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

OFFICE OF
INSPECTOR GENERAL

May 4, 2009

By Hand Delivery

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate
231-A Hart Senate Office Building
Washington, D.C. 20510-6200

Dear Senator Grassley:

In response to your request dated March 26, 2009, enclosed please find the Office of Inspector General's (OIG) report of investigation concerning violations of rules governing employee securities transactions. Certain information has been redacted from the enclosed report at the request of the Office of General Counsel of the Securities and Exchange Commission (Commission) and the United States Attorney's Office for the District of Columbia.

Due to the nonpublic nature of the report, we were required to obtain the Commission's approval before providing the report to you. After following the appropriate processes, we received that approval on Friday, May 1, 2009. In approving our request, the Commission requested that we include the following statement in this transmittal letter: "The Inspector General report of investigation being provided today contains sensitive and nonpublic information, and disclosure could harm the Commission's ability to meet its statutory goals and the interests or reputations of individuals and entities. The confidentiality of the report should be maintained. We understand that it is not the practice of Congressional Committees to make public sensitive, nonpublic information without prior consultation with the responsible agency, and we request that you follow that practice in this instance."

Please do not hesitate to contact me at (202) 551-6037 if you have any questions.

Sincerely,

H. David Kotz
Inspector General

KEY:
- Bracketed numbers refer to persons.
- Bracketed letters refer to companies.

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MEMORANDUM

March 3, 2009

To: The Honorable Mary L. Schapiro
Chairman

From: H. David Kotz HDK
Inspector General

Re: Report of Investigation: Case No. OIG-481

Employees' Securities Transactions Raise Suspicions of Insider Trading and Create Appearances of Impropriety; Violations of Financial Reporting Requirements; and Lack of SEC Employee Securities Transactions Compliance System

Attached is our report of investigation into two Division of Enforcement attorneys' securities transactions during a two year period and whether each possibly engaged in insider trading, traded on nonpublic information, or violated the SEC's Rule 5 of the Conduct Regulation.

Because of the seriousness of the information that the OIG investigation uncovered, we have referred the matter to the United States Attorney's Office (USAO) of the District of Columbia's Fraud and Public Corruption Section, which is conducting an investigation of possible criminal and civil violations together with the Federal Bureau of Investigation (FBI). The USAO and the FBI have requested that we limit the distribution of this report as much as possible. Therefore, this report should not be shared with others at the Commission before consulting with the OIG.

This report is being referred to management for disciplinary action. In order to ensure that we have information necessary to comply with our reporting responsibilities, please advise us within 45 days what action is taken in response to this report.

Please understand that this report is confidential in nature and should be treated in a secure manner. We request that when you are finished with the report, you either shred it or return it to us.

If we can be of further assistance to you, or you have any questions about this report, please do not hesitate to contact me.

Attachments

cc: Peter Uhlmann, Chief of Staff
Scott Friestad, Deputy Director of Enforcement
George Curtis, Deputy Director of Enforcement
David Becker, General Counsel and Senior Policy Director
William Lenox, Ethics Counsel

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REPORT OF INVESTIGATION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
OFFICE OF INSPECTOR GENERAL

Case No. OIG-481

Employee's Securities Transactions Raise Suspicions of Insider Trading and Create Appearances of Impropriety; Violations of Financial Reporting Requirements; and Lack of SEC Employee Securities Transactions Compliance System

March 3, 2009

The SEC believes that this report contains nonpublic and confidential information.

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REPORT OF INVESTIGATION

UNITED STATES SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

Case No. OIG-481

Employees' Securities Transactions Raise Suspicions of Insider Trading and Create Appearances of Impropriety; Violations of Financial Reporting Requirements; and Lack of SEC Employee Securities Transactions Compliance System

Introduction and Summary of Investigative Findings and Recommendations

I. Introduction

On January 23, 2008, the Securities and Exchange Commission ("SEC" or "Commission") Office of Inspector General ("OIG") opened an investigation after the Ethics Office, in the SEC's Office of the General Counsel ("OGC"), informed the SEC OIG that [# 2] frequently contacted their office to get clearances to trade certain securities. [#2] frequent contact with the Ethics Office raised suspicions that she may be engaged in day trading or insider trading and that she may have violated the Commission's Conduct Regulation Rule 5 ("Rule 5"), which places certain restrictions on SEC employees' securities transactions.

The OIG began an investigation into [# 2] securities trading. During the course of that investigation, the OIG identified two other Enforcement attorneys who were friends with [#2] and traded in securities, and who often discussed securities transactions and open Enforcement investigations with each other during regular weekly lunches and via e-mail. Following a review of [# 2] SEC e-mail records, the OIG also obtained the SEC e-mail records of [#2] friends – [#1] and [#3].[1]

After reviewing those e-mails, we added [#1] as another subject of the investigation because [#2] and [#1] often e-mailed each other about stocks and their stock transactions

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[1] SEC records show that [#2] and [#1] both earn more than $167,000, and salary is more than $177,000.

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and [#1] also appeared to trade often. [#3] did not usually respond to the e-mails that [#2] and [#1] sent about stocks and also did not appear to trade often in securities.

The OIG completed a comprehensive review and analysis of more than two years of [#2] e-mail records and obtained more than two years of her brokerage records, comparing those with the reports she filed on her securities transactions and the investigations she worked on. The OIG completed the same comprehensive review and analysis of more than two years of [#1] e-mail records and also obtained more than two years of his brokerage records, comparing those with the reports he filed on his securities transactions and a list of Enforcement matters he and others in [ ] reviewed from January 2006 through July 2008.

II. Summary of Investigative Findings and Recommendations

Our investigation revealed suspicious activity, appearances of improprieties, and evidence of possible trading on nonpublic information, and/or potential insider trading, on the part of SEC Enforcement attorneys [#2] and [#1]. Because of the seriousness of the information that the OIG investigation uncovered, we have referred the matter to the United States Attorney's Office of the District of Columbia's Fraud and Public Corruption Section, which is conducting an investigation of possible criminal and civil violations together with the Federal Bureau of Investigation.

The OIG investigation disclosed that approximately two months before an investigation of a large health care company was opened in her Assistant group, [#2] sold all of her shares of stock in the company. We also found that [#2] purchased additional shares of a global oil company's stock both a few days and a couple of weeks after a formal investigation was opened by her friend who occupies the office next to her. [#2] also sold shares of that company's stock two days before an inquiry was opened in that matter.

We also found that both [#2] and [#1] traded in the stock of a large financial services company, even though their fellow Enforcement attorney [#3] became aware of three separate Enforcement investigations of that company. [#3] credibly testified that she told [2] and [#1] during their regular weekly lunches that she could not purchase additional stock in this company because she had become aware of these investigations. Yet [#2] and [#1] did trade in this particular company, although incredibly they both deny remembering [#3] telling them about any of these investigations.

We also found that [#2], [#1] and [#3] all committed violations of different aspects of the SEC's securities reporting requirements of Rule 5.

The investigation further revealed that although the SEC, through its law enforcement function, is charged with prosecuting cases of violations of securities laws, including insider

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trading on the part of individuals and companies in the private sector, the Commission has essentially no compliance system in place to ensure that Commission employees, with the tremendous amount of non-public information they have at their disposal, do not engage in insider trading themselves. The current disclosure requirements and compliance system are based on the honor system, and there is no way to determine if an employee fails to report a securities transaction. There are no spot checks conducted and the SEC does not obtain duplicate brokerage account statements. In addition, there is little to no oversight or checking of the reports that employees file to determine their accuracy or even whether an employee has reported at all. Moreover, different SEC offices receive each of those reports and do not routinely share that information with each other.

In addition, the OIG concluded that there is a poor understanding and lax enforcement of the reporting requirements. For example, both [#2] and [#1] testified that no one had ever questioned their reported securities holdings or transactions in the decades they have worked at the SEC and traded securities. Moreover, both managers who are responsible for reviewing [#2] and [#1] annual OGE Form 450s testified that they do not recall ever questioning any Commission employee related to their reported securities holdings. In addition, we found that Enforcement attorneys and supervisors lacked a basic understanding of the requirements in place that govern reporting of stock transactions on the part of Commission employees.

The OIG investigation also found that Enforcement personnel, both managers and staff, have different interpretations of the confidentiality policy regarding Enforcement investigations and whether they can discuss their investigative matters with each other. We found that and [#1] routinely discussed stocks and investment strategies in e-mail and in public.

Further, our investigation found that [#2] and [#1] maintained separate folders entitled, "Stocks," in their SEC e-mail accounts, and that on most days, [#2] and [#1] sent e-mails from their SEC e-mail account about stocks and their own stock transactions. We discovered that [#2] trades often and testified that the financial markets are her main hobby and passion. We found that [#2] spent much of her work day e-mailing and searching the Internet about stocks. The OIG also found that these Enforcement attorneys share many of the same investments and have regular lunch meetings where they often discussed the stock market, their own securities transactions, and their SEC work and investigative cases.

The OIG investigation disclosed that [#1] 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 [#2] had recommended those stocks as well. Both [#2] and [#1] inexplicably testified that they failed to see how [#1] sending e-mails to his brother and sister-in-law from his SEC account could raise an appearance that he may be sharing nonpublic information with someone outside of the SEC.

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Notwithstanding the accumulation of evidence against them, [# 2] and [# 1] denied engaging in improper conduct, claimed ignorance of the SEC rules governing their conduct, and would not even acknowledge that their actions caused appearance concerns. While their memories were very clear on certain matters, when faced with evidence of possible wrongdoing, [# 2] and [# 1] testified that they did not recall numerous matters. [# 2] and [# 1] both also denied being aware of the Commission's policy that the SEC e-mail system should be used primarily during non-work hours for personal reasons and both denied sending a large amount of personal e-mails, even when confronted with dozens of e-mail strings they had sent and received about their stock transactions.

In light of the foregoing, the OIG is referring this report to management for disciplinary action against [# 2] and [# 1] We are also providing the Commission with 11 specific recommendations to ensure adequate monitoring of employees' stock transactions. These recommendations include 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 nonpublic information related to each security transaction they conduct and report; conducting regular and thorough spot checks for compliance purposes; and establishing comprehensive and more frequent training on all aspects of Rule 5 and its requirements.

We understand that the Commission's Ethics Office is currently working to set up a compliance office within the Ethics Office that would use an automated web-based tracking system which we believe is critical and long overdue. We encourage the Ethics Office to incorporate all of our recommendations into this new system and to consult with us as appropriate to ensure that a comprehensive Rule 5 compliance system is put into place.

Scope of Investigation

The OIG obtained and reviewed more than two years of the e-mail records of [# 2] [# 1] and [# 3]. We also obtained and reviewed the official personnel folders ("OPF") and conduct folders for [# 2], [# 1], and [# 3]

We obtained and reviewed more than two years of brokerage records for [# 2] and [# 1] The OIG also obtained the following documents or records for [# 2] and [# 1] from January 2006 until January 2008: (1) all SEC Form 681s filed by hand and electronically (over 250 forms); (2) their OGE Form 450s filed for the last available two years (covering 2006 & 2007); (3) all NRSI searches each conducted; (4) all CRST searches each conducted; and (5) the handwritten and e-mail clearances provided to them by the Ethics Office.

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We took sworn, on-the-record testimony of the following Enforcement employees: (1) [# 2]; (2) [# 1]; (3) [# 3]; (4) [# 4]; (5) [# 5]; (6) [# 6]; (7) [# 7]; and (8) [# 8]. We also interviewed [# 9], [# 10], and [# 11]. In addition, we interviewed and consulted with [# 12]. We also consulted with [# 13].

Relevant Commission and Government Regulations and Policies

A. SEC Employees to Maintain Unusually High Standards of Conduct

The Commission's Regulation Concerning Conduct of Members and Employees and Former Members and Employees of the Commission (hereinafter "Conduct Regulation"), at 17 C.F.R. § 200.735-1 *et seq.*, sets forth the standards of ethical conduct required of Commission members (*i.e.*, Commissioners) and employees (hereinafter referred to collectively as employees). The Conduct Regulation states:

> The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy. In view of the effect which Commission action frequently has on the public, it is important that . . . employees . . . maintain unusually high standards of honesty, integrity, impartiality and conduct. 17 C.F.R. § 200.735-2.

Employees ". . . must be constantly aware of the need to avoid situations which might result either in actual or apparent misconduct or conflicts of interest . . . . " *Id.* The Commission's Conduct Regulation further requires that employees "shall not engage in any personal business transaction . . . for personal profit . . . that is based upon confidential or nonpublic information which he or she gains by reason of such position or authority." 17 C.F.R. § 200.735-3(b)(1). The Conduct Regulation also states that employees shall not:

> Divulge to any unauthorized person or release in advance of authorization for its release any nonpublic Commission document, or any information contained in any such document or any confidential information: (A) in contravention of the rules and regulations of the Commission promulgated under 5 U.S.C. §§ 552, 552a and 552b; or (B) in circumstances where the Commission has determined to accord such information confidential treatment. 17 C.F.R. § 200.735-3(b)(7)(i).

Regulations also outline what is to be deemed nonpublic information at 17 C.F.R. § 203.2:

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> Information or documents obtained by the Commission in the course of any investigation or examination, unless a matter of public record, shall be deemed nonpublic, but the Commission approves the practice whereby officials of the Division of Enforcement at the level of Assistant Director or higher . . . may engage in and may authorize members of the Commission's staff to engage in discussions with persons identified in § 240.24c-1(b) of this chapter concerning information obtained in individual investigations or examinations, including formal investigations conducted pursuant to Commission order.

The Commission's Conduct Regulation Rule 5, at 17 C.F.R. § 200.735-5, regarding employee securities transactions is discussed below at pages 8 to 10.

The Standards of Ethical Conduct for Employees of the Executive Branch, 5 C.F.R. Part 2635, requires government employees to "put forth an honest effort in the performance of their duties." 5 C.F.R. § 2635.101(b)(5). Employees also shall not engage in an outside activity that conflicts with his official duties, and shall endeavor to avoid any actions creating the appearance that they are violating ethical standards. 5 C.F.R. § 2635.101(b)(10) & (14). Those regulations also prohibit employees from using public office for private gain, including engaging in a financial transaction using nonpublic information. 5 C.F.R. § 2635.703(a).

B. Duty to Use Government Property for Authorized Purposes

Under the Standards of Ethical Conduct for Employees of the Executive Branch, at 5 C.F.R. § 2635.704, "[a]n employee has a duty to protect and conserve Government property and shall not use such property, or allow its use, for other than authorized purposes." Under 5 C.F.R. § 2635.705, an employee "shall use official time in an honest effort to perform official duties."

SEC Regulation ("SECR") 24-4.3, revised March 8, 2002, established new privileges and additional responsibilities for Commission employees. SECR 24-4.3, attached hereto as Exhibit 1. It permits SEC employees to make limited use of government office equipment "for personal needs if the use does not interfere with official business and involves minimal additional expense to the government. This limited personal use should take place during the employee's non-work time." *Id.*

SEC Administrative Regulation on Electronic Mail established the policies and procedures for use of the SEC electronic mail system and Internet electronic mail. SECR 5-10 (May 20, 1996), attached hereto as Exhibit 2. That regulation states that government provided e-mail is "intended for official and authorized purposes." *Id.* at 2. It further stated that "[w]hile short personal messages are acceptable, parallel to the way government phones are sometimes used, other non-official uses are prohibited." *Id.* Several unacceptable uses are outlined in the regulation, including "[a]ny other activity which interferes with or compromises the performance

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or timely completion of government duties." *Id.* at 9. Employees are warned that inappropriate use of the e-mail system may result in disciplinary action. *Id.* at 2 & 9.

All Commission employees and contractors must also follow the "SEC Rules of the Road" issued March 1, 2004, when using any SEC information technology source, including electronic mail. SECR 24-04.A01 (April 2, 2008), portion attached hereto as Exhibit 3. These Rules are intended to assist employees and contractors to "use the SEC's computing and network facilities responsibly, safely, and efficiently, thereby maximizing the availability of these resources to all employees." *Id.* Rule #3 of the SEC Rules of the Road require employees to "exercise common sense, good judgment, and propriety in the use of e-mail." *Id.*

On March 8, 2002, the Executive Director sent a memorandum to all SEC employees regarding personal use of government office equipment. That memorandum stated in part, "... we are extending the opportunity to SEC employees to use government office equipment, including the Internet and e-mail, for personal use during non-working hours." March 8, 2002 Memorandum, attached hereto as Exhibit 4. More recently, on June 30, 2008, the Executive Director sent a memorandum via e-mail to all SEC employees and contractors entitled, "Use of Government Resources and Official Time." June 30, 2008 Memorandum, attached hereto as Exhibit 5. That memorandum was sent to remind employees that "there are statutory and regulatory restrictions on the use of government resources and official time." *Id.* Specifically, the memorandum outlined, among other restrictions, that government resources can be used only for authorized purposes and official time cannot be used for other than official duties. *Id.*

The Commission's Table of Penalties and Relevant Case Law

The Commission's Table of Penalties, Attachment 3 to SECR 6-10, Discipline and Adverse Actions (Nov. 12, 1990), provide a guide for selecting appropriate penalties in disciplinary actions for employee misconduct. The table has the relevant offense of violations of the Commission's Conduct Regulation, including security transactions and handling of confidential information, which carry with it a typical first time penalty of oral admonishment to removal. Another relevant offense outlined in the table is using government property for other than official purposes, which carries with it a typical first time penalty of oral admonishment to removal.

Misuse of Government Resources

The MSPB has recognized that "[t]he misuse of government resources is a serious charge." *Morrision v. NASA*, 65 M.S.P.R. 348 (1994). As the Board noted in *Morrison*, it has upheld a suspension of 30 days or more for sustained charges of misuse of government resources. The MSPB has held that in order to establish the misuse of government property or resources, the agency must prove only that the appellant used the property belonging to the government and that his use was not authorized. In *Barcia v. Dep't of the Army*, 47 M.S.P.R. 423 (1991), the Board

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issued a 30-day suspension for appellant making telephone calls that had no connection to business and for using the government computer to store personal business information in violation of agency regulations that prohibited such use.

Background and Investigative Findings

I. Results of the Investigation

The investigation uncovered evidence of possible trading on nonpublic information and/or insider trading by Enforcement attorneys [# 2] and [# 1] [# 2] was found to have transacted in companies that her Assistant Group was investigating or just about to investigate. In addition, [# 2] and [# 1] friend [# 3] credibly testified that she informed them that the SEC had begun three separate investigations through 2007 of a company they traded in. [# 2] and [# 1] strongly denied remembering their friend telling them about any investigation into the company or knowing about an SEC investigation when they each traded in that company in 2007 and 2008. As noted above, the OIG referred the possible insider trading to the U.S. Department of Justice, which accepted the referral and is conducting a comprehensive investigation together with the Federal Bureau of Investigation.

The OIG found that [# 2] [# 1] and [# 3] all committed violations of the SEC's securities reporting requirements.[2] The investigation also found that [# 2] and [# 1] failed to adequately consider how their actions could result in appearances of improprieties, which Rule 5 is aimed, in part, at preventing. Moreover, we found that [# 2] and [# 1] misused Commission resources by sending and receiving many e-mails related to securities transactions and the stock market on their SEC e-mail accounts and often sending and receiving these e-mails during the workday. We also discovered that [# 2] and [# 1] own many of the same stocks as each other.

Our investigation revealed that the Commission lacks any true compliance system to monitor SEC employees' securities transactions and detect insider trading. In addition, the OIG found that there is a poor understanding and lax enforcement of the Rule 5 reporting requirements.

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[2] While [# 3] admitted to a couple of Rule 5 securities reporting violations, unlike [# 2] and [# 1] conduct, [# 3] behavior did not raise any concerns or suspicions about possible insider trading or appearances of impropriety. Specifically, [# 3] did not trade in securities often, trade in securities that her Assistant group had ongoing investigations in, or engage in e-mail discussions about particular stocks, stock transactions, or investment strategies. Therefore, we did not add [# 3] as a subject of our investigation.

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II. Rule 5 of the Commission's Conduct Regulation

A. The Mission of the Agency

The mission of the SEC is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. *See* www.sec.gov/about/whatwedo. The SEC was created after passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, which were designed to restore investor confidence in the capital markets after the 1929 stock market crash by providing investors with more reliable information and clear rules for honest dealing. *Id.* The SEC oversees the key participants in the securities world, including securities exchanges, securities brokers and dealers, investment advisors, and mutual funds. *Id.*

As noted on the SEC's website, "[c]rucial to the SEC's effectiveness in each of these areas is its enforcement authority." *Id.* The SEC's Division of Enforcement assists the Commission in executing its law enforcement function by recommending the commencement of investigations of securities laws violations, by recommending that the Commission bring civil actions in federal court or before an administrative law judge, and by prosecuting these cases on behalf of the Commission. *Id.* The SEC website notes that each year the SEC brings hundreds of enforcement actions against individuals and companies for violations of the federal securities laws. *Id.* A common violation that may lead to an Enforcement investigation includes insider trading, which is violating a trust relationship by trading on material, nonpublic information about a security. *Id.*

B. Restrictions on SEC Employee Trading in Securities Designed to Ensure Public Confidence & Prevent Real or Apparent Conflicts of Interest

According to an undated Ethics Office Bulletin maintained on the SEC Intranet, during the Commission's early years there was sentiment that Commission employees should not be permitted to own or trade in securities at all because the Commission administers the federal securities laws and regulates the securities markets. Ethics Bulletin, "Securities Transactions by Employees (Rule 5)," attached hereto as Exhibit 6. It was ultimately determined that employment at the Commission should not result in an absolute bar against owning and trading in securities. *Id.* The Commission, however, imposes certain restrictions on employee's securities transactions. *Id.*

Those restrictions are designed to ensure public confidence that Commission staff are not benefitting personally from their favored position with respect to information about securities and to prevent real and apparent conflicts of interest. *Id.* Securities transactions by SEC employees, their spouses and minor children, are governed by Rule 5 of the Commission's Conduct Regulation, which is found at 17 C.F.R. 200.735-5. "One important purpose of Rule 5 is to ensure public confidence in the Commission, particularly regarding the public's perception of [an

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SEC employee's] access to and use of nonpublic information." *See* August 8, 2007 Ethics NewsGram: "Why CRST?," attached hereto as Exhibit 7.

Rule 5 prohibits employees from purchasing any security which, to his or her knowledge, is involved in any pending investigation by the Commission, or in any proceeding pending before the Commission, or to which the Commission is a party. 17 C.F.R. 200.735-5(g). Rule 5 states in relevant part:

> (a)(2) Members or employees are prohibited from recommending or suggesting the purchase or sale of securities:
>
> (I) Based on non-public information gained in the course of employment; or
>
> (ii) Which a member or employee could not purchase because of the restrictions of this rule, in any circumstance in which the member or employee could reasonably expect to benefit from the recommendation, or to anyone over whom the member or employee has or may have control or substantial influence.
>
> (b)(1) No member or employee shall effect or cause to be effected any transaction in a security expect for bona fide investment purposes. Therefore, all securities purchased by a member or employee must be held for a minimum of six months.

Employees are also prohibited from purchasing or selling a security which is the subject of a registration statement filed under the Securities Exchange Act of 1934 . . . or any security of the same issuer while such a registration statement or letter of notification is pending or during the first 60 days after its effective date. 17 C.F.R. 200.735-5(e)(1). An exception to that rule is the employee may sell a security if the employee can certify that he or she has no information about the registration and the employee's supervisor can certify the employee has not participated in the registration process. 17 C.F.R. 200.735-5(f)(1) & (2).

Other restrictions on employee securities transactions under Rule 5 include purchasing or selling of an option, future contract or option on a future contract involving a security or group of securities; carrying securities on margin; selling short; having a beneficial interest in any broker dealer, investment advisor or other regulated entity through ownership of securities or otherwise; and purchasing stock of any company which is in a receivership or bankruptcy proceeding in which the Commission has filed a notice of appearance. 17 C.F.R. 200.735-5(h).

Under Rule 5, there are exceptions to holding securities for a minimum of six months, including for money market funds, transfer of funds held as shares in a registered investment company for a minimum of 30 days to another registered investment company within same family of registered securities, debt securities with a term of less than 6 months, and a stop/loss order entered at time of purchase (if submitted to OHR). 17 C.F.R. 200.735-5.

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C. Strict Interpretation of Rule 5

As a matter of policy the Commission favors a strict interpretation of the provisions of Rule 5. 17 C.F.R. 200.735-5(r); 53 FR 18553 (May 24, 1988), as amended at 59 FR 43464 (August 24, 1994; 60 FR 52626 (October 10, 1995)). Under Rule 5, the Director of Personnel, or his designee, is authorized to require the disposition of securities acquired as a result of a violation of the rule, whether intentional or not. 17 C.F.R. 200.735-5(q). In addition, Rule 5 states, "[r]epeated violations shall be reported to the Commission for appropriate action."

III. The Rule 5 "Compliance System"

Rule 5 requires that employees report annually to the Director of Personnel a complete list of securities in which he or she owns an interest, and if an employee owns no securities to so state that.[3] 17 C.F.R. 200.735-5(m)(1). Employees must also report every acquisition or sale of any security within five business days of the transaction date or the date confirmation is received. 17 C.F.R. 200.735-5(m)(2).

A. Conduct Regulation Securities Transaction System ("CRST")

To ensure compliance with Rule 5, an employee should first obtain clearance from the Conduct Regulation Securities Transaction System ("CRST"), which is updated by the SEC's Division of Corporation Finance. Exhibit 6. The CRST system interacts with other SEC databases and checks to determine whether a registration statement is pending or is not yet effective related to the particular security an employee requests clearance for. *Id.* For each clearance request to buy or sell a certain security, CRST will notify the employee whether the particular security is restricted or not restricted. *Id.* Employees can print those transaction clearances for their records. *Id.*

If CRST responds that a transaction is approved, it states that there is no restriction on the transaction requested (*i.e.*, buy or sell) and it states, "You have 5 business days to effect this transaction and submit Form 681 to the Office of Administrative and Personnel Management." Conduct Regulation Securities Transaction System (CRST), Transaction Approval sample, attached hereto as Exhibit 8. We note that this statement employees receive on CRST is inaccurate – Rule 5 requires that the SEC Form 681 be submitted to the Office of Human Resources (the Office of Administrative and Personnel Management no longer exists) within five business days of the transaction (*i.e.*, trade date) or of the date confirmation is received, as discussed below, not within five business days of receiving the CRST or Ethics Office clearance. *See* Exhibit 6.

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[3] Currently, the SEC does not have a position of Director of Personnel, but there is an Associate Executive Director for the Office of Human Resources.

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If CRST responds that a transaction is restricted, CRST will not provide a clearance. *Id.* If an employee does not receive clearance from CRST they can check directly with the Ethics Office. March 5, 2008 Ethics NewsGram: "Ask, but Don't Tell," attached hereto as Exhibit 9. As of January 2007, employees could send an e-mail to the CRST Mailbox, which is received by the Ethics Office, to determine whether the denial of the clearance is valid. If the CRST restriction is valid, the Ethics Office will provide the reason the requested transaction is restricted, which is considered nonpublic information. *Id.* If the CRST denial is outdated or no longer valid, the Ethics Office replies to the e-mail telling the employee the security is now clear to buy or sell, whichever the employee requested to do. Memorandum of Interview of [#12] attached hereto as Exhibit 10.

B. Financial Disclosure Reports

SEC employees are required to file certain financial disclosure reports, including the SEC Form 681, on which employees are to report their securities transactions within five business days. Certain higher pay grade employees must also file the OGE Form 450, which is an annual report of employee securities holdings. The basic purpose of the financial disclosure system is to assist the employee and the SEC in avoiding conflicts of interest between their official duties and private financial interests. *See* October 19, 2005 Ethics Article, "Refresh Knowledge of Your Holdings: File Form 450!," attached hereto as Exhibit 11. Most employee financial interests generally arise from their securities holdings. *Id.*

1. SEC Form 681

Employees must report all securities transactions on SEC Form 681. *See* April 16, 2008 Ethics NewsGram: "450 . . . 529 . . . 401 . . . 681 . . . Can You Crack the Code?," attached hereto as Exhibit 12. Reporting of all securities includes every acquisition or sale of a security (including mutual funds), as well as acquisitions of holdings received by gift, inheritance, through marriage, or through a spin-off. *Id.* It does not matter whether these securities are held in a retirement account, savings plan or somewhere else. *Id.* Employees do not have to report money market fund transactions other than the initial purchase and final sale of the entire interest in it or changes in holdings that do not affect disqualification such as automatic reinvestment of dividends, stock splits, dividends, and reclassifications. *Id.*

The SEC Form 681 must be reported to OHR within five business days of the transaction or within five business days of the date confirmation is received. *See* Exhibit 6. SEC Form 681 is available to be downloaded on the CRST database. Exhibit 8. In May 2007 employees were urged to begin to complete and file the SEC Form 681 electronically, and send the completed form via e-mail to the OHR Financial Disclosure Unit mailbox. *See* May 2, 2007 Ethics Article, "Form 681 Goes Totally Electronic!," attached hereto as Exhibit 13. Prior to that, employees had to fill out the forms by hand and submit them to OHR. *Id.* Those hand-written forms were to be

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filed and maintained in an employee's conduct folder. The Ethics Office does not receive or review copies of the SEC Form 681s. *See* Exhibit 10.

2. OGE Form 450 Confidential Financial Disclosure Report

The Office of Government Ethics ("OGE") created the OGE Form 450 Confidential Financial Disclosure Report, which is required by the Ethics Reform Act of 1989. Exhibit 11 The OGE Form 450s cover a one year period, and require that employees report all assets held for investment by themselves, their spouses or dependent children with a value greater than $1,000 on December 31 of that calendar year or which produced more than $200 in income during the calendar year. June 2008 U.S. Office of Government Ethics Confidential Financial Disclosure Report (OGE Form 450), attached hereto as Exhibit 14. Those assets include stocks, bonds, and sector mutual funds, among other things. *Id.*

Only certain SEC employees are required to file the OGE Form 450, specifically: all Pay Grade SK-16 and SK-17 employees; all Pay Grade SK-14 and SK-15 attorneys, accountants, auditors, computer specialists, examiners, and investigators; all financial economists; all Contracting Officer's Technical Representatives; and all procurement and contracting employees.[4] January 7, 2009 Ethics NewsGram: "A New Year and a New Form," attached hereto as Exhibit 15. The reports are required to be reviewed by a management official who is familiar with the work of the employee for any actual or potential conflicts of interest between the employee's job duties and their financial holdings. September 18, 2008 E-Mail entitled, "Procedures to follow when certifying OGE Form 450 reports," attached hereto as Exhibit 16.

The SEC has designated office heads and division directors to review the forms for any financial conflicts. *Id.* In the Division of Enforcement, it is the Associate Directors and other office heads, [ ] who are responsible for reviewing the Form 450s Interview Memorandum of [# 9], October 27, 2008, attached hereto as Exhibit 17. The reviewers are given a copy of the employee's prior year's OGE Form 450 for review. [# 5], September 17, 2008, attached hereto as Exhibit 18, at 14-15. If the reviewer is satisfied that the report is complete and the holdings do not appear to violate any statute or regulation or present a conflict, he or she shall certify it by signature and date. 5 C.F.R. § 2643.605; Exhibit 17. After the supervisory review in Enforcement, the administrative office collects the OGE Form 450s and sends them to the Ethics Office, which then forwards them to OGE. *Id.*

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[4] Other higher-ranking agency officials must file an OGE Form 278, which like the OGE Form 450, is used to assist employees and their agencies in avoiding conflicts between their duties and private financial interests or affiliations. *See* http://usoge.gov/forms/sf278_faq/general_ques.aspx.

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OGE Form 450 reviewers receive written guidelines on the purpose of the review and what to review in each section of the form. Exhibit 16. The guidelines state that the purpose of the OGE Form 450 is "[t]o identify potential conflicts between a filer's official duties and their private financial interests or affiliations." *Id.* The guidelines, however, do not identify how a reviewer should identify a potential or actual conflict. *Id.* According to Ethics Office officials, there is no OGE Form 450 in-person training for those senior managers who review SEC employees' OGE Form 450. As discussed below, most of those senior managers who review OGE Form 450s are required to receive general ethics training every year because they file Form 278s.

C. Employees Cannot Clear Securities Transactions on Other SEC Data Systems or Share Information about Why Certain Transactions are Restricted

The SEC prohibits employees from using SEC computer data systems, such as NRSI (the "Name Relationship Search Index," which is an internal database of all Enforcement inquiries and investigations) or EDGAR (the Electronic Data Gathering, Analysis, and Retrieval System which performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies required to file such forms, such as registration statements, 10-Ks, etc.) for personal reasons, including their securities transactions. The Ethics Office has sent "NewsGrams" reminding employees that they cannot check SEC computer data systems in order to comply with Rule 5. Exhibit 7 & July 13, 2005 Ethics NewsGram: "Are You Trading Securities? Check This Ethics Rule 5 To Do (or Not to Do) List:," attached hereto as Exhibit 19. The only permissible system for clearing securities transactions is the CRST or through the Ethics Office directly, as described above. *Id.* As discussed above, if an employee is blocked or restricted on CRST and they contact the Ethics Office for an explanation of why it is blocked, the explanation is considered nonpublic information and should not be shared with anyone, including their spouses or relatives. Exhibit 9.

IV. Training on Rule 5 Requirements and Confidentiality of NonPublic Information

A. Rule 5

The OIG found that the Commission conducts limited training on Rule 5 for SEC employees and supervisors. According to agency Ethics Office officials, there is only in-person ethics training for higher level SEC employees, specifically those employees who are required to file the OGE Form 450, described above, and the highest-level (senior officer) employees who are required to file an OGE Form 278. The OGE Form 450 filers are required to attend in-person ethics training for one hour every three years; the Form 278 filers are required to attend in-person ethics training for one hour every year. Those training sessions focus on any number of ethics issues, only one of which is Rule 5. Therefore, there may be times when Rule 5 is not covered in these in-person training sessions.

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New employees attend orientation training when they begin work at the SEC, and part of that orientation is a one-hour presentation by an Assistant Ethics Counsel. New Employee Orientation - Ethics (PowerPoint), attached hereto as Exhibit 20. That presentation provides an overview of the rules of ethical conduct. One topic covered in that presentation is Rule 5 and its requirements. *Id.* In addition, the Ethics Office occasionally issues Ethics NewsGrams and Ethics Bulletins to all SEC employees by e-mail. Those NewsGrams and Bulletins are maintained on the SEC Intranet. Currently, the SEC Intranet shows there are seven Ethics Bulletins and fourteen NewsGrams related to employee securities transactions. *See* http://intranet.sec.gov/division_offices/hqo/ethics_bulletins. New employees are also required to sign a certification stating that they have received the OGE Standards of Ethical Conduct for Employees of the Executive Branch. *See* Exhibit 20 at 6. We note that [#2] and [#1] began work at the SEC many years ago and, as such, would not have received this orientation training for new employees.

B. Confidentiality of Enforcement's Investigations

During orientation training, all new hires receive a copy of the "New Hire Orientation Manual," which contain the SEC's Conduct Regulation, and cautions employees not to use or disclose confidential or nonpublic information without the express consent of the Commission. Office of Human Resources, New Orientation Manual, attached hereto as Exhibit 21. In addition, the Orientation Manual states, ". . . employees must be very careful to maintain the confidentiality of Commission information when discussing their work in public places (elevators, restaurants, taxis, airplanes) and when discussing their work with family and friends." *Id.* at 3. In the Division of Enforcement, all new hires participate in the Division's bi-annual new hire training, where they are informed of the Commission's policies concerning the confidentiality of ongoing SEC investigations and they are given access to the Enforcement Manual, discussed below. As noted above, because [#2] and [#1] began work at the SEC many years ago, they would not have received this Orientation Manual.

In March 2008, the Division of Enforcement issued an electronic Enforcement Manual designed as a reference for the Enforcement staff in the investigation of potential violations of the federal securities laws. October 6, 2008 Securities and Exchange Commission Division of Enforcement, Enforcement Manual, attached hereto as Exhibit 22. The Enforcement Manual contains general policies and procedures which are intended to guide staff in their investigations. It states that staff should be aware of ethical considerations that may arise, including policies on confidentiality and the protection of nonpublic information, as well as securities transactions by employees, among other things. *Id.* at 10. The Enforcement Manual also informs staff that, "all information obtained or generated by SEC staff during investigations or examinations should be presumed confidential and nonpublic unless disclosure has been specifically authorized." *Id.* at 115.

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Investigative Findings

I. Enforcement Attorneys Fail to Comply with Rule 5

A. Long-Time Enforcement Attorneys Share Friendships

Our investigation found that [#2] [#1] and [#3] are long-time Enforcement attorneys and have all been friends for several years.

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B. Their Securities Trading and Stock Portfolios

Our investigation found that [#2] and [#1] own stock and trade regularly in the stock market. [#3] also owns stock, but only first purchased stock in 2005. [#3] [#3] owns six different stocks, valued at the time of her testimony in October 2008 at around $28,000, and has held them since she bought them. *Id.* Prior to 2005 [#3] owned only mutual funds. *Id.* [#3] testified that she did not invest in stocks until 2005 because she was and is concerned about being aware of investigations from her duties as [ ] and then inadvertently trading in that company's stock. *Id.* at 38-39; 74; 86; 99; 100-102; & 105.

[#2] is a more active trader than [#1] and has a keen interest in the financial markets. Our review of [#2] SEC Form 681s show that she reported trading 247 times from January 2006 through January 2008. [#2] SEC 681 Forms, January 2006 to January 2008, attached hereto as Exhibit 27. [#2] testified that she spends a great deal of time following the financial markets. Specifically, she testified that she usually watches financial news programs before and after work, and sometimes also follows whatever stock the financial news programs are talking about on her laptop computer. [#2] testified about following the financial markets, ". . . I do spend a lot of time, you know - - it's my main hobby. It's my passion. I am very – I feel very proud of my knowledge." *Id.* at 61. She added, "It's my way of keeping intellectually above what other people are doing." *Id.*

[#2] testified that at the time of her testimony in October 2008 she owned more than 50 stocks after a recent sell-off of stocks. [#2] She testified that her stock portfolio was then valued at about $45,000, but that it had been valued at about $170,000 at one point. *Id.* at 71 & 73. [#2] could not remember how many stocks she owned in October 2007, because she testified she ". . . can't keep up with them all." *Id.* at 73. According to [#2] most recent OGE Form 450, she owned 60 stocks in December 2007. January 14, 2008 OGE Form 450, attached hereto as Exhibit 28. Her brokerage account statement for June 30, 2008 shows [#2] owned approximately $167,732 in securities. [C] attached hereto as Exhibit 29. On October 31, 2007, [#2] owned approximately $170,140 in securities. [C] attached hereto as Exhibit 30.

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[#1] testified he trades a few times a year, that trading is a hobby of his "to some degree," and he had about 15 to 20 stocks when he testified in October 2008. [#1] A review of [#1] SEC Form 681s show that he reported trading 14 times from January 2006 through January 2008. Employee Report of Securities Transactions (April 23, 2006 to January 17, 2008), attached hereto as Exhibit 31. He testified that his stock portfolio was worth approximately $150,000 at the time of his testimony in October 2008. [#1] According to the most recent OGE Form 450, [#1] owned 35 stocks in December 2007. February 6, 2008 OGE Form 450, attached hereto as Exhibit 32. According to his brokerage account statement ending December 31, 2007, [#1] owned over $200,000 in securities. [D] attached hereto as Exhibit 33.

Both [#3] and [#1] testified that they reviewed their securities transactions from January 2006 before they appeared for OIG testimony and found violations. Specifically, [ ] admitted to her failures to submit an SEC Form 681 for one securities transaction and her failure to report within five business days of receiving a confirmation for two of her trades in her testimony before the OIG.[6] [#3] [#1] admitted he could not find an SEC Form 681 for one transaction. [#1] After [#1] testimony, his counsel confirmed by telephone that [#1] also could not find SEC Form 681s for two other transactions we asked him about, which are discussed below. October 17, 2008 E-Mails, attached hereto as Exhibit 34

C. No Tracking Systems to Ensure Compliance with Rule 5

Both [#2] and [#1] testified they did not have any formal system for tracking their compliance with Rule 5 requirements, and neither has kept consistent records of clearances from either the CRST or the Ethics Office. [#1] [#2] Surprisingly, [#2] said she relies on her memory to comply with Rule 5 requirements [#2] Asked how she ensures compliance with Rule 5, [#2]

> It's always in the back of my mind. I'm very conscious of my ethical obligations to the Commission and as soon as I make - - I do a transaction, it's in the back of my mind to be sure it gets reported and on a timely basis. [#2]

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6 We note, however, it is unclear from [#3] testimony whether she actually failed to timely report because she testified that she reported within five business days of receiving a confirmation by regular mail, just not within five business days of the actual trade. [#3] According to the Ethics Office, if [#3] did report the securities transactions within five business days of receipt of confirmation by regular mail that would be compliant with the Commission's policy. This five business day rule of trading within five business days is not part of Rule 5.

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[#2] testified that she looks at her brokerage account online when she prepares an SEC Form 681. *Id.* According to [#2] she compares her brokerage account with her last electronically filed SEC Form 681 to make sure that the stocks in her brokerage account have all been reported before she starts preparing a new Form 681. *Id.* at 164. She told us that she does this comparison very frequently. *Id.* at 165. [#2] further testified, "I feel comfortable that I don't have any access to anything - - nonpublic information concerning an investment that I have because I make sure I don't invest in stocks that I do have nonpublic information about." *Id.* at 142. Asked how she ensures that, she testified, "I just remember." *Id.*

[#1] admitted that he does not have a system to keep track of his securities transactions, nor does he consistently keep records of his compliance with Rule 5. [#1] testified that several years ago he ". . . had a file where I stuffed all that stuff" but that he has not ". . . kept it in a consistent place for the last few years, and I am not sure where that file is." *Id.* at 82-83. [#1] further testified that he has not been keeping the CRST clearance printouts. *Id.* at 64; 94.

Despite [#1] testifying that he does not keep records, when asked if he generally trades right after he has gotten a clearance, [#1] testified, "I don't know without looking at my records. My assumption at this point is that I probably usually do, but I also imagine there were times where I didn't, so - - ." *Id.* at 94. In order to comply with the six month holding requirement under Rule 5, [#1] testified that when he wants to sell he thinks about when he bought it. *Id.* If he has held the stock for a year, [#1] testified he is not worried about it. *Id.* If, however, he feels like it is somewhere close to the six months, he will look up when he purchased the stock. *Id.* Moreover, [#1] testified that he does not keep a list of the OCC matters he has worked on to determine whether there is a conflict of interest or he has nonpublic information about a matter when he trades. *Id.* at 79. [#1] admitted he does not have a really good memory. *Id.*

D. Failures to Report Securities Transactions

1. Failure to Consistently File SEC Form 681

As discussed, under Rule 5 all SEC employees and members must file an SEC Form 681 for every acquisition, including non-purchase acquisitions, or sale of a security, regardless of where the security is held, within five business days of the transaction date or date confirmation is received. Exhibit 12. [#2] [#1] [#3] all failed to report certain transactions on the SEC Form 681.

[#3] admitted that she was required, but failed, to file an SEC Form 681 for a particular stock she bought on January 18, 2008. [#3] told us it was "definitely a screw-up on [her] part." *Id.*

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[# 2] provided us with all of her SEC Form 681 reports from January 2006 through January 2008. Exhibit 27. [# 2] reported 247 securities transactions from January 2006 through January 2008. *Id.* We found that [# 2] filed SEC Form 681s for all of those transactions, except two. Neither she nor the agency had SEC Form 681 reports from her for buying and selling of [E] shares in October 2006. Exhibit 27 & November 6, 2008 E-Mail, Letter, and Exhibits from [# 15] attached hereto as Exhibit 35, at 2 & 7.

[# 1] failed to file SEC Form 681s for three of his stock transactions for the two year period the OIG reviewed for this report: (1) [F] he bought in October 2007; (2) 100 shares of [G] he bought in March 2007; and (3) 100 shares of [H] January 2006.[7] [# 1] [D] attached hereto as Exhibit 38; [D] attached hereto as Exhibit 39; J [D] attached hereto as Exhibit 40. In his testimony, [# 1] admitted that in his review of 18 months of his trading records he conducted before he appeared for OIG testimony, he discovered he had not filed an SEC Form 681 for [F] [# 1] Specifically, [# 1] testified, "I am worried I may have

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7 [# 1] failure to report his sale of [H] is particularly troubling. We found more than a dozen e-mails between him and [# 2] about [H], and one in particular to her about his sale of [H] stock. [# 2] E-Mails dated January 17, 2006, January 17, 2006, January 20, 2006, January 30, 2006, January 30, 2006, February 1, 2006, February 3, 2006, February 6, 2006, March 13, 2006, March 13, 2006, April 13, 2006, April 17, 2006, March 5, 2007, March 20, 2007 and April 5, 2007, attached hereto as Exhibit 36. These e-mail exchanges just prior to his sale of half of his [H] stock should have prompted him to report it to the SEC. Moreover, these e-mails raise suspicions about his June 2002 investment, and subsequent partial sale, of shares of [H] stock because [# 1] testified that he became aware of an Enforcement investigation related to [H] at some point, and that this prevented him from trading in it for some time. SEC Form 681, June 24, 2002, attached hereto as Exhibit 37; [# 1] e-mailed [# 2] about this on February 1, 2006:

> "But this still kills me. [H] was one of my best ideas in years and I knew it at the time - but couldn't buy more because of a damn case. (As I may have whined about before.) I would have bought at least $10K worth back then. Basically 2000 shares instead of 200 . . . ." Exhibit 36 at 7.

Because of the lack of specific information [# 1] gave us about that investigation, we were unable to determine which investigation it was or when it was opened or if it was closed.

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missed that one somehow." *Id.* After his testimony, [#1] counsel confirmed by telephone he did not have records for the other two transactions. Exhibit 34.

In addition, [#1] testified that he failed to ever report securities he obtained through spin-offs or restructuring. [#1] said that it never occurred to him to report these because he did not make a buy or sell decision. *Id.* at 110. The rules on reporting on an SEC Form 681, however, are clear that acquisitions of securities through other means than buying or selling are required to be reported. *See, e.g.*, Exhibit 6; Exhibit 12. As noted in an Ethics NewsGram, ". . . non-purchase acquisitions are especially important to report because they affect what matters you are allowed to work on for financial conflict of interest purposes." Exhibit 12.

[#1] mentioned that [I] [J] [K], and [L] were all companies he ended up owning, but had not bought himself, and in which he failed to file a Form 681.[8] [#1] Another company that [#1] testified was on his brokerage statements was [M] but he did not know when or how he got it. *Id.* at 97. According to [#1] ". . . I get a ton of stuff from the brokerage firm, and there have been times – over the weekend, I saw reference to [a company] called [J] and . . . I have no idea where it came from, and I don't remember ever seeing it." *Id.* at 109-110. [#1] gave another example of a company called [I] that he had seen before on his brokerage statements but did not know "where it came from." *Id.* at 110. [#1] further testified that presumably the brokerage firm sent him something at some point about [J] but that he did not "necessarily read it or remember it." *Id.* at 110. As to his failure to file certain SEC Form 681s, [#1] testified, ". . . hopefully somebody will understand if I make a mistake, ... We all make mistakes." *Id.* at 115.

2. Failure to Report Certain Transactions on OGE Form 450

Both [#2] and [#1] failed to report certain transactions or earnings on their OGE Form 450s during the two year time period the OIG reviewed for this report. We found that while [#2] properly reported all of her security holdings held at the end of each calendar year for her 2006 and 2007 OGE Form 450s, she failed to report any time she earned more than $200 on the stock transactions she conducted during those calendar years. Specifically, [#2] failed to report earned income of more than $200 in fifteen separate instances in 2006 and 2007. [#2] Earned Income Over $200 Not Reported on OGE Form 450, attached hereto as Exhibit 41. [#2] testified that she did not understand that she had to report if she earned $200 or more on a securities transaction unless she held that security at the end of the calendar

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8 The OIG did not determine how many securities [#1] acquired through non-purchase that should have been reported on an SEC Form 681. We recommend that [#1] conduct a review of his securities holdings and file an SEC Form 681 for each security holding obtained by other than purchase.

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year. [#2] As discussed above, however, all sources of earned income greater than $200 must be reported on the OGE Form 450s.

[#1] testified that he failed to report his ownership of [N] on his 2007 OGE Form 450. [#1] ownership of [N] was worth about $3,400 at the end of 2007. Exhibit 33. [#1] testified, ". . . I fully acknowledge it should have been on there, and I . . . was absolutely horrified to see that it was not on there." [#1] He further testified that it was not an intentional error and was "purely an oversight." *Id.* at 102-103.

In addition, [#1] also failed to report transactions during the calendar year in which he earned more than $200. Specifically, [#1] failed to report on earned income of: (1) $723 when he sold [O] on December 27, 2006; and (2) $2,936 when he sold [P] on June 5, 2007. [#1] Earned Income Not Reported on OGE Form 450s, attached hereto as Exhibit 42; February 28, 2007 OGE Form 450, attached hereto as Exhibit 43 & Exhibit 32.

E. Other Violations of Rule 5

1. Failure to Clear Transactions

The OIG found that [#2] did not receive clearance for ten separate transactions during the two year period the OIG reviewed for this report. [#2] testified that it was her practice to seek approval from either CRST or the Ethics Office for each transaction, but that she did not keep a record of clearances she received from the Ethics Office. [#2] does not have evidence that she received clearance to buy or sell those ten separate securities. Although our own check revealed that each of these transactions would have been cleared had she sought clearance at the time she wanted to conduct the transaction, she risked that these transactions would not have been cleared. February 3, 2009 E-Mail from [#12] attached hereto as Exhibit 44.

For six of those ten transactions, the OIG found that [#2] checked on CRST and was told they were restricted. [#2] Submission of Form 681s and Clearance on CRST, attached hereto as Exhibit 45. We do note, however, that [#2] did file SEC Form 681s for four of those six transactions. *Id.* The Ethics Office had no record of [#2] checking with them for clearance of those transactions. For the other four transactions, the OIG found no record of [#2] clearing them. *Id.*

We found that [#1] did clear each of his transactions we reviewed either through CRST or the Ethics Office during the two year review period.

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2. Failure to Report Securities Transactions Timely

During the two year time period we reviewed, [#2] failed to timely report [Q] in which she checked on CRST and received clearance on 5/30/07, but her brokerage records show a settlement date of 6/21/07, much more than five business days later. [#2] Clearance and Settlement Dates, attached hereto as Exhibit 46.

[#1] timely reported each of his transactions in the two year period we reviewed.

As discussed above, at footnote 6, [#3] told us that she failed to report two of her stock transactions within five business days of those purchases. [#3] Before her testimony with the OIG, [#3] testified she reviewed all of her securities transactions and Rule 5. *Id.* Upon her review of Rule 5, [#3] thought she had not timely reported two securities transactions within the five business days because she waited until she received the confirmation in the mail. *Id.* [#3] testified that for those two trades she determined that she was 1 business day and three to four business days beyond the reporting requirement. *Id.* It is unclear whether in fact she was late or had misunderstood the Rule 5 requirement, as discussed above in footnote 6.

3. Improperly Checking EDGAR for Company Information

We found that during the two year period we reviewed, [#2] had improperly checked on EDGAR, the SEC database which contains copies of corporate financial information and filings, on at least five occasions related to five separate securities transactions, although she initially testified she had never checked EDGAR for her stock transactions. [#2] E-Mails dated July 2, 2007, July 9, 2007, July 10, 2007, and July 16, 2007, attached hereto as Exhibit 47. [#2] initially testified, "I don't look at Edgar [sic] for stock purposes . . . ." [#2] She further testified, "I just don't look on Edgar [sic]." When pressed further about whether she had ever searched EDGAR, [#2] testified, "I would say it's not my practice and I have no recollection of having done so." *Id.* She said her understanding of the Commission's rules is that you cannot look at EDGAR to see if there is a registration statement pending. *Id.*

SEC employees are prohibited from checking on EDGAR, or NRSI, for personal trading purposes, or for any personal purpose, since it can be used to gain important information about a company. Exhibit 7.

After she initially denied checking on EDGAR for stock purposes, [#2] was shown four separate e-mails she had sent to the Ethics Office in July 2007 in which she attached information from EDGAR, or said she learned from looking at EDGAR, that there were no registration statements for five separate companies. [#2] claimed not to remember sending these e-mails, but admitted after being presented with those e-mails she had apparently looked at EDGAR. *Id.* at 171. [#2] then testified that at some point Commission

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employees were told not to use EDGAR for personal trading purposes. *Id.* She further testified that she ". . . hadn't looked on Edgar [sic] after that, and I never relied on Edgar [sic] in terms of whether to transact."[9] *Id.* at 171-172. [#2] said she would not know how to analyze the information contained in EDGAR. *Id.* at 174.

We have no evidence that [#1] checked EDGAR for his own securities transactions during the two year period we reviewed, and he testified he has not checked it for his securities transactions. [#1] We also found that neither [#2] nor [#1] checked on NRSI for their own trading purposes, as confirmed by the SEC's records that track everyone who checks on NRSI. [#1] testified he did not think he had ever checked on NRSI for personal use, and would ". . . imagine it would be inappropriate to do that." [#1]

4. Improperly Sharing Clearance Denial Reason with Each Other

We also found that [#2] and [#1] shared with each other not only whether something cleared in the CRST system, but the basis for at least one denial of a clearance to trade. The basis for any denial of a clearance to trade is nonpublic information and should not be shared with anyone, including fellow employees. *See* Exhibit 9. The Ethics Office has reminded employees of this fact, and noted that this nonpublic information may not be shared with anyone including an employee's spouse, relatives, their broker, or beneficiary of a trust. *Id.*

Despite this prohibition, [#2] and [#1] shared with each other the nonpublic reason for a denial of clearance, as evidenced by an e-mail. November 8, 2007 E-Mails, attached hereto as Exhibit 48. [#1] forwarded an e-mail he received from the CRST Mailbox about [R] [#2] and [#3] *Id.* In that November 8, 2007, e-mail, the Assistant Ethics Counsel stated:

> The [R] is currently blocked because of . Under Rule 5, everyone at the SEC is blocked from buying [R] while the . *Id.*

[#2] responded to [#1] e-mail saying, "Oh yuckola! I wonder if this is the proposed merger that [redacted] got fired over because he hadn't told the board about it! Wouldn't that be a hoot?" *Id.*

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9 We note that on August 8, 2007, the Ethics Office did send out an Ethics NewsGram reminding SEC employees they are prohibited from checking on NRSI or EDGAR for anything other than mission-related activities. Exhibit 7. We did not find evidence that [#2] checked EDGAR after July 2007, although the policy was already in effect.

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II. Enforcement Attorneys' Frequent Discussions About Securities Trading and Access to Nonpublic Information Raises Concerns and Creates Appearance of Improprieties

A. Enforcement Attorneys' Widespread Access to Nonpublic Information

1. Enforcement's Office of Chief Counsel

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10. The role of the OCC is to ensure that the Commission's Enforcement program actions have a sufficient legal basis, conform with Commission policy and is consistent nationwide. *Id.* at 7.

The OCC staff reviews all enforcement actions, both for headquarters and the regional offices, before they are presented to the Commission. *Id.* The OCC reviews formal orders and various memoranda including action, advice, and settlement memoranda. *Id.* at 30-31. In addition, the OCC staff perform a counseling role, and act as "nationwide consultants throughout the course of an investigation." *Id.* Those consultations can occur anytime during the course of an investigation, even before an investigation is opened. *Id.* at 8-9.

According to [#4] there are "about 4,000 investigations ongoing at any point in time." *Id* at 10. The OCC has about 20 employees when it is fully staffed. *Id.* There are [ ] [#19] and [#7] *Id.* [#7] [#1] *Id.* at 35; Transcript of Testimony of [#7] August 26, 2008, attached hereto as Exhibit 50, at 6. Matters are assigned by subject – [#7] group reviews insider trading, regulated entities, and municipal securities; [#19] staff reviews financial fraud, FCPA, and corporation finance issues. [#7]

[#4] testified that the OCC does not have an automated tracking system for the matters they review, but there is an electronic mailbox where all memoranda to be reviewed are sent. [#4] [#19] [#7] are responsible for reviewing the matters sent to that electronic mailbox and then assigning the matters to their staff. *Id.* at 29. Intake sheets are then prepared manually by [#19] and [#7] to track assignments. [#4] does not receive any reports from these intake sheets. *Id.* at 30. [#4] testified that she mostly becomes aware of

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matters as they get closer to being put on the Commission calendar or if there's a "Wells" meeting.[10] *Id.* at 33-34.

The OCC staff generally provide comments to the memoranda they are assigned by e-mail. Those e-mails are to be maintained on a shared drive on the computer so that all staff in the OCC has access to the comments. *Id.* at 43. The OCC has so-called "bagel meetings" every Friday where the OCC staff meet. *Id.* The OCC staff tend not to discuss work in those meetings, but if they do discuss work it is usually what happened in the most recent Commission meeting. *Id.* Given that the OCC reviews all Enforcement matters and that OCC staff have access to all comments and information related to matters being considered or referred for Enforcement action, [#1] has access to a tremendous amount of nonpublic information.

2. The Other Associate Groups

As discussed above, [#3] and [#2] work in [ ] within the

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[#2] told us that her Assistant group has weekly bagel meetings every Thursday where they generally talk about what was discussed at the senior staff meetings and cases in their group. *Id.* at 15. [#2] testified that her cases have been discussed in bagel meetings. *Id.* at 16. She said that she generally becomes aware of what is mentioned in the staff meetings but that she didn't "keep up with other people's caseloads." *Id.* at 16.

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10 The "Wells submission" process represents a critical phase in SEC investigations. Pursuant to the Securities Act Release No. 5310, Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations (September 27, 1972), at the conclusion of an Enforcement investigation where staff has decided to seek authority from the Commission to bring a public administrative proceeding or civil injunctive action against an individual or entity, Enforcement staff may advise prospective defendants of the proposed charges against them and provide them the opportunity to file a written statement "setting forth their interests and position" in accordance with Rule 5(c) of the Commission's Rules on Informal and Other Procedures, 17 C.F.R. § 202.5(c). Prospective defendants use these responding statements – known by the SEC and the securities bar as "Wells submissions" – as an opportunity to set forth the reasons why the staff should not pursue such action before the Commission brings formal charges.

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[#3] said that since she joined the new Assistant group last year, they have held about three or four staff meetings, during which they did discuss cases they are working on. *Id.* at 22. In [#20] group, [#3] testified that they had regular bagel meetings every Wednesday where they discussed cases before they went to the Commission. *Id.* at 23. As a [#3] attends Enforcement's weekly senior staff meetings where cases are discussed. [#3] testified that she directly supervises four attorneys. *Id.* at 8. In her Assistant group, however, there are eight staff attorneys and the Branch Chiefs supervise all of them on individual cases. *Id.*

B. Enforcement's Confidentiality Policy

Each person who testified in this matter gave us different views of the confidentiality policy as it relates to Enforcement investigations and, in particular, whether Enforcement staff can share nonpublic information internally. In addition, we found no specific written policy on whether nonpublic information can be shared with others at the SEC. For example, [#4] testified that "... information is generally only shared that needs to be." [#4] testified that there is a prohibition on Enforcement attorneys sharing information with non-Commission persons, other than witnesses and people involved in the cases. *Id.* at 50.

As to whether Enforcement attorneys can discuss cases with other Commission employees, [#4] testified that they "might want to discuss particular legal theories" and share information, but that they should be discreet about it. *Id.* at 50-51. [#4] further testified that it would not concern her if she learned that an employee in the OCC e-mailed an Enforcement attorney in another group or even other Commission divisions because they frequently discuss cases. *Id.* at 51. But when asked if it would concern her if one of the OCC staff attorneys was recommending stocks from his SEC e-mail account to people outside of the Commission, such as [#1] did, [#4] testified, "... that would raise concerns because people would assume that the individual had access to information." *Id.* at 54.

[#5] however, testified that his understanding of Enforcement's confidentiality policy is that the investigations are confidential because they are nonpublic and that "[t]hey can't be discussed or shared with anyone outside of the investigative team or other folks within the building who have a need to be involved in our investigations."

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[#2] [#1] [#3] also had different views of the confidentiality policy. [#3] testified that investigations are "absolutely confidential" and not to be discussed with anyone outside of the Commission. [#3] pointed out that if someone calls and asks about an investigation, Enforcement attorneys cannot admit or deny the existence of an investigation. *Id.* As to whether Enforcement attorneys can discuss investigations with other SEC employees "[w]ithin the building," she testified, "I think the policy has changed over time." *Id.* at 18.

[#3] then testified that several years ago when [#16] was her [ ] he would caution the attorneys in his group not to discuss cases "around the building" and would say, ". . . look don't chat amongst your friends about what you're working on." *Id.* She further testified about [#16] cautions to staff: "You should be very careful about discussing your cases. Unless there's a need to do so, you shouldn't be discussing your cases with staff [sic] shouldn't be the topic of idle chatter." *Id.* at 19-20.

She said that she did not remember any other [ ] "saying anything expressly" about confidentiality, but testified ". . . it just sort of permeates how we function." *Id.* at 21. [#3] then went on to discuss how there are frequent discussions among Enforcement staff about not interviewing anyone calling from a cell phone or receiving nonpublic documents by facsimile. *Id.* at 20-21. According to [#3] Enforcement senior staff are cautious in their management meetings not to discuss open Enforcement investigations because:

> . . . internally there's a certain sensitivity that you don't make your investigations sort of the topic of idle chatter unless there's some constructive reason for why you are having a discussion with somebody else. *Id.* at 19.

[#1] testified that he believes the confidentiality policy is that Enforcement staff cannot discuss investigations with those who do not work for the SEC. [#1] But as to whether he could discuss Enforcement investigations with others at the Commission he testified:

> As far as my understanding of rules or limitations, unless something is an executive session item, there is no strict prohibition on talking about it with colleagues, and colleagues, as far as my understanding of any rule – it's not necessarily limited to Enforcement." *Id.* at 34.

[#1] testified he does not remember where that understanding came from. *Id.* at 35. [#1] said there is a value to sharing experiences and lessons with colleagues. *Id.* at 32.

[#2] testified that her understanding of the confidentiality policy is ". . . to keep our investigations in the strictest of confidence." [#2] elaborated, "Meaning we don't discuss them with anybody in the public, only among the people we need to

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discuss them with or, you know, within the Commission." *Id.* at 21. She did not know what the policy was for discussing investigations "within the Commission." *Id.* [#2] testified she did not think the policy was any different if it was being discussed within her Assistant group or outside of it because she thinks of Enforcement as a "general group." *Id.* at 22.

[#2] testified she ". . . will bounce ideas off others in Enforcement" at lunch and when she is visiting their offices. *Id.* at 23. She further testified that she had not heard of a policy that information about investigations should only be shared with those who need to know about it. *Id.* [#2] remembers being told about the confidentiality requirements when she began at the Commission in 1981, but does not remember it being reinforced over the years. *Id.* at 24-25.

C. Testimony about the Enforcement Attorneys' Character and Integrity

The OIG investigation revealed that everyone we interviewed or took testimony of said they thought highly of both [#2] and [#1] character and integrity and would be very surprised if either of them used information they learned in their jobs at the SEC for personal trading purposes. Everyone also testified or told us that they are both careful, experienced attorneys. [#10] testified that he found [#3] to be a very careful, good attorney, as well. Memorandum of Interview of [#10] August 5, 2008, attached hereto as Exhibit 51, at 5.

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D. Enforcement Attorneys Engage in Frequent and Regular Discussions about Stock Transactions and Work

1. Long-Standing Regular Weekly Lunches

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All three testified that during their "standing lunch on Mondays," [#1] [#2] and [#3] often discussed stocks, their contemplated stock transactions, and the financial markets, as discussed below. In addition, we found that they also discussed work at their lunches. [#2] [#1] [#3] We found that they did not have a policy of not discussing their Enforcement cases or matters with each other. [#2] During the earlier years of their lunches, they generally frequented the [ ] restaurant near the former SEC headquarters building. [#1] In more recent years, they usually met for lunch at

[#2]

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[#3] testified that in more recent years, [#2] [#1] and [#3] had lunch together about 40 times a year and that those lunches would last an hour or an hour and a half. [#3] estimated that of about 60 hours each year they would spend at lunch together, they spent about 15-20 hours devoted to discussing particular securities, another 15-20 hours discussing general market conditions, and the remainder of their time discussing politics. *Id.* at 86. Therefore, according to [#3] their lunch discussions would consist of about 30-40 hours of discussion annually about stocks and the financial markets.

a. Discussions of Stock Transactions

According to [#3] who we found to be a credible witness, there were two primary topics of conversation during their standing lunches with the three of them – politics and securities trading. [#3] [REDACTED PER REQUEST OF USAO]

[#2] reluctantly admitted that the stock market came up frequently at their lunches, and that they have discussed particular stock transactions. [#2]

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[#1] testified that he discussed stocks with [#2] "pretty often" and that the stock market and trading was a "significant topic of conversation" between them.

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Many of the e-mails we reviewed showed that they discussed particular stocks and contemplated stock transactions at their lunches.

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In addition, many of the e-mails they sent each other about meeting for lunch contained discussions about stocks.

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b. Discussions of Enforcement Matters

[#2] [#1] and [#3] all admitted that they discussed work and their cases with each other, particularly at their lunches which was the time they primarily saw each other. [#2] [#1] [#3]. [#2] testified that they sometimes discussed their cases and that she sometimes solicited their advice on cases. [#2] testified she would seek [#1] advice, ". . . if I had an issue in a case because [#1] is in the [ ] and I would sometimes get some feedback from him." *Id.* at 33. As to [#3] [#2] testified, [#3] a [ ] here and she's had a lot of experience and I would sometimes get input from her." *Id.* at 34. [#2] claimed not to recall [#1] discussing any of the matters he reviewed [ ] *Id.* at 37.

[#2] testified she, [#1] and [#3] discussed their SEC work, despite the fact that none of them had a need to know about each other's investigative matters. *Id.* at 41. [#2] testified when they discussed work at lunch, they "would try to be very careful" and would not mention case names. *Id.* at 123-124. But she said that they would discuss things like "sending a memo up on a case" or "we're taking testimony right now in a case." *Id.* at 123. [#2] was not sure whether they ever mentioned witness names, but testified that she did not think they got that specific in their discussions. *Id.* at 123.

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[#3] testified that she discussed work with [#1] although "not the substance of the work" but more of the legal issues that arise or hassles she was having. [#3] But [#3] told us it is not unusual for her to discuss cases that are going to the Commission with [#1] *Id.* at 115.

[#1] testified that [#2] discussed her cases with him "to some degree" and that [#3] updates him about her cases, and usually solicits his advice. [#1] E-mails show that [#1] was clearly aware of [#3] cases. For example, on April 7, 2006 [#1] e-mailed [#3] that he noticed that one of her "trading suspension" cases had not been written about in a weekly e-mail sent regularly by the Enforcement Director or in a Digest discussing recently brought cases, either. April 7, 2006 E-Mails, attached hereto as Exhibit 58.

2. Frequent E-Mail Discussions About Stocks During Work Day Violates Commission Policy on E-Mail Use and Raises Concerns

A review of their e-mails establish that [#2] and [#1] had frequent e-mail discussions with each other about personal matters during the workday.[11] Some of those e-mails related to their lunches, and others were about particular stocks, the financial markets, and their anticipated or completed stock transactions. [#3] was often copied on those e-mails but rarely responded.[12] [#2] and [#1] both maintained folders in Microsoft Outlook entitled "Stocks." Despite substantial evidence to the contrary, [#2] and [#1] both denied under oath using their SEC e-mail frequently to discuss the stock market. [#2] [#1] Both were unfamiliar with the SEC policy and rules that their SEC e-mail could be used for personal reasons primarily during non-work hours. [#2] [#] Similarly, [#3] was unaware of the *de minimus* personal use requirement for SEC e-mails.

A review of randomly selected days throughout the e-mail review period of more than two years, shows that [#2] and [#1] sent e-mails from their SEC e-mail accounts, often to each other, about stocks (and other non-work matters) nearly every work day. A sample of some of those e-mails is attached. [#2] E-Mails dated August 8, 2006, July 19, 2006, January 8,

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11 [#2] testified that she works the alternative work schedule called "5-4-9" and that her work hours are 9:00 a.m. to 6:30 p.m. most days, with every other Friday off and one shorter work day every two weeks of 9:00 a.m. to 5:30 p.m. [#2] [#1] testified that he generally works every day from 10:00 a.m. until 6:30 p.m. [#1]

12 [#3] was included as a recipient on most of the e-mails discussed below. For the sake of brevity, however, we are not referencing her as a recipient since [#3] rarely responded to these e-mails.

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2007, January 30, 2007, February 28, 2007, April 18, 2007, April 26, 2007, May 8, 2007, May 21, 2007, July 17, 2006, January 17, 2008, & January 28, 2008, attached hereto as Exhibit 59 & [#1] E-Mails dated April 5, 2006, April 28, 2006, August 2, 2006, December 18, 2006, January 8, 2007, March 20, 2007, April 26, 2007, May 29, 2007, May 31, 2007, July 17, 2007, attached hereto as Exhibit 60. Each of those days selected for review show both [#2] and [#1] sent e-mails about stocks and sometimes several each day. *Id.* An overall review of their e-mails shows that they sent e-mails about stocks at least a few times a week. *Id.* We therefore find that [#2] and [#1] use of e-mail for personal reasons was excessive and violated the Commission's policy on personal use of SEC resources. It also raises suspicions about their securities trading activities.

Both also claimed under oath not to remember sending or receiving any of the two dozen e-mails they were shown in testimony taken from their SEC e-mail accounts. *See, e.g.*, [#2] Tr. at 42; 44; 83; 85; 87; 89; 92; 95; 98; 99; 101; 103; 106; 108; 112; 115; 116; 124; 128; & 145; [#1] at 67; 72; 75; 121; 146; 160; 162; 165; 166; 169; 170; 172; 173; 174; 175; 187; 194; 205; 207; 209; & 211. Some of those e-mails were lengthy e-mail chains about particular stocks and stock transaction they had made or were thinking of making, as discussed below. We did not find this testimony credible. [#1] sometimes solicited [#2] advice about particular securities, referring to her at times as a "stock guru," and even sent e-mails to his brother and sister-in-law recommending stocks and telling them that [#2] was recommending it, as discussed below. These e-mails also raise suspicions given each of the subjects' tremendous access to nonpublic information.

According to [#3] [#2] and [#1] used to send e-mails to each other and her about a variety of topics unrelated to work, including the stock market. [#3] [#3] also said that if [#2] was on the e-mail she knew it was personal and not work related. *Id.* at 66. According to [#3] [#1] e-mails her "pretty regularly," and that more recently she gets two to three e-mails from him throughout the week, less than in prior years, about his outside interests. *Id.* at 58-59. She testified that she tends not to read most of them because most are not work related. *Id.* [#3] testified, "I think that there were times when we might have discussion about a stock during lunch or a stock which one of them knew the other to own and there'd be follow up communication during the week relating to the stock." *Id.* at 62. She told us that she did not respond to many of their e-mails about stocks because she did not have time and she was not sophisticated enough about the stock market to respond. *Id.* at 66.

Even though [#2] denied remembering any of the e-mails we asked her about, she testified as to almost all of these e-mails that she recalled the particular market conditions at the time of the e-mail, or that [#1] was interested in owning, or did own, the particular stocks, or

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that they had discussed the stock at issue at their regular lunches.[13] *See, e.g.*, [#2]

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[13] We did not focus our investigative resources on whether [#2] used the SEC Internet for stock trading or personal purposes, but it is clear from her own testimony and several of her e-mails, discussed below, that she did in fact use the SEC Internet for her own trading purposes despite her testimonial assertions to the contrary. *See* [#2] [#2] testified that she uses the SEC Internet to keep abreast of the financial markets and to find possible companies to investigate, all in support of her work at the SEC. [#2] further claimed she checked the Internet two to three times a day when she was taking a break from work and to see what was happening in the financial markets that may affect her work. *Id.* at 53. [#2] also admitted to viewing Bloomberg, Yahoo finance, and Google Finance, as well as visiting message boards, from her SEC computer during the work day. *Id.* at 58.

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Other e-mails [#2] and [#1] exchanged show that they often discussed stocks and their own stock transactions using their SEC e-mail, and often during the work day.

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These are just some of the examples of e-mail exchanges between [#2] and [#1] about particular stocks using their SEC e-mail accounts. *See also* Exhibits 59 & 60. Although many of the e-mails she sent that we showed her were during her work hours, [#2] testified, ". . . I would say that I was taking a break from my work at that time." [#2] In all, these e-mails establish that [#2] and [#1] often shared specific information about particular stocks and their investments and [#1] sometimes sought advice from [#2] about his securities transactions. A review of their brokerage records also establish that [#2] and [#1] own many of the same stocks. Joint Stock Activity of [#2] and [#1], attached hereto as Exhibit 75.

E. [#1] Recommends Stocks to Family from SEC E-Mail Address

Our investigation revealed that [#1] e-mailed his brother and sister-in-law from his SEC e-mail address on a number of occasions about investments and ideas for trading. [#1] Specifically, we questioned [#1] about five separate e-mails he sent to his brother and sister-in-law from his SEC e-mail account about a few different stocks. [#1] claimed not to remember any of those e-mails, which were sent in late 2007 and early 2008. [#1] [REDACTED PER REQUEST OF USAO] On more than one occasion, e-mailed his brother and sister-in-law that his "stock watching friend, [#2]" told him about investment ideas, as discussed below. [#1] admitted:

> I know I shared with him stock investment ideas or telling him - - I was thinking about doing it or not. I am quite confident that those were in e-mails, either from home or work or both. I cannot quantify it. [#1]

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[#1] further testified that he sometimes shares with his brother stocks he is thinking of buying or has bought. *Id.* at 209. [#1] admitted it is pretty rare his brother shares information with him. *Id.*

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[#1] told us that his brother knows he works in the Enforcement Division at the SEC but testified that he believes his brother also knows ". . . I would never tell him anything that I shouldn't." [#1] also testified that he has no reason to believe that his brother or sister-in-law share the e-mails he sends them with anyone. [#1] When asked why he told his brother and sister-in-law about what [#2] recommended, he testified that he did not recall if they knew [#2] works at the SEC. *Id.* at 206. said he may have told them that [#2] likes to trade and is pretty savy about the markets, but claimed not to remember one way or another. *Id.* We did not find this explanation credible.

When asked if [#1] thought it was appropriate to be sending e-mails discussing stocks to persons outside the Commission from his SEC e-mail address, [#1] testified:

> I think I can have personal contacts with my brother on the SEC computer, within reason. I am not aware of there being any subject matter limitation to that, and - - nor, sitting here today, should there be, necessarily. The question is, am I telling him something that - that would in any way suggest that, you know, he should trade on something that maybe I'm not allowed to trade on. I mean, definitely, that would potentially be a problem, but that's not the case. [#1]

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[#1] denied the e-mails created any appearance of an impropriety, testifying that he did not share nonpublic information with him. *Id.* at 215 & 219. In addition, [#1] testified, "I was not aware of an e-mail to my brother about something I bought creating an appearance of conflict." *Id.* at 219. [#1] further testified:

> I can't answer for you what others may think. I would tell them, if they were outsiders and they said, gee, is this a problem, or we think it is, I would say I'm sorry you do think it's a problem, I did not, and to the extent you're concerned, let me assure you, I did not pass on material nonpublic information. If you were concerned, look at the records, look to see if I knew anything about [N] in this example. I did not. There's no basis. *Id.*

[#1] admitted that to the extent there were questions about his sending these e-mails, he would avoid it in the future "to the extent of being asked [sic] by the IG or supervisors or whoever." *Id.*

As discussed above, [#4] testified that if she learned that one of her staff attorneys was recommending stocks from his SEC e-mail account to people outside the Commission, ". . . that would raise concerns because people would assume that the individual had access to information." [#4]

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F. Admitted Risks of Trading on Nonpublic Information

As discussed above, [#3] testified that she has had a concern about "scrubbing [her] mind clean" of information she learned in her work as [ ] in Enforcement when she has purchased stock. [# 3] at 38-39; 74; 86; 99; 100-102 & 105. [# 3] testified:

> . . . I do remember expressing on a number of occasions orally . . . how do I choose an investment, I haven't been privy to something that someone hasn't said something that I need to know about, and so, before I invest, that's why I oftentimes pick a stock and then I will continue to hold. *Id.* at 99.

[#3] testified that she waits for a long time to invest because she wants to figure out if there is anything that she's heard about that company at work. *Id.* She explained, "I would worry, is there something that someone may have said in a Monday morning [senior staff] meeting, or in a discussion with me, or in a bagel meeting, that may be a problem here, and how do I control that." *Id.* [# 3] continued, "If you even are even [sic] subconsciously aware of it, but you just have a generally favorable view or even negative view, you want to sell a security. How do you scrub your mind clean of that detail even though you may not be consciously aware of it." *Id.* at 105.

In an e-mail [#3] sent to [# 1] about [RR] on Saturday, January 21, 2006, she asked [# 1] "Do you think investing in [RR] is feasible. I worry that there is some investigation about which I should know about, and can't think of anything. But if there's something obvious that is out there, I don't want to make a gaff in investing." January 21, 2006 E-Mails, attached hereto as Exhibit 81.

When asked, ". . . do you think that it's possible that in [#2] or [#1] securities transactions, that they might at least be colored by some of the information that they've gained by their work, or heard in the building?," [#3] replied, "I think as a practical matter, that's a risk that each and every one of us runs . . . ." [#3] said that is why historically no one at the SEC was allowed to trade in securities. *Id.* [#3] continued, "So, I mean, yeah there are risks that something's going to be out there and I will find out about it, and it's not going to register with me, I cannot trade." *Id.* at 102.

[#3] added, "As a general matter, the higher up you go in the hierarchy the more cases you are exposed to, the greater the risk." [#3] admitted that [# 1] and others in [ ] have access to a great deal of nonpublic information in their jobs. *Id.* at 105. She testified, ". . . those people that are exposed to more matter and information, yeah, clearly that's a greater risk." *Id.* at 105. [# 3] estimated that Enforcement brought about 600 cases this year, and noted that [ ] have worked on all of those matters. *Id.*

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[#2] and [#1] testified they did not share these same concerns as [#3] about unwittingly trading on nonpublic information. [#2] testified she has never used nonpublic information. [#2] claimed she does not really hear about cases in staff meetings, and testified she did not remember ever discussing something in a staff meeting that she held as an investment. *Id.* at 139. As discussed above, [#2] said she ensures she does not invest in stocks she has nonpublic information about by "just remembering." *Id.* at 142.

[#2] denied there being an appearance of an impropriety if she traded in a company's stock that was being investigated at the same time, or around the same time, that she invested. She testified, "I don't see it as an appearance problem as long as I didn't have the information. I just don't." *Id.* at 246. [#2] further testified that she did not see how there is an appearance problem if there is no underlying problem or violation or issue. *Id.*

Similarly, [#1] testified, "I have never been concerned that I would trade on [nonpublic] information. I know I am not supposed to. I never have." [#1] When asked if he could have unwittingly traded on nonpublic information, he testified, "How could I do that inadvertently? If I don't know about the fact, I'm not trading based on that fact." *Id.* [#1] added if he had learned about something and then forgotten it:

> I have potentially created a problem for myself, because someone may wonder whether I remembered and what I remembered, but I have not, in that situation, traded on any kind of material nonpublic information. My heart is pure. *Id.*

When asked, "Is it possible that . . . either one of them [#2] [#3], or you, perhaps unwittingly traded on information that you learned from the SEC but could not separate out that you learned it somewhere else versus internally?," [#1] testified, "I have no reason to believe that happened." [#1] said he could not answer whether it could have happened. *Id.* at 195. [#1] told us the only other alternative is for him, and other SEC employees, not to trade at all. *Id.* at 195 & 201.

III. Enforcement Attorneys' Trading in Stocks Being Investigated by Her Assistant Group Has An Appearance of Conflict and Impropriety

Our investigation revealed that [#2] traded in two particular stocks in the last couple of years in which her [ ] had ongoing Enforcement investigations. There is, at least, an appearance of impropriety and possibly evidence of insider trading because [#6] testified that there is generally a familiarity among his staff with most cases being investigated by his group. [#6], August 26, 2008, attached hereto as Exhibit 82, at 19. Moreover, we found e-mails between [#2] and [#1] discussing their investments in these two companies – [A] [B]

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A. [A]

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[#8] testified that while she herself had never bought a stock, she assumed that there was some kind of alert list if there is an open matter, and that you either cannot trade in that stock or you certify that you have no knowledge of the open matter. [#8] In fact, no such list or certification currently exists.

B. [b]

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IV. Enforcement Attorneys Both Trade in Company Friend Told Them Was Being Investigated by Enforcement in Three Separate Investigations

[#3] testified that she purchased stock in a large financial services company [R] in August 2005 after she received clearance from the Ethics Office. [#3] According to [#3] before she purchased the stock she told [#1] that she was denied clearance by CRST for [R] and he told her that CRST always gives a denial and that she needed to call the Ethics Office. *Id.* at 31-32 [#3] testified that she called the Ethics Office to determine whether she could trade in [R] since the company has a brokerage component and SEC employees are not allowed to invest in broker dealers. *Id.* at 31. [#3] was told by the Ethics Office that, as difficult as it was to believe, yes she could trade in [R] [#3] recalled that the Ethics Office counsel told her that because [R] was sufficiently diversified from its brokerage component SEC employees were allowed to trade in [R] stock. *Id.*

[#3] also testified that after she purchased [R] stock she learned ". . . on three successive occasions, that there were three separate open investigations . . . ." *Id.* at 39. She said she learned in Fall 2005, then Spring 2006, and then June 2007 of the three separate [R] investigations. *Id.* According to [#3] her position is that she cannot now purchase additional stock in [R] [#3] testified that she had planned to buy a lot of [R] stock but ". . . that just did it, as soon as I heard that" as to her additional purchases of [R] stock. *Id.* at 40.

[#3] further testified that she shared with [#2] and [#1] the information she learned about the three separate investigations of [R] at their lunches. *Id.* at 73; 98; 125-126. In fact, [#3] testified that [#2] and [#1] would tell her to buy more [R] stock, and she told them she could not purchase more because of the investigations of [R] she had learned about. *Id.* at 125-126. [#3] testified she believed neither [#2] nor [#1] owned stock in [R] *Id.* at 98. [#3] was incorrect.

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Both [#2] and [#1] traded in [R]. [#3] had a clear recollection of raising the SEC investigations into [R] with [#2] and [#1] and they all clearly discussed it with [#3] at lunch and in e-mail. We find those facts raise at least an appearance of an impropriety and possible Rule 5 violations if, in fact, [#2] and [#1] knew about ongoing Enforcement investigations and traded anyway. Because of the seriousness of the information we uncovered, as discussed above, we referred this matter to the United States Department of Justice.

V. Inadequacy and Inefficiency of the Rule 5 "Compliance System"

A. Enforcement Attorneys Never Questioned about Stock Holdings

Our investigation revealed a general lack of knowledge about Rule 5 requirements among the Enforcement staff and supervisors we spoke to during this investigation. None of the supervisors we interviewed or took testimony of held stock themselves. *See, e.g.*, [#10] [#8] [#5] [#6] [#7] [#4]

Moreover, none of them had a good understanding of Rule 5 requirements or the SEC's Rule 5 compliance system, discussed above. [#4] testified that although she is [ ] she is only "generally familiar with Rule 5" and would call the Ethics Office if she had a question. [#4] She further testified that she has limited experience with it personally. *Id.* at 15. Despite this general lack of understanding of Rule 5 requirements and how the Rule 5 compliance system actually works, these supervisors are charged with ensuring compliance with it.

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[#6] testified, "I just don't know the rules of how involved you have to be in the cases before you can buy or sell because I'm not familiar with Rule 5." [#6]

[#8] testified, "I would be surprised that a purchase like that [A] would get through in approval." [#8] She further testified, "I would assume if we have an open matter there's some list like firms have, sort of a watch list, an alert list that where either you don't buy or you certify somehow that you have no knowledge." *Id.* at 28. In fact, the SEC does not have such a list nor are employees required to certify they have no knowledge of any ongoing Enforcement investigation related to that company.

Moreover, [#2][#1] and [#3] all misunderstood the Rule 5 requirements, as discussed above. [#2] failed to report when she earned more than $200 in any given year on the OGE Form 450. [#1] failed to report securities he received through non-acquisition such as restructuring or spin-offs, as required. And [#3] may have failed to timely report certain transactions, as discussed *supra* in footnote 6.

In addition, the investigation revealed that there was a lack of proper review of the OGE Form 450s. No office head who supervises or supervised [#2] and [#1] ever questioned any of their stock holdings listed on their OGE Form 450s, even where they held securities in companies that had been or were being investigated by the SEC. [#2] [#1] [#4] and [#5] testified that in the years they have been reviewing the OGE Form 450s they have never once questioned an employee about any of their stock holdings. [#4] [#5] Yet both [#4] and [#7] identified several companies listed on [#1] Form 450s [ ] had reviewed over the years. *See* [#4] [#7]

Moreover, both [#4] and [#5] rely solely on their memories and knowledge of open investigations and which staff are assigned to those investigations when analyzing conflicts. [#4] [#5] [#4] testified that she does not often remember who is working on what so she would be thinking of what the whole office has reviewed in terms of conflicts on the Form 450s. [#4] Further, the only documents either office head has in front of them when reviewing the Form 450s is the employee's prior year Form 450 and an instruction sheet. [#4] [#5]

[#5] testified that he compares the prior year Form 450 and the current year "... to see if there has been any significant changes that I think raise a red flag." [#5] [#5] claimed to have a "very strong understanding" of what cases are open in his group because a case cannot be opened without his approval. [#5] testified that he has a "pretty good understanding" of who is working on what matters. *Id.* at 23. He admitted, however, that he is rarely involved in deciding which staff attorneys are assigned to each

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matter because those decisions are usually made by the Branch Chief or Assistant Director. *Id.* at 25.

Surprisingly, no one we interviewed was clear as to which office had responsibility for the OGE Form 450. [#4] testified, "I always thought I dealt with the ethics office on it." [#4] Similarly, [#4] did not know who in Enforcement was reviewing the OGE Form 450s besides herself. *Id.* at 16. [#5] did not know what office administers the OGE Form 450. [#5] [#4] believed that someone at her level, however, should be reviewing the OGE Form 450s because they "... have a general awareness of the cases that are being done in the office." [#4] As discussed above, [#5] believes he has a "very good understanding" of what matters are open under him and a "pretty good understanding" of who is working on what matters. [#5] As we noted at page 42, however, we found one example of a matter currently being investigated by a Branch Chief in [#5] group that he admitted he was unaware of. [#5]

[#8] testified that she believed either OHR or OGC reviewed the OGE Form 450, but that no supervisor reviewed hers. [#8] Specifically, [#8] testified, "... it is my understanding and my expectation that my financial information either go directly to the reviewer or if there's any stop in between, it's purely ministerial." *Id.* at 29. When asked who she thought was reviewing it for conflicts, which she admitted was the purpose of filing the OGE Form 450, she testified, "Oh, interesting question. I've never thought about it." *Id.*

B. "No True Compliance System"

Both Ethics Office and OHR officials admit that there is "no true compliance system" at the SEC for determining whether SEC employees have committed Rule 5 violations. Exhibit 10. First, the employee financial disclosure reporting requirements are based on the honor system. *Id.* Employees are expected to comply with the financial disclosure and clearance systems, yet there is no checking to determine reporting or clearance accuracy or even whether an employee has reported at all. *Id.* There are no spot checks nor does the SEC obtain duplicate copies of the employee's brokerage records. *Id.* In addition, no one checks to see if there is compliance with trading and then reporting within five business days of the employee receiving clearance or confirmation, respectively. *Id.* Moreover, no one checks to see if the employee cleared the transaction before their reported trades. *Id.*

Our investigation revealed that office heads do not throughly review the OGE Form 450s for conflicts of interest. In addition, those OGE Form 450s are only a snapshot in time, showing securities held by the employee on December 31st of the calendar year. Exhibit 14. Therefore, an employee could trade in a company's stock that they were investigating, but not have to report it on the OGE Form 450 if they sold it before December 31 and did not earn more than $200 on the sale. *Id.* Moreover, only certain, higher pay grade employees are required to file an OGE Form

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450. Direct supervisors seem to be in the best position to review an employee's securities holdings for conflicts because they are most aware of staffing and caseload, yet the office heads are responsible for reviewing the OGE Form 450s. And, as shown here, the office heads are not necessarily aware of all the cases or of all the subordinate employees who are assigned to those cases. *See* [#4] [#5]

As discussed above, at pages 11 to 14, several different offices which are not interrelated and do not share information with each other handle various responsibilities under Rule 5. For example, OHR collects and retains SEC Form 681s, but the Ethics Office is responsible for sometimes clearing securities transactions that then get reported on the SEC Form 681s. Exhibits 6; 9; 12; & 13. The OGE Form 450s are reviewed by office heads and collected by the Ethics Office to be sent to OGE. Exhibits 16 & 17. Ethics Office officials informed us that the SEC's Division of Corporation Finance updates and maintains CRST.

While OHR has responsibility for employee financial disclosure and receives the SEC Form 681s, it is not a primary function in OHR and we understand that historically, it is not an area they have willingly accepted responsibility for. Currently, there is primarily only one employee responsible for receiving and maintaining all SEC Form 681s. From the SEC Form 681, OHR can produce annual reports for individual employee holdings, although it is unclear whether these reports are routinely produced or reviewed. Moreover, we found the report for [#2] to be inaccurate as to some of her securities transactions. Annual Report of Securities Holdings for Employee, March 18, 2008, attached hereto as Exhibit 98.

As both [#2] and [#1] testified, CRST is not well maintained and updated. [#2] [#1] The Ethics Office agreed that CRST rarely gives clearance for a transaction and that most of them should have been cleared. *See* Exhibit 63. The Ethics Office responds to requests from the CRST mailbox to verify whether certain transactions should in fact be blocked based only on pending registration statements. *Id.* To do that, an attorney in the Ethics Office checks EDGAR to determine whether in fact a registration statement is pending or has yet to go effective. *Id.*

[#2] who has likely used the CRST system hundreds of times over the years, testified that about 60% of the security names entered into CRST show up as blocked. [#2] [#1] testified that he finds the CRST system frustrating because it blocks many securities transactions that should not be blocked. [#1] Then [#1] said he has to go to the CRST mailbox to check to see if the transaction should in fact be blocked. *Id.* at 63. [#1] testified that employees are trying to do the right thing and "there is a delay if you have to go behind it and see if it's accurate." *Id.* at 65. This prevents [#1] from buying or selling when he wants. *Id.* at 66. Moreover, [#2] testified that sometimes the CRST system is down and other times it operates very slowly. [#2]

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Finally, the employee financial disclosure reporting is not automated or interrelated. This lack of an automated system results not only in a less effective compliance system but in a waste of time and resources for both employees and agency officials. Because the CRST is not updated regularly, it is often incorrect. Therefore, the employee has to spend time asking the Ethics Office if the blocked clearance is valid. Ethics Office counsel spend time reviewing EDGAR to make that determination, and then reporting back to the employee.

The Ethics Office is currently working to set up a compliance office within the Ethics Office that would use an automated web-based Rule 5 tracking system.

Recommendations & Conclusion

Our investigation revealed suspicious activity, appearances of improprieties, and we identified stocks for which there is evidence that [#1] and [#2] may have traded on nonpublic information or engaged in insider trading. The OIG investigation found that [#2] [#1] and [#3] all committed violations of the SEC's Rule 5 reporting requirements. Moreover, the investigation found that [#2] and [#1] failed to consider how their actions could result in appearances of improprieties, which Rule 5 is aimed, in part, at preventing. [#2] and [#1] also misused government resources by frequently sending and receiving e-mails related to their stock transactions, which also raised suspicions about their trading activities.

The OIG strongly recommends that the Commission immediately begin to institute steps to better monitor SEC employees' compliance with Rule 5, as outlined below. The OIG also recommends that apparent or actual violations of Rule 5 be reported to the Ethics Office and the OIG when discovered. We note that Rule 5 currently requires repeated violations be reported to the Commission for "appropriate action."

The OIG specifically recommends that:

(1) One office have primary responsibility for ensuring compliance with Rule 5;

(2) There be an integrated, computerized system for every facet of Rule 5 compliance, including CRST clearance, SEC Form 681s and OGE Form 450s;

(3) The SEC give serious consideration to obtaining duplicate copies of brokerage record confirmations for each securities transaction for every SEC employee, to ensure that employees who do trade in securities report each transaction and that they report it accurately and timely;

(4) The SEC Form 681s be amended to require employees to certify in writing that they do not have nonpublic information related to each security transaction they conduct and report;

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(5) The SEC Form 681s be reviewed and checked against the CRST clearances to ensure that employees did obtain clearance to buy or sell it and that the trade was timely made after obtaining clearance;

(6) Have the employees' direct supervisor (not the office head) review a list of all pending cases in his or her group over the last year to compare against a list of all securities reported on the OGE Form 450 for each employee (the employee's name could be withheld for privacy purposes) to ensure no potential or actual conflicts or insider trading;

(7) Have the office primarily responsible for Rule 5 compliance conduct regular thorough spot checks for Rule 5 compliance for randomly selected employees each quarter, particularly if the SEC does not obtain duplicate brokerage record confirmations;

(8) Conduct separate comprehensive and more frequent training on Rule 5, its purpose and its requirements, for all SEC employees, supervisors and contractors, including training on the OGE Form 450 for both (a) employees who file the reports, and (b) the office heads who review the reports;

(9) The OGE Form 450s be compared against each employee's SEC Form 681s to ensure accuracy;

(10) The SEC consider expanding the staff who are required to file OGE Form 450s beyond the higher-paying grades currently required to file; and

(11) There should be a clear written policy on the confidentiality of Enforcement investigations, and other SEC confidential, nonpublic information, and whether and when staff can discuss with each other their confidential investigations or matters. Employees should be regularly reminded of that policy.

The OIG investigation revealed that the Commission lacks any true compliance system to monitor SEC employees' securities transactions. In addition, the OIG found that there is a poor understanding and lax enforcement of the reporting requirements.

The Ethics Office plans to institute a web-based system to automate SEC employee reporting of personal securities transactions and holdings. On December 2, 2008, the SEC held a pre-solicitation conference on the Employee Securities Transaction Compliance System related to its plans to issue a request for proposals to implement such a system. The Ethics Office will use the automated system to administer, supervise and manage certain compliance processes, including employee reporting, record keeping, pre-trade clearance, and alerting and transaction monitoring.

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This matter is initially being referred only to the Chairman, the Chairman's Chief of Staff, the General Counsel and Senior Policy Director, the Director of the Division of Enforcement, and the Ethics Counsel for appropriate disciplinary action against [#2] and [#1] and for implementation of the above recommendations.

Submitted: Kelly J. Andrews Date: 3/3/09
Kelly J. Andrews

Concur: Date: 3/3/09
Noelle Frangipane

Approved: Date: 3/3/09
H. David Kotz