.
439 - Student Loan Program	03/27/2008	Undertake actions to delegate in writing approving waivers, amend Form 2497, and issue guidance for approval requirements of Student Loan Program (SLP) awards.
		Review Office of Personnel Management regulation to ensure proper individual approves SLP awards.
		Ensure SLP files contain appropriate documentation of repayments by employees not completing service agreements.
		Ensure documentation in SLP files correctly indicates who prepared/reviewed the payments.
		Implement methods to mitigate the risk of fraudulent documentation submitted by employees.
		Ensure the reliability of management records regarding former employees.
		Review the reliability of management records involving former employees.
		Implement a separation of duties in the review, processing and approval of SLP awards.
		Consult with the Department of Interior to ensure that monies owed to the SEC are collected, documented and recorded in a timely manner.
		Conduct a thorough review of the employee clearance process to initiate improvements.

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
		Implement recommendations of contractor retained by the Office of Financial Management to increase the likelihood of collection of employee debts relating to the SLP or, if not feasible, prepare a report explaining why the recommendations were not implemented.
		In consultation with the Union, provide supervisors with guidance on preparing substantial justification memoranda.
		Return to supervisors justification memoranda that lack substantiation of the criteria.
		Prepare document regarding the required criteria for justification memoranda for the 2008 Open Season.
		Implement an automated process for monitoring lifetime awards before the 2009 Open Season.
		Develop a plan to obtain data and a methodology to analyze and record data to comply with Collective Bargaining Agreement requirements.
		In consultation with the Union, develop a detailed distribution plan.
442 - Enterprise Architecture Assessment	03/31/2008	Develop Enterprise Architecture (EA) metrics to assess or track SEC's performance in implementing, and tracking performance of, SEC Federal Enterprise Architecture (FEA) program.
		Through the Information Technology Capital Planning and Investment Control Board, require periodic reports on EA progress overall, including specifically how EA can help to make strategic purchasing decisions.
		Create subcommittees on Data Management, Technology Standards, IT Strategy and other areas of focus.
		Involve EA in all technology implementations, especially ones that are "fast tracked."
		Through high-level policy makers, establish a process that ensures participation from the EA team prior to approving IT initiatives.

<b>Audit/Inspection/ Evaluation # and Title</b>	<b>Issue Date</b>	<b>Summary of Recommendation</b>
446A - SEC's Oversight of Bear Stearns and Related Entities: CSE Program	09/25/2008	Require compliance with existing rule requiring external auditors to review the CSE firms' risk management control systems, or seek Commission approval for deviation from this requirement.
		Develop internal guidelines for timely CF filing reviews, and track and monitor compliance with these guidelines.
		Create a Task Force led by the Office of Risk Assessment to determine the costs and benefits of supervising on a consolidated basis large firms that hold significant amounts of customer funds and have unregulated entities.
		Establish a policy outlining when firms are expected to respond substantively to issues raised in CF comment letters, and track and monitor compliance with this policy.
446B - SEC's Oversight of Bear Stearns and Related Entities: BD Risk Assessment Program	09/25/2008	Establish a timeframe to update and finalize rules 17h-1T and 17h-2T within six months.
		Ensure the BDRA system includes financial information, staff notes and other written documentation and is used to generate management reports.
		Resolve technological problems with the BDRA system.
447- Premium Travel	09/29/2008	Revise current policies and procedures to ensure that they are comprehensive and current.
		Enhance travel computer system to produce travel upgrade data and implement procedures to ensure all upgrades are approved prior to travel.
448 - 2008 Sensitive Payments	03/27/2009	Provide a detailed justification for senior officer merit pay increases of \$20,000 or more, or bonuses of \$20,000 or more.
		Send written reminder to senior executives that time and attendance should be certified by a senior official of equal or higher grade.
		Revise policies and procedures to inform travelers of proper currency conversion rates.



Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
		Keep an account of prohibited gifts that are returned of which the Ethics Office has knowledge.
450 - Practices Related to Naked Short Selling Complaints and Referrals	03/08/2009	Develop written in-depth triage analysis steps for naked short selling complaints.
		Revise written guidance to Enforcement Complaint Center (ECC) staff to ensure proper scrutiny and referral of naked short selling complaints.
		Add naked short selling to categories of complaints on public webpage and develop tailored online complaint form.
		Develop uniform written policies and procedures for the Complaints, Tips and Referrals (CTR) program at headquarters and the regional offices.
		Designate office or individual at headquarters to provide nationwide oversight for the CTR program.
		Require the Office of Internet Enforcement (OIE) to perform necessary follow-up to ensure that all CTR packages contain complete documentation and are entered into the CTR database.
		Require regional office senior officials to perform monthly review of CTRs.
		Improve analytical capabilities of the ECC's e-mail complaint system.
		Improve CTR database to include additional information about and better track complaints.
		Ensure OIE updates and resumes using previous complaint referral tracking system or develops a new system.
451- 2008 Federal Information Security Management Act (FISMA) Executive Summary Report	09/29/2008	Address certain requirements, including modifying all contracts related to common security settings to include the new Federal Acquisition Regulation 2007-004 language.
452 - Enforcement's Disgorgement Waivers	02/03/2009	Ensure staff comply with procedures and consider payment plans and partial waivers.

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
		Ensure the review of financial information for accuracy prior to recommending a disgorgement waiver.
		Clarify policies and procedures regarding when supporting documentation should be obtained and retained.
		Ensure sworn financial statements from defendants/respondents who request disgorgement waivers are retained, signed and notarized.
		Ensure checklist for disgorgement waiver cases is retained and signed by supervisor.
		Ensure documentation is retained in case files and compliance with procedures for obtaining tax returns.
		Ensure public database searches are performed for all defendants/respondents.
		Ensure staff attorneys receive periodic formal training in disgorgement waiver process.
454 - The Division of Enforcement's Draft Policies and Procedures Governing the Selection of Receivers, Fund Administrators, Independent Distribution Consultants, Tax Administrators and Independent Consultants	09/16/2008	Revise policy on the selection of receivers and independent consultants to address actual and apparent conflicts of interest and provide guidance to staff.
		Determine whether any time limit should be placed on a request for conflict of interest or background information, or whether that information should be requested for more than five years.
		Include in the attachment to the policy the applicant's certification that the information provided is complete and truthful and that the applicant understands the consequences for providing false information.

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
455- Attorney Annual Certification of Bar Membership	09/09/2008	Require all SEC attorneys to certify annually that they are active bar members and to acknowledge that their failure to maintain active bar membership may result in referral to the appropriate authorities and/or disciplinary action.
456 - Public Transportation Benefit Program	03/27/2009	Conduct periodic training and issue reminders to Administrative Officers to verify participants' eligibility and commuting costs.
		Conduct internal review periodically of program participants to ensure proper reduction of benefits.
		Implement additional management controls over regional office program operations.
459 - Regulation D Exemption Process	03/31/2009	Develop process to assess and ensure compliance with Regulation D.
		Establish procedures to review Form D information in the aggregate and develop management reports.
		Take appropriate action when issuers fail to file Form D.
		Reintroduce early intervention program and use it to assist in enforcement of Regulation D.
		Develop criteria for referral of potential Regulation D abuses and improve communication and coordination with the Division of Enforcement.
		Take efforts to finalize proposed rule.
		Raise with Commission the option of making Filing Form D a condition for claiming Regulation D Exemptions.
		Discuss enhancements to and work to revise Form D.
		Coordinate with staff who review registration statements, 10-Ks and 8-Ks and follow up with delinquent Form D filers.

Audit/Inspection/ Evaluation # and Title	Issue Date	Summary of Recommendation
		Issue formal, public guidance on how to request a waiver of disqualification under Rule 505.
		Evaluate Electronic Data Gathering And Retrieval (EDGAR) authentication process and make necessary changes to further streamline or simplify the process.
		Analyze how other agencies have implemented authentication processes and implement any appropriate procedures.
		Work with the North American Securities Administrators' Association (NASAA) to finalize memorandum of understanding and recommend Commission approval.
		Timely coordinate with NASAA staff to develop system to enable issuers to file Form D electronically with the states.
		Determine further coordination with NASAA staff and contact state regulatory staff when discussing and drafting proposed Regulation D rule changes.
461 - The Commission's Restacking Project	03/31/2009	Conduct another survey of staff after the restacking process has been completed.
		Conduct appropriate analysis and complete and submit an Exhibit 300 to the Office of Management and Budget (OMB).
		Develop and adopt policies and procedures for investments in space consistent with OMB guidance.
464 - Notification to the OIG of Decisions on Disciplinary Actions and Settlement Agreements Involving Subjects of OIG Investigations	01/23/2009	Provide the OIG with three business days notice prior to decisions on disciplinary action.
		Provide the OIG with five business days notice prior to executing settlement agreements.

## Table 4 Summary of Investigative Activity

<b>CASES</b>	<b>NUMBER</b>
Cases Open as of 3/31/09	21
Cases Opened during 3/31/09 - 9/30/09	9
Cases Closed during 3/31/09 - 9/30/09	13
Total Open Cases as of 9/30/09	17
Referrals to Department of Justice for Prosecution	5
Prosecutions	1
Convictions	0
Referrals to Agency for Disciplinary Action	7
<b>PRELIMINARY INQUIRIES</b>	<b>NUMBER</b>
Inquiries Open as of 3/31/09	49
Inquiries Opened during 3/31/09 - 9/30/09	49
Inquiries Closed during 3/31/09 - 9/30/09	20
Total Open Inquiries as of 9/30/09	78
Referrals to Agency for Disciplinary Action	8
<b>DISCIPLINARY ACTIONS</b>	<b>NUMBER</b>
Removals (Including Resignations)	2
Suspensions	0
Reprimands	1
Warnings/Other Actions	5



## Table 5 Summary of Complaint Activity

DESCRIPTION	NUMBER
Complaints Pending Disposition at Beginning of Period	18
Hotline Complaints Received	162
Other Complaints Received	104
Total Complaints Received	266
Complaints on which a Decision was Made	246
Complaints Awaiting Disposition at End of Period	38
<b>Disposition of Complaints During the Period</b>	
Complaints Resulting in Investigations	8
Complaints Resulting in Inquiries	49
Complaints Referred to OIG Office of Audits	4
Complaints Referred to Other Agency Components	106
Complaints Referred to Other Agencies	11
Complaints Included in Ongoing Investigations or Inquiries	18
Response Sent/Additional Information Requested	59
No Action Needed	6





## Table 6 References to Reporting Requirements of the Inspector General Act

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

	<b>INSPECTOR GENERAL ACT REPORTING REQUIREMENT</b>	<b>PAGES</b>
Section 4(a)(2)	Review of Legislation and Regulations	101-102
Section 5(a)(1)	Significant Problems, Abuses, and Deficiencies	13-21, 24-51, 56-95
Section 5(a)(2)	Recommendations for Corrective Action	19-21, 24-51, 56-95
Section 5(a)(3)	Prior Recommendations Not Yet Implemented	109-116
Section 5(a)(4)	Matters Referred to Prosecutive Authorities	56-95, 117
Section 5(a)(5)	Summary of Instances Where Information Was Unreasonably Refused or Not Provided	103
Section 5(a)(6)	List of OIG Audit and Evaluation Reports Issued During the Period	105
Section 5(a)(7)	Summary of Significant Reports Issued During the Period	24-51, 56-95
Section 5(a)(8)	Statistical Table on Management Decisions with Respect to Questioned Costs	107
Section 5(a)(9)	Statistical Table on Management Decisions on Recommendations That Funds Be Put To Better Use	107
Section 5(a)(10)	Summary of Each Audit, Inspection or Evaluation Report Over Six Months Old for Which No Management Decision Has Been Made	103
Section 5(a)(11)	Significant Revised Management Decisions	103
Section 5(a)(12)	Significant Management Decisions with Which the Inspector General Disagreed	103





# SEMIANNUAL REPORT TO CONGRESS

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**Written Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the U.S. Senate  
Committee on Banking, Housing and Urban Affairs**

**Thursday, September 10, 2009  
2:30 p.m.**

## **Introduction**

Good afternoon. Thank you for the opportunity to testify today before this Committee on the subject of “Oversight of the SEC’s Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance” as the Inspector General of the Securities and Exchange Commission (SEC). I appreciate the interest of the Chairman, as well as the other members of the Committee, in the SEC and the Office of Inspector General (OIG). In my testimony today, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

Since being appointed as the Inspector General of the SEC in December 2007, my Office has issued numerous audit and investigative reports involving issues critical to SEC operations and the investing public. These have included comprehensive audit reports on important topics such as the factors that led to the collapse of Bear Stearns, the Division of Enforcement’s (Enforcement) efforts pertaining to complaints about naked short selling, and the SEC’s oversight of credit rating agencies. We have also issued investigative reports regarding a wide range of allegations including claims of improper securities trading by SEC employees, preferential treatment given to high-level securities industry officials, retaliatory termination, Enforcement’s failure to vigorously pursue an investigation, and perjury by supervisory Commission attorneys.

### **Request to Undertake Madoff Investigation**

On the late evening of December 16, 2008, former SEC Chairman Christopher Cox contacted me and asked my Office to undertake an investigation into allegations made to the SEC regarding Bernard L. Madoff (Madoff), who had just confessed to

operating a multi-billion dollar Ponzi scheme, and the reasons why the SEC had found these allegations to be not credible.

### **Commencement of our Madoff Investigation**

We began our investigation immediately. On December 18, 2008, we issued a document preservation notice to the entire SEC, stating that the OIG had initiated an investigation regarding all Commission examinations, investigations or inquiries involving Madoff, and/or any related individuals or entities. We formally requested that each SEC employee and contractor preserve all electronically-stored information and paper records related to Madoff in their original format.

We also took immediate steps to begin gathering evidence. On December 17, 2008, we initiated our first request for e-mail records from the SEC's Office of Information Technology (OIT). Over the course of the investigation, the OIG made numerous requests from OIT for e-mails, including: (1) all e-mails of former Office of Compliance Inspections and Examinations (OCIE) employee Eric Swanson during his tenure with the SEC; (2) all e-mails of six staff members who were involved in the SEC's investigation of the Madoff firm that was initiated in 2006 for the period from January 2006 through January 2008; (3) all e-mails for SEC Headquarters, New York Regional Office (NYRO) and Boston Regional Office (BRO) staff members from January 1, 1999, through December 11, 2008, that contained the word "Madoff"; (4) additional e-mails for approximately 68 current and former SEC employees for various time periods relevant to the investigation, ranging from 1999 to 2009. In all, we estimate that we obtained and searched approximately 3.7 million e-mails during the course of our investigation.

On December 24, 2008, we sent comprehensive document requests to both Enforcement and OCIE, specifying the documents and records we required to be produced for the investigation. We followed up with memoranda to OCIE in April, May and June of 2009. We also had follow-up communications with Enforcement on January 21, 2009 and July 22, 2009. We further had numerous e-mail and telephonic communications with both OCIE and Enforcement regarding the scope and timing of the document requests and responses, as well as meetings to clarify and expand the document requests as necessary.

We collected all the information produced in response to our document production request. We then carefully reviewed and analyzed the investigative records of all SEC investigations conducted relating to Madoff, the Madoff firm, members of Madoff's family, and Madoff's associates from 1975 to the present.

During the investigation, we also reviewed the workpapers and examination files of nine SEC examinations of Madoff's firms from 1990 to December 11, 2008. Where documents from the examinations were not available, we sought testimony and conducted interviews of current and former SEC personnel who had worked on the examinations.

We also sought information and documentation from third parties in order to undertake our own analysis of Madoff's trading records. During the course of the OIG investigation, we requested and obtained records from: (1) the Depository Trust Company (DTC) relating to position reports for Madoff's firm; (2) the National Securities Clearing Corporation (NSCC) relating to clearing data records for executions effected by Madoff's firm; and (3) the Financial Industry Regulatory Authority (FINRA) Order Audit Trail System data (OATS) submitted by Madoff's firm for six National



Association of Securities Dealers Automated Quotations (NASDAQ)-listed stocks and the NASDAQ Automated Confirmation of Transactions (ACT) database for a trading period in March of 2005.

### **Retention of Experts**

In order to assist us in the Madoff investigation, we retained two sets of outside consultants. In February 2009, we retained FTI Consulting, Inc. (FTI engagement team) to assist with the review of the examinations of Madoff and his firms that were conducted by the SEC. Members of the FTI engagement team engaged by the OIG included Charles R. Lundelis, Jr., Senior Managing Director, Forensic and Litigation Consulting; Simon Wu, Managing Director, Forensic and Litigation Consulting; John C. Crittenden III, Managing Director, Corporate Finance Group; and James Conversano, Director, Forensic and Litigation Consulting. Each individual member of the FTI engagement team brought a unique and specialized experience to the analyses that FTI engagement team conducted, including expertise in complex financial fraud investigations, securities-related inspections and examinations, hedge fund operations, cash flow analysis and valuations, market regulation rules, market structure issues, accounting fraud, investment suitability, the underwriting process and compliance and due diligence practices.

At our direction, the FTI engagement team conducted a thorough review of all relevant workpapers and documents associated with the OCIE examinations of Madoff's firm, scrutinized the conduct of the Madoff-related SEC examinations and investigations, and analyzed whether the SEC examiners overlooked red flags that could have led to the discovery of Madoff's Ponzi scheme. The FTI engagement team also replicated aspects of

the OCIE cause examinations of Madoff to determine whether the SEC sought the appropriate information in the examinations and analyzed that information correctly.

In addition, OIT advised us during the course of our investigation that there were substantial gaps in the e-mails we were seeking to review as part of our investigation because of failures to back up tapes, hardware or software failures during the backup process, and/or lost, mislabeled or corrupted tapes. In order to ensure that we were able to conduct a thorough and comprehensive investigation, in June 2009, we retained the services of First Advantage Litigation Consulting Services (First Advantage) to assist us in the restoration and production of relevant electronic data. First Advantage's team had significant experience in leading numerous large-scale electronic discovery consulting projects, as well as assisting with highly sensitive and confidential investigations for corporations and the Federal Bureau of Investigation.

In connection with its retention on the Madoff investigation, First Advantage provided consulting and technical support to the OIG and the SEC, and was able to successfully preserve and restore potentially relevant data within the universe of electronic data we had requested from OIT. As a result, we were able to review additional Madoff-related e-mails that were pertinent to our investigation.

#### **Testimony and Interviews Conducted in the Madoff Investigation**

We also conducted 140 testimonies under oath or interviews of 122 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Madoff and his firms. We interviewed all current or former SEC employees who had played any significant role in the SEC's significant examinations and investigations of Madoff and his firms over a period spanning approximately 20 years.

### **The OIG's Investigative Team**

I think it appropriate to acknowledge the extraordinary efforts of the OIG Investigative team that I have been honored to lead in conducting this important investigation. These included Deputy Inspector General Noelle Frangipane, Assistant Inspector General for Investigations David Fielder, and Senior Counsels Heidi Steiber, David Witherspoon and Christopher Wilson. Additional assistance was provided to this investigation by my Assistant, Roberta Raftovich, in coordinating many of the administrative aspects of compiling the report. Without the incredible devotion and exceptional work of these individuals, we would not have been able to complete this investigation and present a thorough and comprehensive report within such a short period of time.

### **Issuance of Comprehensive Report of Investigation**

On August 31, 2009, we issued to the Chairman of the SEC a comprehensive report of investigation (ROI) in the Madoff matter containing over 450 pages of analysis. The ROI detailed the SEC's response to all complaints it received regarding the activities of Madoff and his firms, and traced the path of these complaints through the Commission from their inception, reviewing what, if any, investigative or examination work was conducted with respect to the allegations. Further, the ROI assessed the conduct of examinations and/or investigations of Madoff and his firm by the SEC and analyzed whether the SEC examiners or investigators overlooked red flags (which other entities conducting due diligence may have been identified) that could have led to a more comprehensive examination or investigation and possibly the discovery of Madoff's Ponzi scheme.

Our ROI also analyzed the allegations of conflicts of interest arising from relationships between any SEC officials or staff and members of the Madoff family. This included an examination of the role that former SEC OCIE Assistant Director Eric Swanson (Swanson), who eventually married Madoff's niece Shana Madoff, may have played in the examination or other work conducted by the SEC with respect to Madoff or related entities, and whether such role or relationship in any way affected the manner in which the SEC conducted its regulatory oversight of Madoff and any related entities.

We have also considered the extent to which the reputation and status of Madoff and the fact that he served on SEC Advisory Committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials, may have affected Commission decisions regarding investigations, examinations and inspections of his firm.

### **Results of the Madoff Investigation**

The OIG investigation found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's investment adviser operations and should have led to questions about whether Madoff was actually engaged in trading. We also found that the SEC was aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent investment returns.

Our report concluded that notwithstanding these six complaints and two articles, the SEC never conducted a competent and thorough examination or investigation of

Madoff for operating a Ponzi scheme and that, had such a proper examination or investigation been conducted, the SEC would have been able to uncover the fraud.

The first complaint, which was brought to the SEC's attention in 1992, related to allegations that an unregistered investment company was offering "100%" safe investments with high and extremely consistent rates of return over significant periods of time to "special" customers. The SEC actually suspected the investment company was operating a Ponzi scheme and learned in its investigation that all of the investments were placed entirely through Madoff and consistent returns were claimed to have been achieved for numerous years without a single loss.

The second complaint was very specific, and different versions of it were provided to the SEC in May 2000, March 2001 and October 2005. The complaint submitted in 2005 was entitled, "The World's Largest Hedge Fund is a Fraud," and detailed approximately 30 red flags indicating that Madoff was operating a Ponzi scheme, a scenario it described as "highly likely." These red flags included the impossibility of Madoff's returns, particularly the consistency of those returns and the unrealistic volume of options Madoff represented to have traded.

In May 2003, the SEC received a third complaint from a respected hedge fund manager identifying numerous concerns about Madoff's strategy and purported returns. Specifically, the complaint questioned whether Madoff was actually trading options in the volume he claimed, noted that Madoff's strategy and purported returns were not duplicable by anyone else, and stated that Madoff's strategy had no correlation to the overall equity markets in over ten years. According to an SEC manager, the hedge fund manager's complaint laid out issues that were "indicia of a Ponzi scheme."

The fourth complaint was part of a series of internal e-mails of another registrant that the SEC discovered in April 2004. The e-mails described the red flags that a registrant's employees had identified while performing due diligence on their own Madoff investment using publicly-available information. The red flags identified included Madoff's incredible and highly unusual fills for equity trades, his misrepresentation of his options trading, and his unusually consistent, non-volatile returns over several years. One of the internal e-mails provided a step-by-step analysis of why Madoff must be misrepresenting his options trading. The e-mail clearly explained that Madoff could not be trading on an options exchange because of insufficient volume and could not be trading options over-the-counter because it was inconceivable that he could find a counterparty for the trading. The SEC examiners who initially discovered the e-mails viewed them as indicating "some suspicion as to whether Madoff is trading at all."

The SEC received the fifth complaint in October 2005 from an anonymous informant. This complaint stated, "I know that Madoff [sic] company is very secretive about their operations and they refuse to disclose anything. If my suspicions are true, then they are running a highly sophisticated scheme on a massive scale. And they have been doing it for a long time." The informant also stated, "After a short period of time, I decided to withdraw all my money (over \$5 million)."

The sixth complaint was sent to the SEC by a "concerned citizen" in December 2006, and advised the SEC to look into Madoff and his firm as follows:

Your attention is directed to a scandal of major proportion which was executed by the investment firm Bernard L. Madoff . . . Assets well in excess of \$10 Billion owned by the late [investor], an ultra-wealthy long time client of the

Madoff firm have been “co-mingled” with funds controlled by the Madoff company with gains thereon retained by Madoff.

In March 2008, the SEC Chairman’s Office received a second copy of the previous complaint, with additional information from the same source regarding Madoff’s involvement with the investor’s money, as follows:

It may be of interest to you to that Mr. Bernard Madoff keeps two (2) sets of records. The most interesting of which is on his computer which is always on his person.

The two 2001 journal articles also raised significant questions about Madoff’s unusually consistent returns. One of the articles noted his “astonishing ability to time the market and move to cash in the underlying securities before market conditions turn negative and the related ability to buy and sell the underlying stocks without noticeably affecting the market.” This article also observed that “experts ask why no one has been able to duplicate similar returns using [Madoff’s] strategy.” The second article quoted a former Madoff investor as saying, “Anybody who’s a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naïve.”

The complaints all contained specific information and could not have been fully and adequately resolved without a thorough examination and investigation of Madoff for operating a Ponzi scheme. The journal articles should have reinforced the concerns expressed in the complaints about how Madoff could have been achieving such unusually high returns.

According to the FTI engagement team, the most critical step in examining or investigating a potential Ponzi scheme is to verify the subject’s trading through an

independent third party. The OIG investigation found that the SEC conducted two investigations and three examinations related to Madoff's investment adviser business based upon the detailed and credible complaints that raised the possibility that Madoff was misrepresenting his trading and could have been operating a Ponzi scheme. Yet, at no time did the SEC ever verify Madoff's trading through an independent third party and, in fact, SEC staff never actually conducted a Ponzi scheme examination or investigation of Madoff.

The first examination and first Enforcement investigation involving Madoff were conducted in 1992 after the SEC received information that led it to suspect that a Madoff associate had been conducting a Ponzi scheme. Yet, the SEC focused its efforts on Madoff's associate and never thoroughly scrutinized Madoff's operations even after learning that Madoff made all the investment decisions and being apprised of the remarkably consistent returns Madoff had claimed to achieve over a period of numerous years with a basic trading strategy. While the SEC ensured that all of Madoff's associate's customers received their money back, it took no steps to investigate Madoff. The SEC focused its investigation too narrowly and seemed not to have considered the possibility that Madoff could have taken the money that was used to pay back his associate's customers from other clients for which Madoff may have had held discretionary brokerage accounts. In the examination of Madoff, although the SEC did seek records maintained by DTC (an independent third party), they obtained those DTC records from Madoff rather than going to DTC itself to verify if trading occurred. Had the SEC sought records from DTC, there is an excellent chance it would have uncovered Madoff's Ponzi scheme in 1992.



In 2004 and 2005, the SEC's examination unit, OCIE, conducted two parallel cause examinations of Madoff based upon the hedge fund manager's complaint and the series of internal e-mails the SEC had discovered. The examinations were remarkably similar in nature. There were initial significant delays in the commencement of the examinations, notwithstanding the urgency of the complaints. The teams assembled were relatively inexperienced, and there was insufficient planning for the examinations. The scopes of the examination were in both cases too narrowly focused on the possibility of front-running, with no significant attempts made to analyze the numerous red flags about Madoff's trading and returns.

During the course of both these examinations, the examination teams discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies. However, they either disregarded these concerns or simply asked Madoff about them. Even when Madoff's answers were seemingly implausible, the SEC examiners accepted them at face value.

In both examinations, the examiners made the surprising discovery that Madoff's mysterious hedge fund business was making significantly more money than his well-known market-making operation. However, none of the examiners identified this revelation as a cause for concern.

Astoundingly, both examinations were open at the same time in different offices without either office knowing the other one was conducting a virtually identical examination. In fact, it was Madoff himself who informed one of the examination teams that the other examination team had already received the information being sought from him.

In the first of the two OCIE examinations, the examiners drafted a letter to the National Association of Securities Dealers (NASD) (another independent third party) seeking independent trade data, but they never sent the letter, claiming that it would have been too time-consuming to review the data they would have obtained. The OIG's expert opined that had the letter to the NASD been sent, the data collected would have provided the information necessary to reveal Madoff's Ponzi scheme. In the second examination, the OCIE Assistant Director sent a document request to a financial institution that Madoff claimed he used to clear his trades, requesting trading done by or on behalf of particular Madoff feeder funds during a specific time period, and received a response that there was no transaction activity in Madoff's account for that period. However, the Assistant Director did not determine that the response required any follow-up and the examiners working under the Assistant Director testified that the response was not shared with them.

Both examinations concluded with numerous unresolved questions and without any significant attempt to examine the possibility that Madoff was misrepresenting his trading and operating a Ponzi scheme.

The investigation that arose from the most detailed complaint provided to the SEC, which explicitly stated it was "highly likely" that "Madoff was operating a Ponzi scheme," never really investigated the possibility of a Ponzi scheme. The relatively inexperienced Enforcement staff failed to appreciate the significance of the analysis in the complaint, and almost immediately expressed skepticism and disbelief about the complaint. Most of the investigation was directed at determining whether Madoff should register as an investment adviser or whether Madoff's hedge fund investors' disclosures were adequate.

As with the examinations, the Enforcement staff almost immediately caught Madoff in lies and misrepresentations, but failed to follow up on inconsistencies. They rebuffed offers of additional evidence from the complainant, and were confused about certain critical and fundamental aspects of Madoff's operations. When Madoff provided evasive or contradictory answers to important questions in testimony, the staff simply accepted his explanations as plausible.

Although the Enforcement staff made attempts to seek information from independent third parties, they failed to follow up on these requests. They reached out to the NASD and asked for information on whether Madoff had options positions on a certain date. However, when they received a report that there were in fact no options positions on that date, they did not take any further steps. An Enforcement staff attorney made several attempts to obtain documentation from European counterparties (another independent third party) and, although a letter was drafted, the Enforcement staff decided not to send it. Had any of these efforts been fully executed, they would have led to Madoff's Ponzi scheme being uncovered.

The OIG also found that numerous private entities conducted basic due diligence of Madoff's operations and, without regulatory authority to compel information, came to the conclusion that an investment with Madoff was unwise. Specifically, Madoff's description of both his equity and options trading practices immediately led to suspicions about his operations. With respect to his purported trading strategy, many private entities simply did not believe that it was possible for Madoff to achieve his stated level of returns using a strategy described by some industry leaders as common and unsophisticated. In addition, there was a great deal of suspicion about Madoff's

purported options trading, with several entities not believing that Madoff could be trading options in such high volumes where there was no evidence that any counterparties had been trading options with Madoff.

The private entities' conclusions were drawn from the same red flags regarding Madoff's operations that the SEC considered in its examinations and investigations, but ultimately dismissed.

We also found that investors who may have been uncertain about whether to invest with Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud. Moreover, we found that Madoff proactively informed potential investors that the SEC had examined his operations. When potential investors expressed hesitation about investing with Madoff, he cited the prior SEC examinations to establish credibility and allay suspicions or investor doubts that may have arisen while due diligence was being conducted. Thus, the fact the SEC had conducted examinations and investigations and did not detect the fraud lent credibility to Madoff's operations and had the effect of encouraging additional individuals and entities to invest with him.

We did not, however, find evidence that any SEC personnel who worked on an SEC examination or investigation of Madoff or his firms had any financial or other inappropriate connection with Madoff or the Madoff family that influenced the conduct of the examination or investigatory work. We also did not find that former SEC Assistant Director Eric Swanson's romantic relationship with Bernard Madoff's niece, Shana Madoff, influenced the conduct of the SEC examinations of Madoff and his firm. We further did not find that senior officials at the SEC directly attempted to influence

examinations or investigations of Madoff or the Madoff firm, nor was there evidence any senior SEC official interfered with the staff's ability to perform its work.

As I discussed earlier, we did find that despite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme before Madoff confessed.

As a result of our findings, we have recommended that the Chairman carefully review our report and share with OCIE and Enforcement management the portions of this report that relate to performance failures by those employees who still work at the SEC, so that appropriate action (which may include performance-based action) is taken, on an employee-by-employee basis, to ensure that future examinations and investigations are conducted in a more appropriate manner and the mistakes and failures outlined in this report are not repeated.

### **Additional OIG Reports**

While the report we issued to the Chairman on August 31<sup>st</sup> describes in detail the factual circumstances surrounding the Madoff-related complaints received by the SEC and the SEC's examinations and investigations of Madoff over the years, my Office plans to issue three additional reports relating to these matters. Because our investigation identified systematic breakdowns in the manner in which the SEC conducted its examinations and investigations, we plan to issue two separate audit reports providing the

SEC with specific and concrete recommendations to improve the operations of both OCIE and Enforcement.

With respect to recommendations concerning OCIE, our expert, FTI, has conducted extensive fieldwork to analyze further the adequacy of OCIE's examinations of Madoff. The FTI engagement team reviewed our August 31, 2009 Report of Investigation, as well as related findings, exhibits, witness testimony and other supporting documentation (i.e., OCIE examination staff work papers), and interviewed over a dozen key personnel representing OCIE's broker-dealer, investment adviser and risk assessment programs. In addition, the FTI Engagement Team reviewed OCIE's policies and procedures with regard to its examination processes and other third party records, including FINRA order and execution data and DTC and NSCC records. The FTI Engagement Team also was granted access to OCIE's various Intranet sites, including the Broker-Dealer, Investment Adviser/Investment Company, Office of Market Oversight, and Training Branch sites, in order to view its examination policies and procedures.

The FTI engagement team is currently finalizing a report that will describe its analysis of OCIE's examination process and provide numerous "lessons learned" arising from its analysis, with specific recommendations to improve OCIE's operations. While these recommendations are currently in draft status, I can report that the recommendations we are considering include the following:

- Establishing a protocol for SEC examiners to identify relevant information from industry news articles and other sources outside of the agency;
- Establishing a protocol that explains how to identify red flags and potential violations of securities law based on an evaluation of information found in industry news articles and other relevant industry sources;

- The implementation of an OCIE-related collection system that adequately captures information relating to the nature and source of each tip or complaint and also chronicles the vetting process to document why each tip or complaint was or was not acted upon and who made that determination;
- Mandating procedures for review of credible and compelling tips and complaints;
- Mandating timelines for the vetting of tips and complaints, as well as for the commencement of cause examinations;
- Requiring proper procedures for the use of scope memoranda to ensure that examinations conducted in response to tips and complaints that are received are not too narrowly focused;
- Establishing procedures for the timely modification of scope memoranda when significant new facts and issues emerge;
- Ensuring the appropriate review and analysis of planning memoranda for cause examinations to ensure that cause examinations are thoroughly planned based upon the tip or complaint that triggered the examination;
- Creating procedures to ensure that all steps of the examination methodology, as stated in the planning memorandum, are completed before the examination is closed;
- Requiring the documentation of all substantive interviews conducted by OCIE of registrants and third parties during OCIE's pre-examination activities and during the course of an examination;
- Prescribing procedures for the preparation of workpapers for an OCIE examination to ensure sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached;
- Establishing, reviewing and testing procedures for logging all OCIE examinations into an examination tracking system;
- Ensuring that the focus of an examination is determined in an appropriate and thoughtful manner, and not simply based upon on the availability or the skills of a particular group of examiners;
- Ensuring that personnel with the appropriate skills and expertise are assigned to cause examinations with unique or discrete needs;
- Requiring that a Branch Chief, or a similarly-designated lead manager, be assigned to every substantive project including all cause examinations;

- Requiring the development of a formal plan within OCIE to ensure that OCIE staff and managers are obtaining and maintaining professional designations and/or licenses by industry certification programs that are relevant to their examination activities;
- Recommending the development and implementation of interactive exercises to be administered by OCIE training staff or an independent third party and reviewed prior to hiring new OCIE employees in order to evaluate the relevant skills necessary to perform examinations;
- The training of OCIE examiners in the mechanics of securities settlement, both in the United States and in major foreign markets;
- The training of OCIE examiners in methods to access the expertise of foreign regulators, such as the United Kingdom's Financial Services Authority, as well as foreign securities exchanges and foreign clearing and settlement entities;
- Requiring OCIE examination staff to verify a test sample of trading or balance data with counterparties and other independent third parties such as FINRA, DTC, or NSCC whenever there are specific allegations of fraud involved in an examination;
- Recommending the training of OCIE examiners jointly with the Office of Economic Analysis economists by FINRA, other self-regulatory organizations (SROs) and exchange staff in understanding trading databases, regional exchanges, option exchanges, and DTC/NSCC, etc.;
- Ensuring that OCIE staff have direct access to certain databases maintained by SROs or other similar entities in order to allow examiners to access necessary data for verification or analysis of registrant data;
- Mandating procedures to ensure that when an examination team is pulled off an examination for a project of higher priority, the examination team return to the previous examination upon completion of the other project and bring the prior examination to a conclusion;
- Implementing procedures for tracking the progress of all cause examinations, including the number of cause examinations opened, the number ongoing and the number closed for each month; and
- Requesting OCIE management provide express support to their examiners regarding the examiners' pursuit of evidence in the course of an examination, even if pursuing that evidence requires contacting customers or clients of the target of that examination.



We are also finalizing a report that analyzes “lessons learned” from the investigations conducted by the SEC’s Enforcement Division of Madoff and prescribes concrete recommendations for improvement within Enforcement. For this analysis, we launched an extensive survey questionnaire to Enforcement staff and management in both headquarters and the regional offices. This survey was designed to obtain feedback from Enforcement staff on numerous topics, such as allocation of resources, performance measurement, case management procedures, communication, adequacy of policies and procedures, employee morale, and management efficiency and effectiveness.

The Enforcement-related recommendations that we are currently considering include the following:

- Establishing formal guidance for evaluating various types of complaints (e.g., Ponzi schemes) and training of appropriate staff on the use of such guidance;
- Ensuring that the SEC’s tip and complaint handling system provides for data capture of relevant information relating to the vetting process to document why a complaint was or was not acted upon and who made that determination;
- Requiring tips and complaints to be reviewed by individuals experienced in the subject matter to which the complaint or tip relates, prior to a decision not to take further action;
- Establishing guidance to require that all complaints that appear on the surface to be credible and compelling be probed further by in-depth interviews with the sources to assess the complaints’ validity and to determine what issues need to be investigated;
- The training of staff to ensure they are aware of the guidelines contained in Section 3 of the Enforcement Manual and Title 17 of the Code of Federal Regulations, Section 202.10, for obtaining information from outside sources;
- Requiring annual review and testing of the effectiveness of Enforcement’s policies and procedures with regard to its tip and complaint handling system;
- Implementing procedures to ensure that investigations are assigned to teams comprised of individuals who have sufficient knowledge of the pertinent subject matter (e.g. Ponzi schemes);

- The training of staff on what resources and information are available within the Commission, including how and when assistance from internal units should be requested;
- Mandating that planning memoranda be prepared at the beginning of an investigation and that the plan include a section identifying what type of expertise or assistance is needed from others within and outside the Commission;
- Requiring that after the planning memorandum is drafted, it be circulated to all team members assigned to the investigation, and all team members then meet to discuss the investigation approach, methodology and any concerns team members wish to raise;
- Conducting periodic internal reviews of any newly-implemented policies and procedures related to information sharing with divisions and offices outside of Enforcement to ensure they are operating efficiently and effectively and necessary changes are made;
- Requiring that the planning memoranda and associated scope, methodology and time frames be routinely reviewed by an investigator's immediate supervisor to ensure investigations remain on track and to determine whether adjustments in scope, etc. are necessary;
- Ensuring that sufficient resources, both supervisory and support, are dedicated to investigations up front to provide for adequate and thorough supervision of cases and effective handling of administrative tasks;
- Establishing policies and procedures to ensure staff have an understanding of what types of information should be validated during investigations with independent parties such as FINRA, DTC and the Chicago Board Options Exchange;
- Updating Enforcement's complaint handling procedures to ensure complaints received are properly vetted even if an investigation is pending closure; and
- Conducting periodic internal reviews to ensure that Matters Under Inquiry (MUIs) are opened in accordance with any newly-developed Commission guidance and examining ways to streamline the case closing process.

Both of these reports containing recommendations to OCIE and Enforcement will be finalized and issued within the next few weeks. We also plan to issue an additional report analyzing the reasons that OCIE's investment adviser unit did not

conduct an examination of Madoff after he was forced to register as an investment adviser in 2006, and prescribing recommendations as appropriate to improve this process. We plan to issue this report by the end of November 2009.

My Office is committed to following up with respect to all the recommendations that we will be making to ensure that significant changes and improvements are made in the SEC's operations as a result of our findings in the Madoff investigation. We are aware that improvements have already been begun under the direction of Chairman Schapiro even prior to our report being issued. We are confident that under Chairman Schapiro's leadership, the SEC will carefully review our analyses and reports and take the appropriate steps to implement our recommendations and ensure that fundamental changes are made in the SEC's operations so that the errors and failings we found in our investigation are properly remedied and not repeated in the future.

### **Conclusion**

In conclusion, we appreciate the Chairman's and the Committee's interest in the SEC and our Office and, in particular, in the facts and circumstances pertinent to the Madoff Ponzi scheme. I believe that the Committee's and Congress's continued involvement with the SEC is helpful in strengthening the accountability and effectiveness of the Commission. Thank you.



**Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Subcommittee on Oversight and  
Investigations, Committee on Financial Services  
U.S. House of Representatives**

**Monday July 13, 2009  
2:00 p.m.**

## **Introduction**

Good afternoon. Thank you for the opportunity to testify today before this Subcommittee on the subject of “Preventing Unfair Trading by Government Officials” as the Inspector General of the Securities and Exchange Commission (SEC or Commission). I appreciate the interest of the members of the Subcommittee in the SEC and the Office of Inspector General. In my testimony today, I am representing the Office of Inspector General, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks this afternoon by discussing the role of my Office and the oversight efforts we have undertaken during the past year. The mission of the Office of Inspector General is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC Office of Inspector General includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our Office of Audits conducts, coordinates and supervises independent audits and evaluations related to the Commission’s internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

Over the past year, we have issued numerous audit reports involving issues critical to SEC operations and the investing public, including a comprehensive report analyzing the Commission's oversight of the SEC's Consolidated Supervised Entity (CSE) program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers, and providing a detailed examination of the adequacy of the Commission's monitoring of Bear Stearns, including the factors that led to its collapse. In the past few months, we have also completed audits of the \$178 million in disgorgement waivers that the SEC Division of Enforcement (Enforcement) granted between October 2005 and May 2008, and Enforcement's practices and procedures for responding to and processing naked short selling complaints. We anticipate issuing several additional audit reports in the next few months, including a comprehensive analysis of the SEC's oversight of the Nationally Recognized Statistical Rating Organizations.

Our Office of Investigations examines allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The Office of Investigations conducts thorough and independent investigations into allegations received in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation (FBI) as appropriate.

Several of these investigations conducted by our staff have involved senior-level Commission employees and represent matters of great concern to the Commission, Congressional officials and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removals. Specifically, over the past year and a half, we have issued investigative reports regarding, inter alia, claims of improper preferential treatment given to prominent persons, retaliatory termination, the Division of Enforcement's failures to pursue Enforcement investigations vigorously or in a timely manner, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms, lack of impartiality in the performance of official duties, unauthorized disclosure of non-public information related to an Enforcement investigation, and the misuse of official position, government resources and official time.

In addition to the work I just described, we are conducting a wide-ranging investigation and evaluation of matters related to Bernard Madoff and affiliated entities. We have made substantial progress in our investigation and plan to issue shortly a comprehensive investigative report detailing all the examinations and investigations that the SEC conducted of Madoff or Madoff-related entities from 1992 until the present, and analyzing the reasons why the SEC did not uncover the Madoff Ponzi scheme, notwithstanding these examinations and investigations. We have already interviewed over 100 witnesses and reviewed millions of e-mails and documents in connection with these investigative efforts. We also plan to issue two additional reports providing specific and detailed recommendations for improvement of both the SEC's Division of



Enforcement and the Office of Compliance Inspections and Examinations, which will incorporate the findings from our investigative report.

### **The Investigation of the Securities Transactions of Enforcement Attorneys**

It is with this background in mind that I wish to discuss an investigation that we recently concluded relating to the securities transactions of two SEC Enforcement attorneys over a two-year period. Our office received information from the SEC's Ethics Office that a particular Enforcement attorney was trading securities very frequently. As we began investigating this Enforcement attorney's trading activity, we identified another Enforcement attorney who was a friend of this individual and with whom the first attorney often discussed securities transactions and open Enforcement investigations during regular weekly lunches and via e-mail.

We conducted a year-long investigation of these Enforcement attorneys, which encompassed a comprehensive review and analysis of more than two years of brokerage records, ethics filings, securities transaction filings, and e-mail records. We also took sworn, on-the-record testimony of numerous SEC Enforcement attorneys, and conducted interviews of several other SEC staff members.

On March 3, 2009, we issued our report of investigation to the agency. Our investigation revealed suspicious conduct, appearances of improprieties, and evidence of possible trading based on non-public information on the part of the two SEC Enforcement attorneys. Because of the seriousness of the information that our investigation uncovered, we referred the matter to the United States Attorney's Office of the District of Columbia's Fraud and Public Corruption Section, which, together with the FBI, is conducting an investigation of possible criminal and civil violations. Because this

joint U.S. Attorney/FBI investigation is ongoing, I am somewhat limited in my ability to discuss the details of this matter.

In addition to the suspicions of insider trading, our investigation found that the Enforcement attorneys committed numerous violations of the SEC's securities reporting requirements. For example, although SEC rules require employees to file a notification form within five business days of the purchase or sale of every security, these Enforcement lawyers failed to file these forms for certain transactions. Moreover, although the Office of Government Ethics (OGE) Form 450 requires the reporting of an employee's security holdings with a value greater than \$1,000 at the end of each calendar year or that generated income of more than \$200 during the year, the Enforcement attorneys failed to report certain transactions or earnings that were over these limits on their OGE Form 450s during the two-year period we reviewed during our investigation. We also found that the one of the Enforcement attorneys failed to clear numerous stock transactions through an agency database prior to purchasing stocks.

Our investigation further found generally that, although the SEC is charged with prosecuting cases of violations of the federal securities laws, including the investigation and prosecution of insider trading on the part of individuals and companies in the private sector, the SEC had essentially no compliance system in place to ensure that its own employees, with tremendous amounts of non-public information at their disposal, did not engage in insider trading themselves. The existing 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 as required. No spot checks were 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. Moreover, different SEC offices received the various types of reports and did not routinely share that information with each other.

We also found a poor understanding and lax enforcement of the securities transaction reporting requirements. For example, both of the Enforcement attorneys whose trading we investigated testified that no one had ever questioned their reported securities holdings or transactions in the decades they worked at the SEC and traded securities. Moreover, both managers who were responsible for reviewing these attorneys' annual OGE Form 450s testified that they did not recall ever questioning any SEC employees with respect to their reported securities holdings. In addition, we found that the Enforcement attorneys and supervisors who provided information during our investigation lacked a basic understanding of the requirements in place that govern Commission employees' reporting of securities transactions.

Our investigation also found that Enforcement personnel, both managers and staff, had different interpretations of the confidentiality policy regarding Enforcement investigations and whether they could discuss their investigative matters with one another. We found that the Enforcement attorneys we investigated routinely discussed stocks and investment strategies in e-mails and in public. They maintained separate folders entitled, "Stocks," in their SEC e-mail accounts and, on most days, sent e-mails from those accounts about stocks and their own stock transactions. We discovered that one of the Enforcement attorneys traded often, and even testified that the financial markets were her main hobby and passion. We found that this attorney spent much of her

work day e-mailing her co-workers about various stocks. We also found that these Enforcement attorneys shared many of the same investments and had regular weekly lunch meetings where they often discussed the stock market, their own securities transactions, and their SEC work and investigative cases.

Our investigation also disclosed that one of the Enforcement attorneys sent e-mails to his brother and sister-in-law from his SEC e-mail account during the work day recommending particular stocks, and sometimes informing them that the other Enforcement employee had recommended those stocks as well.

Our report recommended that the SEC take disciplinary action against the two Enforcement attorneys who we found violated the SEC's securities transactions requirements. We also provided the Commission with 11 specific recommendations to ensure adequate monitoring of employees' future securities transactions. These recommendations included establishing one primary office to monitor employees' securities transactions; instituting an integrated, computerized system for tracking and reporting purposes; obtaining duplicate copies of brokerage record confirmations for each securities transaction for every SEC employee; requiring employees to certify in writing that they do not have non-public information related to each security transaction they conduct and report; ensuring that the forms SEC employees are required to file are checked with the existing database; requiring SEC employees' supervisor to review a list of pending cases to compare with a list of the securities reported by the employees; conducting regular and thorough spot checks for compliance purposes; developing a clear, written policy on the confidentiality of Enforcement investigations; and

establishing comprehensive and more frequent training on all aspects of the SEC's rules regarding employees' securities transactions.

### **SEC Response to the OIG's Report of Investigation**

Our investigation underscored the need for the SEC to revamp completely its current process for monitoring SEC employees' securities transactions. In response to our report, on May 22, 2009, SEC Chairman Mary Schapiro announced that the SEC would be taking measures to address the problems we identified. These measures include drafting a new set of internal rules governing securities transactions for all SEC employees that will require pre-clearance of all trades and, for the first time, prohibit staff from trading in the securities of companies under SEC investigation regardless of whether the employee has personal knowledge of the investigation. Chairman Schapiro also announced that the SEC was contracting with an outside firm to develop a computer compliance system to track, audit and oversee employees' securities transactions and financial disclosure in real time. Chairman Schapiro further stated that she signed an order consolidating responsibility for oversight of employees' securities transactions and financial disclosure reporting within the Ethics Office and authorized the hiring of a Chief Compliance Officer.

The OIG is pleased that the SEC is planning to take concrete steps to address the serious issues identified by our investigation. These steps, if implemented, would satisfy the concerns raised in our report, and would even, in a few instances, go beyond the OIG's recommended actions. We plan to scrutinize carefully the new processes and system that the SEC intends to implement to ensure that they operate effectively and as planned.

### **Concluding Remarks**

In conclusion, we appreciate the Subcommittee's interest in the SEC and our Office. I believe that the Committee's and Congress's involvement with the SEC is beneficial to strengthen the accountability and effectiveness of the Commission. Thank you.

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