U.S. Securities and Exchange Commission

Office of Inspector General

Office of Audits

Assessment of the SEC's Bounty Program

March 29, 2010
Report No. 474

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

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

March 29, 2010

To: Robert Khuzami, Director, Division of Enforcement

From: H. David Kotz, Inspector General, Office of Inspector General (OIG)

Subject: *Assessment of the SEC's Bounty Program,* Report No. 474

This memorandum transmits the U.S. Securities and Exchange Commission OIG's final report detailing the results of our assessment of the Commission's bounty program. This review was conducted in accordance with our annual audit plan.

Based on the written comments received to the draft report and our assessment of the comments, we revised the report accordingly. This report contains nine recommendations. Your office concurred with all the recommendations. Management's full comments to this report are included in the appendices.

Within the next 45 days, please provide OIG with a written corrective action plan that is designed to address the recommendations. The corrective action plan should include information such as the responsible official/point of contact, time frames for completing the required actions, milestone dates identifying how you will address the recommendations cited in this report, etc.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our auditor.

Attachment

cc: Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman
Diego Ruiz, Executive Director, Office of the Executive Director
Joan McKown, Chief Counsel, Division of Enforcement

Assessment of SEC Bounty Program

Executive Summary

Background. There is evidence that bounty programs are an effective tool to encourage whistleblowers to come forward and provide necessary incentives for outside entities to bring complaints about possible illegal activity.

Section 21A(e) of the Securities Exchange Act of 1934 (Exchange Act), 18 U.S.C. § 78u-1(e), authorizes the Securities and Exchange Commission (SEC or Commission) to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who tipped information to an insider trader, or from a person who directly or indirectly controlled an insider trader. All bounty determinations, including whether, to whom, or in what amount to make payments, are within the sole discretion of the SEC. However, the total bounty may not currently exceed 10 percent of the amount recovered from a civil penalty pursuant to a court order.

The SEC recently sent to Congress proposed legislation to expand its authority to permit bounties for any judicial or administrative action brought by the Commission under the securities laws that results in monetary sanctions exceeding $1,000,000. The proposed legislation was included in the Investor Protection Act of 2009 (H.R. 3817), which was introduced in the U.S. House of Representatives on October 15, 2009 by Representative Paul Kanjorski (D-Pa.) and referred to the House Committee on Financial Services. Variations of this legislation are being considered by both the U.S. House of Representatives and U.S. Senate.

Objectives. This review was conducted as a result of an issue that we identified during the OIG's investigation into the SEC examination and investigations of Bernard L. Madoff and related entities, OIG's Report of Investigation, *Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme,* Report No. 509, August 31, 2009.

The primary objectives of the review were to:

- Assess whether necessary management controls have been established and operate effectively to ensure bounty applications are routed to appropriate personnel and are properly processed and tracked; and

- Determine whether other government agencies with similar programs have best practices that could be incorporated into the SEC bounty program.

Results. Although the SEC has had a bounty program in-place for more than 20 years for rewarding whistleblowers for insider trading tips and complaints, our review found that there have been very few payments made under this program. Likewise, the Commission has not received a large number of applications from individuals seeking a bounty over this 20-year period. We also found that the program is not widely recognized inside or outside the Commission. Additionally, while the Commission recently asked for expanded authority from Congress to reward whistleblowers who bring forward substantial evidence about other significant federal securities law violations, we found that the current SEC bounty program is not fundamentally well-designed to be successful.

More specifically, we found that improvements are needed to the bounty application process to make it more user-friendly and help ensure that bounty applications provide detailed information regarding the alleged securities law violations. We also found that the criteria for judging bounty applications are broad and the SEC has not put in place internal policies and procedures to assist staff in assessing contributions made by whistleblowers and making bounty award determinations. Additionally, we found that the Commission does not routinely provide status reports to whistleblowers regarding their bounty applications, even if a whistleblower's information led to an investigation. Moreover, we found that once bounty applications are received by the SEC and forwarded to appropriate staff for review and further consideration, they are not tracked to ensure they are timely and adequately reviewed. Lastly, we found that files regarding bounty referrals did not always contain complete documentation, such as a copy of the bounty application, a memorandum sent to the whistleblower to acknowledge receipt of the application, and a referral memorandum showing the office or division and official to whom the bounty application was referred for further consideration.

We wish to note that the SEC has begun to take steps to correct the deficiencies identified in its whistleblower/bounty program. The SEC has had consultations with the Department of Justice (DOJ), Internal Revenue Service (IRS), and other agencies, as well as the Financial Industry Regulatory Authority, to identify best practices from existing well-defined whistleblower programs. The SEC has also attempted to incorporate some of these best practices into legislation which it is seeking from Congress to include expanded authority to reward whistleblowers for securities law violations. The proposed legislation also takes into account some issues identified in this report in connection with the existing insider trading bounty program.

We believe that it is critical for the SEC to implement the following recommendations to ensure that it has a fully-functioning and successful whistleblower program in place as its authority is potentially expanded.

Summary of Recommendations. Specifically, the review recommends that the Division of Enforcement:

(1) Develop a communication plan to address outreach to both the public and SEC personnel regarding the SEC bounty program. The plan should include efforts to make information available on the SEC's intranet, enhance information available on the SEC's public website, and provide training to employees who are most likely to deal with whistleblower complaints.

(2) Develop and post to its public website an application form that asks the whistleblower to provide information, including, for example:

a) The facts pertinent to the alleged securities law violation and explanation as to why the whistleblower believes the subject(s) violated the securities laws;
b) A list of related supporting documentation in the whistleblower's possession and available from other sources;
c) A description of how the whistleblower learned about or obtained the information that supports the claim, including the whistleblower's relationship to the subject(s);
d) The amount of any monetary rewards obtained by the subject violator(s) (if known) as a result of the securities law violation, and how the amount was calculated; and
e) A certification that the application is true, correct, and complete to the best of the whistleblower's knowledge.

(3) Establish policies on when to follow-up with whistleblowers who submit applications to clarify information in the bounty applications and obtain readily available supporting documentation prior to making a decision as to whether a whistleblower's complaint should be further investigated.

(4) Develop specific criteria for recommending the award of bounties, including a provision that where a whistleblower relies partially upon public information, such reliance will not preclude the individual from receiving a bounty.

(5) Examine ways in which the Commission can increase communications with whistleblowers by notifying them of the status of their bounty requests without releasing non-public or confidential information during the course of an investigation or examination.

(6) Develop a plan to incorporate controls for tracking tips and complaints from whistleblowers seeking bounties into the development of Enforcement's tips, complaints, and referrals processes and systems for

other tips and complaints. These controls should provide for the collection of necessary information and require processes that will help ensure that bounty applications are reviewed by experienced Commission staff, decisions whether to pursue whistleblower information are timely made, and whistleblowers who provide significant information leading to a successful action for violation of the securities laws are appropriately rewarded.

(7) Require that a bounty file (hard copy or electronic) be created for each bounty application. The file should contain at a minimum the bounty application, any correspondence with the whistleblower, documentation of how the whistleblower's information was utilized, and documentation regarding significant decisions made with regard to the whistleblower's complaint.

(8) Incorporate best practices obtained from DOJ and the IRS into the SEC bounty program with respect to bounty applications, analysis of whistleblower information, tracking of whistleblower complaints, recordkeeping practices, and continual assessment of the whistleblower program.

(9) Establish a timeframe to finalize new policies and procedures for the SEC bounty program that incorporates the best practices from DOJ and IRS as well as any legislative changes to the program.

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Background and Objectives

Background

There is evidence that bounty programs are an effective tool to encourage whistleblowers to come forward and provide incentives for outside entities to bring complaints about possible illegal activity. We identified two government agencies, the Internal Revenue Service (IRS) and Department of Justice (DOJ), that have well-defined whistleblower functions.

Section 21A(e) of the Securities Exchange Act of 1934 (Exchange Act), 18 U.S.C. § 78u-1(e), authorizes the Securities and Exchange Commission (SEC or Commission) to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader,[1] from a person who tipped information to an insider trader, or from a person who directly or indirectly controlled an insider trader. All bounty determinations, including whether, to whom, and in what amount to make payments, are within the sole discretion of the SEC. However, the total bounty may not currently exceed 10 percent of the amount recovered from a civil penalty pursuant to a court order.

Section 21A(e) of the Exchange Act was added by the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSEA), Pub L. No. 100-704. ITSEA embodied a series of statutory changes that Congress viewed as necessary at that time to augment existing methods of detection and punishment of insider trading behavior. Particularly in light of the stock market crash in October 1987, Congress viewed the changes as an essential ingredient to restore the confidence of the public in the fairness and integrity of the securities markets.

The Commission has adopted regulations to provide for administration of the process for making bounty requests. These regulations are included in the Code of Federal Regulations, Title 17: *Commodity and Securities Exchanges, Part 201- Rules of Practice, Subpart C-Procedures Pertaining to the Payment of Bounties Pursuant to Subsection 21A(e) of the Securities Exchange Act of 1934,* Sections 201.61-201.68. The SEC bounty program regulations require that applications be in writing, and that applications be filed within 180 days after the entry of the court order requiring payment of the insider trading penalty from which the bounty is to be paid.[2] An application for a bounty must contain, among

[1] The term "insider trading" refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust or confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include tipping such information, securities trading by the person tipped and security trading by those who misappropriate such information. (http://www.sec.gov/answers/bounty.htm.)

[2] 17 C.F.R. §§ 201.62 and 201.63.

other things, information concerning the dates and times upon which, and the means by which, information was provided, as well as the identity of the Commission staff to whom the information was provided.[3]

The SEC bounty program is administered by the Division of Enforcement (Enforcement). While the program has been in place for more than 20 years, there have been very few payments by the Commission under the program. Likewise, the Commission has not received a large number of applications from individuals seeking a bounty. The SEC bounty program is limited to insider trading cases and the stated criteria for judging bounty applications are broad, somewhat vague and not subject to judicial review. Moreover, there is no entitlement to a reward even if the whistleblower's information causes the government to recover money from wrongdoers.

In testimony before the House Subcommittee on Financial Services and General Government Appropriations of the House Committee on Appropriations in March 2009, SEC Chairman Mary Schapiro spoke about the possible expansion of the SEC's authority to award whistleblowers.[4] Chairman Schapiro stated that "right now, the main reward for being a whistleblower is the good feeling you get of having done something important, because [the SEC does not] have the authority to pay except where the whistleblowing relates to insider trading."[5] Chairman Schapiro added that "[w]histleblowers tend to do a lot of the work for you, hand you something that is pretty fully baked."[6] She further stated that expanding authority would enable the SEC to "run with that kind of information and to pursue cases in a much more aggressive way."[7]

The SEC recently sent to Congress proposed legislation to expand the authority of the program, in addition to other reforms, to permit bounties for any judicial or administrative action brought by the Commission under the securities laws that result in monetary sanctions exceeding $1,000,000. The proposed legislation was included in the Investor Protection Act of 2009 (H.R. 3817), which was introduced in the U.S. House of Representatives on October 15, 2009 by Representative Paul Kanjorski (D. PA) and referred to the House Committee on Financial Services. Variations of this legislation are being considered by both the U.S. House of Representatives and the U.S. Senate.

[3] 17 C.F.R. § 201.64.
[4] Securities and Exchange Commission Actions Relating to the Financial Crisis: Hearing Before the Subcommittee on Financial Services and General Government of the H. Comm. on Appropriations, 111 Cong. (2010) (testimony of Mary Schapiro, Chairman, Securities and Exchange Commission).
[5] Id.
[6] Id.
[7] Id.

Objectives

This review was conducted in accordance with our annual audit plan, as a result of an issue that we identified during the OIG's investigation into the SEC examination and investigations of Bernard L. Madoff and related entities, OIG Report of Investigation*, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme,* Report No. 509. The primary objectives of the review were to:

- Assess whether necessary management controls have been established and operate effectively to ensure bounty applications are routed to appropriate personnel and are properly processed and tracked; and

- Determine whether other government agencies with similar programs have best practices that could be incorporated into the SEC bounty program.

Findings and Recommendations

We found that while a bounty program has been in place at the SEC for more than 20 years, there have been very few payments made by the Commission under the program. Likewise, the Commission has not received a large number of applications from individuals seeking a bounty. The program is also not widely recognized inside or outside the Commission. We also found that the SEC bounty program is limited to insider trading cases and the stated criteria for judging bounty applications are broad, somewhat vague and not subject to judicial review.

In addition, we generally found that bounty applications the Commission received were acknowledged in writing and were then forwarded to appropriate senior-level staff in headquarters and the regional offices for further consideration. However, bounty applications were not adequately tracked to ensure timely and adequate handling of the information. We did find that the Commission made formal determinations and notified bounty claimants, accordingly, with respect to all persons the Commission deemed eligible for award in accordance with the statute. We also found that on the few occasions when the Commission has made an award, it has paid the maximum allowed by the statute.

We further identified areas that need increased management controls with regard to the bounty application process, maintenance of files pertaining to bounty applications, and correspondence with whistleblowers regarding the status of their bounty applications.

Lastly, we identified several best practices utilized by agencies with similar programs that should be adopted by the SEC in developing a successful bounty program.

Finding 1: SEC Bounty Program Has Made Very Few Payments and Received a Relatively Small Number of Bounty Applications

> The SEC bounty program has made very few payments to whistleblowers since its inception and received a relatively small number of bounty applications. As a result, the program's success has been minimal and its existence is practically unknown.

Since the inception of the SEC bounty program in 1989, the SEC has paid a total of $159,537 to five claimants as detailed in Table 1 below.

Table 1: Bounty Payments to Whistleblowers

Bounty Claimant	Year	Bounty Amount
1) Claimant 1	1989	$3,500
2) Claimant 2	2001	$18,152
3) Claimant 3	2002	$29,079
4) Claimant 4	2005	$17,500
4) Claimant 4	2006	$29,920
4) Claimant 4	2009	$55,220
5) Claimant 5	2007	$6,166
Total		**$159,537**

Source: OIG Generated

As Table 1 illustrates, Claimant 4 received three payments because the information provided by the claimant led to the filing of three separate insider trading cases. All payments were for the 10 percent maximum amount permitted by statute.

The Commission also formally denied five bounty applications since the inception of the program as summarized below.

- In 1990, the Commission denied a bounty request to Claimant 6 on the grounds that the statute did not authorize payment for information provided prior to its effective date.

- In 1990, the Commission denied a bounty request to Claimant 7 on the same ground asserted in the aforementioned bounty request for Claimant 6.

- In 1996, the Commission denied a bounty request to Claimant 8 because, as with the aforementioned two bounty requests, Claimant 8 had provided information prior to the effective date of the statute. However, Claimant 8 also provided additional information after the effective date of the statute. SEC staff recommended denial of the bounty request on the grounds that the latter information did not result in the addition of any defendants, securities transactions or violations to the complaint.

- In 2001, the Commission denied the bounty request of Claimant 9. The Commission asserted that Claimant 9 had provided fictitious information that resulted in the unnecessary use of staff resources, and falsely claimed to have provided information to the Chicago Board Options Exchange, which had earlier alerted the Commission to suspicious trading.

- In 2004, the Commission denied the joint bounty request of Claimant 10, Claimant 11, and Claimant 12, three brokerage employees. The Commission recommended denial on the grounds that the initial information about insider trading had been provided by the brokerage firm's general counsel's office. The SEC did not seek or obtain any information directly from Claimant 11 or Claimant 12.

In addition to the aforementioned bounty applications that were formally approved or denied by the Commission, we determined that from January 1, 2005 to January 1, 2010, the SEC received approximately 30 other bounty applications, but did not formally take action to approve or deny any of them and did not notify the bounty applicant accordingly. The person responsible for overseeing the SEC bounty program stated that this occurred because the Commission only makes a formal bounty determination and provides notice to an applicant when the bounty information results in the recovery of an insider trading civil penalty in accordance with the Exchange Act. Thus, while the Commission has made formal determinations with respect to all persons that it deemed eligible for award in accordance with the statute, the 30 bounty applicants were never notified of the results of the SEC's review.

Further, we found that while the Commission reported in its 2009 Performance and Accountability Report that only 6 percent of the Commission's Enforcement cases in Fiscal Year 2009 related to insider trading,[8] the SEC filed or initiated 37 insider trading cases in 2009. However, only one payment was approved under the SEC bounty program during Fiscal Year 2009. Additionally, the SEC filed or initiated a total of 204 insider trading cases between Fiscal Years 2005 - 2008, but only approved three payments under the SEC bounty program. Based on the number of insider trading cases initiated by the Commission during the past five years, it would appear that there could have been more utilization of the SEC bounty program.

We believe that the minimal use of the SEC bounty program can be attributed primarily to the fact that the program has not been widely publicized, internally within the agency or externally to the public. We found that general information

[8] http://www.sec.gov/about/secpar2009.shtml, Chart 2.10, at page 34.

on how to apply for a bounty can be found on the SEC's public website, but there is no contact information or e-mail address to which potential bounty claimants can send questions. Also, there is no application form, only instructions on what type of information should be included in a narrative format.[9] The SEC also developed an informational pamphlet for the bounty program that was intended to be used as an educational device to be routinely sent by staff to individuals who provide information that might lead to award of a bounty. While the pamphlet is a good tool for marketing the program, we found no evidence that staff members are generally aware of the pamphlet and provide it routinely to potential bounty applicants. In addition, the SEC has publicly released only limited information on Commission decisions regarding bounty awards and denials. Commission officials provided information showing that with the exception of one payment and one denial, the identity of bounty applicants has not been disclosed publicly, nor has the SEC disclosed that all bounty payments have been for the maximum 10 percent permitted by the statute. The years in which bounties have been awarded and the total amount of the payments, however, have been disclosed.

In addition, based on discussions with various senior Enforcement staff in headquarters as well as the regional offices, we found varying degrees of knowledge regarding the SEC bounty program among Commission staff. Some staff who had received bounty applications for further consideration remarked that they knew nothing about the bounty program, while others had some knowledge of the workings of the program and associated laws and regulations. Therefore, more extensive marketing of the program both internally and externally is necessary to ensure Commission staff, as well as potential whistleblowers, are aware of the program. This holds especially true for staff who are in positions where they evaluate whistleblower information.

We learned through discussions with responsible Commission officials that there has been extensive work performed by the Office of the Chairman, Enforcement, and the Office of General Counsel (OGC) on drafting proposed legislation to revamp the current bounty program in the wake of the Bernard Madoff scandal. The proposed legislation, among other things, would provide expanded authority for the program to permit bounties in connection with any judicial or administrative action brought by the Commission under the securities laws that result in monetary sanctions exceeding $1,000,000. The proposed legislation was included in the Investor Protection Act of 2009 (H.R. 3817), which was introduced in the U.S. House of Representatives on October 15, 2009 by Representative Paul Kanjorski and referred to the House Committee on Financial Services. We are encouraged by the actions the Commission has taken and support the timely passage of the proposed legislation as a necessary step to develop a successful SEC whistleblower/bounty program. Additionally, the SEC

[9] http://www.sec.gov/divisions /enforce/insider.htm.

has begun to explore ways to more extensively market the bounty program in an effort to increase awareness both inside and outside the Commission.

Recommendation 1:

The Division of Enforcement should develop a communication plan to address outreach to both the public and Securities and Exchange Commission (SEC) personnel regarding the SEC bounty program. The plan should include efforts to make information available on the SEC's intranet, enhance information available on the SEC's public website, and provide training to employees who are most likely to deal with whistleblower cases.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 2: Standardized Bounty Application Forms Would Help Make the Bounty Application Process More User Friendly for Whistleblowers

Information on the SEC's public website regarding how an individual may apply for a bounty can be misleading and potentially a deterrent to prospective whistleblowers.

With regard to how and when a prospective whistleblower may apply for a bounty, the SEC's public website currently states in a section entitled, "How and When Do You Apply for a Bounty?" as follows:

> An application must be clearly marked as an "Application for Award of a Bounty," and must contain the information required by the Commission's rules. The application must give a detailed statement of the information that the applicant has about the suspected insider trading.
>
> Any person who desires to provide information to the Commission that may result in the payment of a bounty may do so by any means desired. The Commission encourages

> persons having information regarding insider trading to provide that information in writing, either at the time they initially provide the information to the Commission or as soon as possible afterwards. Providing information in writing reduces the possibility of error, helps assure that appropriate action will be taken, and minimizes subsequent burdens and the possibility of factual disputes. In any event a written application for a bounty must be filed with 180 days after the day on which the court orders payment of the civil penalty.[10]

The SEC's website also includes in a subsequent section entitled, "Statutory and Regulatory Provisions," the Commission rules for bounty applications. Rule 64 Form of application and information required, states that "[e]ach application pursuant to this subpart shall be identified as an Application for Award of a Bounty and shall contain a detailed statement of the information provided by the applicant that the applicant believes led or may lead to the imposition of a penalty."[11] The rule also states that "[w]hen the application is not the means by which the applicant initially provides such information, each application shall contain: the dates and times upon which, and the means by which, the information was provided; the identity of the Commission staff members to whom the information was provided; and if the information was provided anonymously, sufficient further information to confirm that the person filing the application is the same person who provided the information to the Commission."[12]

Based on this language, a bounty applicant may be unclear as to what constitutes an acceptable application, i.e., what level of detail should be provided, if supporting documents should be included or referenced, etc. During our review we found that many bounty applications were essentially generalized tips and complaints about potential insider trading based on public information without any real evidence or actual knowledge that an individual or individuals used material non-public information when purchasing or selling securities.

To illustrate, one bounty application included in our sample that was referred to a senior official in headquarters by the bounty program for further consideration stated:

> Company A doubled in price with extremely high volume prior to the announcement that Company B had loaned them (Company A) millions of $ to help in preventing bankruptcy. This possible insider trading occurred on Tuesday Aug 18. [13]

[10] http://www.sec.gov/divisions/enforce/insider.htm, at p. 2.
[11] Id. at 4.
[12] Id.
[13] Information obtained from SEC bounty file maintained by the Office of Chief Counsel within the Division of Enforcement.

Because the bounty application was vague, the senior official that received it stated that it was not useful or relevant to his ongoing investigation into the subject. Additionally, the senior official dismissed the tip without contacting the bounty applicant to determine if he had further information.

For another bounty application, the bounty applicant alleged the existence of a "wide ranging community of individual investors and investing business entities who willingly participate in, for lack of a better term, a group that trades on selected equities in various ways for the purpose of can't lose investment transactions." [14] The senior-level official who received the bounty application for further consideration stated that the complaint was not specific as to the securities (or even category of securities) in which the alleged insider trading occurred and contained no information on how insider trading information was allegedly shared. Further, the bounty applicant had submitted previous complaints of wide-ranging conspiracies that the official deemed to lack credible support upon which to base an investigation. Therefore, the bounty application was dismissed without further action.

As part of our review, we contacted some bounty applicants to obtain feedback regarding the bounty application process. One individual stated that it would be useful if the SEC had a link on its website to an application form that can be downloaded. Another individual stated that he had additional information to support his bounty application, but that no one from the SEC had contacted him to follow up and ask for supporting information.

To help ensure that bounty applications are complete and the information provided is useful, we believe the Commission should develop a standardized electronic form that can be downloaded. Also, at a minimum, whistleblowers should be asked to provide the following information, in addition to relevant contact information:

- The facts pertinent to the alleged securities law violation and explanation as to why the subject(s) violated the securities laws.

- A list of related supporting documentation in the whistleblower's possession and/or available from other sources.

- A description of how the whistleblower learned about/and or obtained the information that supports the claim, including the whistleblower's relationship to the subject(s).

[14] Id.

- The amount of any monetary rewards reaped by the subject violator (if known) as a result of the securities violation and how the amount was calculated.

- A certification that the application is true, correct, and complete to the best of the whistleblower's knowledge.

Additionally, the Commission should follow up with whistleblowers, where appropriate, regarding their applications to ensure all available information has been obtained in order to effectively evaluate whether the information should result in further investigation.

Recommendation 2:

The Division of Enforcement should develop and post to its public website an application form that asks the whistleblower to provide information, including:

(1) The facts pertinent to the alleged securities law violation and an explanation as to why the subject(s) violated the securities laws;
(2) A list of related supporting documentation in the whistleblower's possession and available from other sources;
(3) A description of how the whistleblower learned about or obtained the information that supports the claim including the whistleblower's relationship to the subject(s);
(4) The amount of any monetary rewards obtained by the subject violator(s) (if known) as a result of the securities law violation and how the amount was calculated; and
(5) A certification that the application is true, correct, and complete to the best of the whistleblower's knowledge.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Recommendation 3:

The Division of Enforcement should establish policies on when to follow up with whistleblowers who submit applications to clarify information in the bounty applications and obtain readily available supporting documentation prior to making a decision as to whether a whistleblower's complaint should be further investigated.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 3: Criteria for Judging Bounty Applications Are Broad and Somewhat Vague

> The criteria for judging bounty applications are broad, somewhat vague and not subject to judicial review. As a result, the criteria may not be consistently applied by Enforcement staff.

Although the Commission adopted bounty program regulations to provide a structure for the orderly administration of the process for making bounty payments, the regulations essentially repeat, instead of clarifying or supplementing, much of the language found in the statute regarding bounty determinations.

The Code of Federal Regulations (CFR), Title 17: *Commodity and Securities Exchanges, Part 201- Rules of Practice, Subpart C - Procedures Pertaining to the Payment of Bounties Pursuant to Subsection 21A(e) of the Securities Exchange Act of 1934*, Section 201.61, *Scope of Subpart*, states as follows:

> Section 21A of the Securities and Exchange Act of 1934 authorizes the courts to impose civil penalties for certain violations of that Act. Subsection 21A(e) permits the Commission to award bounties to persons who provide information that leads to the imposition of such penalties. Any such determination, including whether, to whom, or in what amount to make payments, is in the sole discretion of the Commission. This subpart sets forth procedures regarding applications for the award of bounties pursuant to Subsection 21A(e). Nothing in this subpart shall be deemed to limit the discretion of the Commission with respect to determinations under subsection 21A(e) or to subject any such determination to judicial review.

Additionally, Section 201.68, *No promises of payment,* states as follows:

> No person is authorized under this subpart to make any offer or promise, or otherwise to bind the Commission with respect to the payment of any bounty or the amount thereof.

Because of the use of language such as "information that leads to the imposition of such penalties" and "in the sole discretion of the Commission," the criteria for a bounty award are broad and subject to interpretation. In addition, Enforcement does not have internal policies and procedures to assist Commission staff in assessing contributions that are made by whistleblowers and recommending bounty award determinations. The Commission should establish internal policies and procedures to provide more specific guidelines for awarding bounties.

Recommendation 4:

The Division of Enforcement should develop specific criteria for recommending the award of bounties, including a provision that where a whistleblower relies partially upon public information, such reliance will not preclude the individual from receiving a bounty.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 4: More Frequent Communication with Whistleblowers is Needed

> The Commission does not routinely provide status reports to whistleblowers regarding their bounty applications, even if there is an ongoing investigation or examination. This practice could discourage individuals from continuing to utilize the program and from providing useful follow-up information to their bounty applications.

We found that the SEC bounty program only provides written notification to whistleblowers regarding the status of their bounty applications to:

(1) Acknowledge receipt of the applications; and
(2) Notify them if formal determinations are made by the SEC with respect to their bounty applications.

According to Commission officials, a formal determination is made only if the information provided by the whistleblower leads to an insider trading civil penalty being imposed by the court in a Commission civil action, and the penalty has actually been paid by the defendant. Consequently, if a whistleblower's information was never pursued for one reason or another, or was pursued but did not lead to an insider trading penalty being recovered, the whistleblower would typically not receive any correspondence from the SEC regarding the status of his or her bounty request, other than the initial acknowledgement letter. This may result in a whistleblower wondering if the information provided even made it into the right hands. The initial acknowledgement letter sent to whistleblowers includes the following language:

> This is to acknowledge receipt of your Application for Award of a Bounty, dated XX.
>
> You may be assured that the information you have provided will receive full consideration by the Commission's staff. Information from members of the public is an important source of information to the Commission in the conduct of its law enforcement functions.
>
> As a matter of policy, the Commission staff can neither affirm nor deny the existence of any investigation arising from the information you have provided until it files a public enforcement action. This policy is intended to prevent premature disclosure of information that may interfere with the successful completion of an investigation, and to protect the privacy of persons who have not been formally charged with violations of laws.
>
> All determinations with respect to bounties are made at the Commission's discretion and no determinations are made until a civil penalty has been imposed and actually recovered in a Commission enforcement action. Section 21A(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78u-1(e)]. You will be informed of any determination in accordance with our bounty regulations. See 17 C.F.R. 201.61-68.[15]

While we acknowledge that Commission staff cannot release non-public or sensitive information during the course of an investigation, the Commission should examine ways to notify whistleblowers of the status of their bounty

[15] Code of Federal Regulations, Title 17: Commodity and Securities Exchanges, Part 201-Rules of Practice, Subpart C-Procedures Pertaining to the Payment of Bounties Pursuant to Subsection 21A(e) of the Securities Exchange Act of 1934, Sections 201.61-201.68.

requests beyond simply acknowledging receipt of the applications. This is especially needed when a whistleblower's information results in an investigation that may take years to close.

Recommendation 5:

The Division of Enforcement, in consultation with the Office of General Counsel, should examine ways in which the Commission can increase communications with whistleblowers by notifying them of the status of their bounty requests, without releasing non-public or confidential information during the course of an investigation or examination.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 5: Better Tracking of the Use of Whistleblower Information is Needed

While we generally found that the SEC conducted an initial cursory review of bounty applications and forwarded them to appropriate senior-level program staff in the headquarters and regional offices for further consideration, we found that the recipient offices handled the applications on an individualized, *ad hoc* basis. Consequently, better tracking of bounty applications and related information is needed to ensure that bounty information is timely reviewed by experienced Commission staff and significant decisions are documented.

Bounty applications received by the Commission are either filed after recovery of an insider trading civil penalty or prior to payment of an insider trading civil penalty, in connection with a tip or complaint about alleged insider trading.

When an insider trading civil penalty has already been recovered and a related bounty application is received by the Office of the Secretary, the application is forwarded to the Office of the Chief Counsel (OCC) in Enforcement. OCC then contacts the appropriate staff in the headquarters or regional office responsible for the case in which the insider trading civil penalty was recovered and forwards them a copy of the bounty application. If the applicant's information pertains to a

case in which there was recovery of an insider trading civil penalty, the office to whom the bounty application was referred may recommend that the Commission grant a bounty up to 10 percent of the amount recovered as an insider trading penalty. In those cases, the responsible headquarters or regional office, in consultation with OCC and OGC, prepares an action memorandum, which is then provided to the Chairman and Commissioners for final approval. Since inception of the bounty program, formal recommendations have only been prepared in response to 10 bounty applications, where there was recovery of an insider trading civil penalty.

When applications are filed prior to the assessment of an insider trading civil penalty, the Office of the Secretary forwards the application to OCC. OCC then performs a search of the Commission's electronic databases (NRSI,[16] CATS 2000,[17] and the HUB[18]) to determine whether the application relates to conduct that is already the subject of an Enforcement investigation or action. If there is an investigation or action related to the conduct described in the application, the application is referred to the staff responsible for the investigation or action. If the database search does not result in the identification of an ongoing investigation or action, OCC staff determines the appropriate staff to whom the application should be directed. If the application alleges misconduct by officers, directors, or employees of a public company, OCC staff will determine the headquarters location of the issuer. The application will be referred to staff in the Commission office with responsibility for that geographic location. If the application alleges misconduct by individuals who are in a location other than the SEC region in which the issuer is headquartered, the application is referred to staff in the Commission office with responsibility for that geographic location. If the application does not contain information sufficient to identify the location of the alleged insider traders, the application is referred to staff in the Commission office with responsibility for the geographical location in which the whistleblower resides.

Referrals of bounty applications to Commission staff are generally accompanied by a memorandum that states as follows:

> Attached is a copy of a bounty application submitted by X. The claim involves alleged insider trading violation by X company through its X office. The application seeks an insider trading bounty under Section 21A(e) of the Exchange

[16] Name Relationship Search Index (NRSI) provides an index to names contained in various internal and external automated SEC information systems, including filings with the Division of Corporation Finance, and Division of Enforcement inquiries and investigations.
[17] Case Activity Tracking System (CATS 2000) provides case tracking and workflow management for Division of Enforcement offices nationwide.
[18] HUB interfaces with CATS 2000 and provides case management and tracking for Division of Enforcement offices nationwide including the ability to produce various reports.

> Act. I have sent a letter acknowledging receipt of the application. A copy of my letter is attached.
>
> I am referring this matter to your office for such further action as you may consider appropriate.

The whistleblower is also sent an acknowledgement letter, as discussed previously.

During our review, we interviewed responsible Commission staff in Enforcement at headquarters, as well as Enforcement staff from three regional offices to gain an understanding of how offices tracked and utilized bounty application information. We also examined nine out of approximately 30 bounty applications (30 percent) submitted to the Commission between January 1, 2005 and January 1, 2010 (that were neither formally approved or denied by the Commission), to determine if sufficient documentation existed to support timely and appropriate handling of the bounty applications. Further, we reviewed supporting documentation pertaining to five bounty applications that were formally denied by the Commission to determine if adequate documentation was maintained by the Commission to support the denial of the applications.

We found that adequate documentation existed to support the disposition of the five bounty applications that were formally denied by the Commission. However, documentation was not readily available from OCC to show the disposition for the nine bounty applications that were forwarded to Enforcement staff in headquarters and the regional offices for further consideration, but were not formally approved or denied.

We found that once a bounty application is referred by OCC to the appropriate senior-level official in headquarters or a regional office, it is up to that official to take whatever action he or she deems necessary and to document the results of any decisions that are made, according to that office's procedures. Based on our review of available documentation from Enforcement staff in headquarters and three regional offices pertaining to the nine sampled bounty applications, it appears that the bounty applications were generally reviewed timely. However, we found that one application had been referred to a regional office on November 18, 2009, by OCC and was still awaiting review as of January 6, 2009. We also found that Enforcement staff conducted preliminary reviews of the information contained in the bounty applications they received, but did not routinely go back to bounty applicants to clarify information or ask for additional supporting documentation. Rather, general or vague bounty applications were typically dismissed. In addition, for two of the nine bounty applications, we were unable to obtain specific information pertaining to the handling of the applications. We did find that based on information provided by one whistleblower, the responsible

regional office filed both criminal and civil actions and also provided assistance to the whistleblower in the preparation of his bounty application. The whistleblower, however, was not awarded a bounty because no insider trading penalty was recovered. Lastly, we found that Enforcement staff documented the results of their reviews of bounty applications and decisions made using different methods, including personal notes and files and/or use of the Commission's electronic complaint handling system (CTR 2009), as well as the HUB case tracking system.

The SEC has recently taken steps to improve its ability to handle and track all tips and complaints. In February 2009, the SEC retained The MITRE Corporation: Center for Enterprise Modernization[19] to complete a comprehensive review of internal procedures for evaluating tips, complaints, and referrals. The OIG has learned that the project is intended to be significant in scope. On August 5, 2009, Enforcement announced the creation of the Office of Market Intelligence (OMI). OMI is Enforcement's liaison to the Agency's Tip, Complaint, and Referral (TCR) process and system, which is responsible for the collection, analysis, risk-weighing, triage, referral and monitoring of the hundreds of thousands of tips, complaints and referrals that the Commission receives each year. By analyzing each tip according to internally-developed risk criteria and making connections between and among tips from different sources, Enforcement hopes to be able to better focus its resources on the tips that have the greatest potential for uncovering wrongdoing. OMI will also utilize the expertise of the SEC's other divisions and offices as well as the newly-created specialized units within Enforcement, to help analyze tips and identify securities law violations.

We believe that the Commission should incorporate necessary management controls in its new TCR process and information technology system to include complaints and tips from whistleblower's who seek a bounty, in addition to other types of tips and complaints. This will help ensure that bounty applications are appropriately and timely evaluated by experienced Commission staff and bounty application information can be linked with other related complaints and tips.

Recommendation 6:

The Division of Enforcement should develop a plan to incorporate controls for tracking tips and complaints from whistleblowers seeking bounties into the development of its tip, complaints and referral processes and systems for other tips and complaints. These controls should provide for the collection of necessary information and require processes that will help

[19] The MITRE Corporation: Center for Enterprise Modernization (www.mitre.org) is a not-for-profit organization that provides systems engineering, research and development, and information technology support to the government.

ensure that bounty applications are reviewed by experienced Commission staff, decisions whether to pursue whistleblower information are timely made, and whistleblowers that provide significant information leading to a successful action for violation of the securities laws.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 6: Bounty Files Did Not Always Contain Complete Information

Some bounty files maintained by OCC were missing key documents.

We obtained and reviewed the hard-copy bounty files maintained by OCC (OCC's primary recordkeeping method for the bounty program) for the nine sampled bounty applications. We found that generally the bounty files maintained by OCC contained a copy of the bounty application, an acknowledgement memorandum that was sent to the bounty applicant to acknowledge receipt of their application, and a copy of a memorandum showing to which senior-level official within the Commission the bounty application was forwarded for consideration. However, for the nine bounty applications the OIG reviewed, we found in some instances that not all these documents were maintained.

Specifically, we found:

- For one of nine bounty files, the actual bounty application was missing.
- For three of nine bounty files, a copy of the acknowledgement memorandum that was sent to the whistleblower was missing. However, there was mention in other documentation in the file that an acknowledgement memorandum was sent.
- For two of nine bounty files, the memorandum showing to which headquarters or regional office that OCC referred the bounty application for further consideration was missing.

We believe that, at a minimum, OCC should maintain copies of pertinent data pertaining to bounty applications, including the application itself, a copy of any correspondence with the whistleblower, and documentation showing the Commission office(s) to which the information was referred for action.

Recommendation 7:

The Division of Enforcement should require that a bounty file (hard copy or electronic) be created for each bounty application. The file should contain at a minimum the bounty application, any correspondence with the whistleblower, documentation of how the whistleblower's information was utilized, and documentation regarding significant decisions made with regard to the whistleblower's complaint.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Finding 7: SEC Bounty Program Should Incorporate Best Practices from other Agencies with Whistleblower Programs

The IRS and the DOJ are two large government agencies that use whistleblower programs to identify cases that would otherwise go undetected. There is some evidence that DOJ's whistleblower program has played a role in the increase of civil recoveries obtained by DOJ over a 10-year period. The IRS also has a system in place under which it provides bounties to individuals who present the IRS with information leading to the collection of federal taxes.

We reviewed documentation related to these whistleblower programs and identified several best practices that the Commission should adopt in developing a successful SEC bounty program. In order to protect the confidentiality of privileged information we obtained during our review, the best practices are summarized and not specifically identified with a particular agency. We identified best practices related to tracking and handling whistleblower-type complaints as follows:

- Establishment of a separate "Whistleblower Office" staffed with experienced officials that handles intake of whistleblower complaints and

referral of complaints to other offices as appropriate, while maintaining authority to make award determinations.

- Continual tracking and documentation of the handling of whistleblower complaints through a case tracking system, including information pertaining to the identification of the whistleblower and any representatives, actions taken to assign whistleblower claims to applicable offices and individuals, and the status of significant decisions made and still needed with regard to outstanding whistleblower claims (e.g., whether a claim will be paid and in what amount).

- Use of standardized forms for the intake of whistleblower information as well as recording significant decisions made by operating divisions while processing a whistleblower claim (i.e. operating division assessments on how a whistleblower's information aided in collection of funds pertaining to an examination).

- Initial analysis of whistleblower information by the Whistleblower Office and then by Operating Division subject matters experts to evaluate the information and determine whether it may materially contribute to a case or examination. Additionally, subject matter experts meet with whistleblowers to clarify the whistleblowers' submissions as necessary, gather information about the credibility of the whistleblowers, obtain information regarding legal issues that can affect the use of documents, and obtain possible leads to other sources of information.

- Requirement that routine feedback in the form of status reports be provided to the Whistleblower Office by Operating Divisions regarding the status of cases and examinations that pertain to whistleblower complaints.

- Establishment of a whistleblower award file (created in addition to a regular case file) that is sent by Operating Divisions at the conclusion of an examination to the Whistleblower Office that contains pertinent forms and data to enable the Whistleblower Office to make an award determination.

- Establishment of a requirement that whistleblower complaints be reviewed and pursued, if applicable, within a specified time frame.

- Continual assessment of whistleblower programs through feedback sought from Operating Divisions and others involved in processing whistleblower claims.

Through discussions with Commission officials responsible for drafting the recent proposed legislation to expand the SEC's authority to reward whistleblowers, we learned that the Commission met extensively with representatives from both DOJ and the IRS to identify best practices for revamping the SEC's current bounty program. Commission officials stated they plan to incorporate many of these best practices into implementing regulations and policies and procedures, as appropriate, upon passage of the proposed legislation. Until such time as this legislation may be passed, the Commission should begin to incorporate best practices we identified from DOJ and the IRS.

Recommendation 8:

We recommend that the Division of Enforcement incorporate best practices from the Department of Justice and the Internal Revenue Service into the Securities and Exchange Commission bounty program with respect to bounty applications, analysis of whistleblower information, tracking of whistleblower complaints, recordkeeping practices, and continual assessment of the whistleblower program.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Recommendation 9:

We recommend that the Division of Enforcement set a timeframe to finalize new policies and procedures for the Securities and Exchange Commission bounty program that incorporate the best practices from Department of Justice and the Internal Revenue Service, as well as any legislative changes to the program.

Management Comments. Concur. See Appendix V for management's full comments.

OIG Analysis. We are pleased that Enforcement concurred with this recommendation.

Acronyms and Abbreviations

DOJ	Department of Justice
Enforcement	Division of Enforcement
Exchange Act	Securities Exchange Act of 1934
IRS	Internal Revenue Service
ITSEA	Insider Trading and Securities Fraud Enforcement Act of 1988
OCC	Office of Chief Counsel, Division of Enforcement
OIG	Office of Inspector General
OMI	Office of Market Intelligence
SEC or Commission	U.S. Securities and Exchange Commission
TCR	Tip Complaint and Referral Process

Scope and Methodology

This review was not conducted in accordance with the government auditing standards.

Scope. We examined Enforcement program activities related to the SEC bounty program since its inception in 1989, and assessed whether necessary management controls have been established and operate effectively to ensure bounty applications are routed to appropriate personnel and are properly processed and tracked. We also determined whether other government agencies with similar programs have best practices that could be incorporated into the SEC bounty program. Fieldwork was performed during December 2009 and January 2010.

Methodology. In order to accomplish our audit objectives, we reviewed applicable Commission policies and procedures pertaining to the SEC bounty program; interviewed personnel from the Office of the Chairman, Enforcement and three regional offices to understand how bounty applications are processed; reviewed documentation to support all ten bounty applications that were formally approved or denied; and selected a sample of bounty applications that were not formally approved or denied to determine if sufficient documentation existed to support timely and appropriate handling of bounty applications. We also gathered information regarding the IRS and DOJ whistleblower programs to identify best practices.

Judgmental Sampling. We judgmentally selected a sample of nine out of approximately 30 bounty applications that were received by the Commission, but were not formally approved or denied. We then reviewed applicable files and documentation maintained by Enforcement as well as three of the 11 regional offices to determine whether the bounty applications were tracked, reviewed by experienced Commission staff and appeared to be appropriately handled.

Prior OIG Coverage. This review was conducted as a result of an issue that we identified during OIG's investigation into the SEC examination and investigations of Bernard L. Madoff and related entities, OIG's Report of Investigation*, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme,* Report No. 509, August 31, 2009.

Criteria

Section 21A(e) of the Securities Exchange Act of 1934, 18 U.S.C. § 78u-1(e), as added by the Insider Trading and Securities Fraud Enforcement Act of 1988, Public Law 111-72 (enacted on October 13, 2009). Authorizes the SEC to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who tipped information to an insider trader, or from a person who directly or indirectly controlled an insider trader. All bounty determinations, including whether, to whom, or in what amount to make payments, are within the sole discretion of the SEC, however, the total bounty may not currently exceed 10 percent of the amount recovered from a civil penalty pursuant to a court order.

17 C.F.R., Part 201, Subpart C- Procedures Pertaining to the Payment of Bounties Pursuant to subsection 21A(e) of the Securities Exchange Act of 1934. Sets forth procedures regarding applications for the award of bounties pursuant to Subsection 21A(e) of the Securities and Exchange Act of 1934.

List of Recommendations

Recommendation 1:

The Division of Enforcement should develop a communication plan to address outreach to both the public and the Securities and Exchange Commission (SEC) personnel regarding the SEC bounty program. The plan should include efforts to make information available on the SEC's intranet, enhance information available on the SEC's public website, and provide training to employees who are most likely to deal with whistleblower cases.

Recommendation 2:

The Division of Enforcement should develop and post to its public website an application form that asks the whistleblower to provide information, including, for example (1) the facts pertinent to the alleged securities law violation and an explanation as to why the subject(s) violated the securities laws; (2) a list of related supporting documentation available in the whistleblower's possession and available from other sources; (3) a description of how the whistleblower learned about or obtained the information that supports the claim including the whistleblower's relationship to the subject(s); (4) the amount of any monetary rewards obtained by the subject violator(s) (if known) as a result of the securities law violation and how the amount was calculated; and (5) a certification that the application is true, correct, and complete to the best of the whistleblower's knowledge.

Recommendation 3:

The Division of Enforcement should establish policies on when to follow-up with whistleblowers who submit applications to clarify information in the bounty applications and obtain readily available supporting documentation prior to making a decision as to whether a whistleblower's complaint should be further investigated.

Recommendation 4:

The Division of Enforcement should develop specific criteria for recommending the award of bounties, including a provision that where a whistleblower relies partially upon public information, such reliance will not preclude the individual from receiving a bounty.

Recommendation 5:

The Division of Enforcement, in consultation with the Office of General Counsel, should examine ways in which the Commission can increase communications with whistleblowers by notifying them of the status of their bounty requests without releasing non-public or confidential information during the course of an investigation or examination.

Recommendation 6:

The Division of Enforcement should develop a plan to incorporate controls for tracking tips and complaints from whistleblowers seeking bounties into the development of its tip, complaints and referral processes and systems for other tips and complaints. These controls should provide for the collection of necessary information and require processes that will help ensure that bounty applications are reviewed by experienced Commission staff, decisions whether to pursue whistleblower information are timely made, and whistleblowers that provide significant information leading to a successful action for violation of the securities laws.

Recommendation 7:

The Division of Enforcement should require that a bounty file (hard copy or electronic) be created for each bounty application. The file should contain at a minimum the bounty application, any correspondence with the whistleblower, documentation of how the whistleblower's information was utilized, and documentation regarding significant decisions made with regard to the whistleblower's complaint.

Recommendation 8:

We recommend that the Division of Enforcement incorporate best practices from the Department of Justice and the Internal Revenue Service into the Securities and Exchange Commission bounty program with respect to bounty applications, analysis of whistleblower information, tracking of whistleblower complaints, recordkeeping practices, and continual assessment of the whistleblower program.

Recommendation 9:

We recommend that the Division of Enforcement set a timeframe to finalize new policies and procedures for the Securities and Exchange Commission bounty program that incorporate the best practices from Department of Justice and the Internal Revenue Service, as well as any legislative changes to the program.

Management Comments

MEMORANDUM

TO: H. David Kotz, Inspector General, Office of Inspector General

FROM: Robert Khuzami, Director, Division of Enforcement

RE: Enforcement's Response to the Office of Inspector General's Report, Assessment of SEC Bounty Program, Report No. 474

DATE: March 24, 2010

This memorandum is in response to the Office of Inspector General's Draft Report No. 474, entitled *Assessment of SEC Bounty Program*. Thank you for the opportunity to review and respond to this report. We concur in the report's recommendations.

Early last year, Chairman Schapiro directed staff to begin working to establish a world-class whistleblower program. To that end, we conducted an extensive review of whistleblower programs at other governmental agencies and the Financial Industry Regulatory Authority (FINRA) to identify best practices for administering a successful program at the SEC. Our effort resulted in legislation currently under consideration by Congress that would create a new, more-comprehensive whistleblower program related to all securities violations.

As a result of our review, and as noted in your report, Division leadership was aware, prior to the audit, of the issues with the insider trading bounty program raised in your report. The Division's independent findings, and its plans for developing a new whistleblower program, are consistent with those set forth in the report.

In addition, it is not surprising that only a small percentage of insider trading cases have been initiated as a result of tips submitted through the insider trading bounty program. The vast majority of insider trading cases arise from routine surveillance performed by the SEC staff and the Self-Regulatory Organizations (SROs), such as FINRA and the stock exchanges, and not from tips submitted by members of the public. For example, of the 37 insider trading actions brought by the Commission in FY 2009, 31 were the result of surveillance by the SROs or the Division itself. We believe the principal reason that the current bounty program has not yielded more rewards derives more from its relatively narrow scope and the confidential nature of insider trading violations than from the procedural shortcomings we recognize exist. Notwithstanding the program's limitations, the Commission has an excellent track record of paying eligible claimants, as each award has been for the maximum amount allowed by the bounty statute

The proposed whistleblower legislation was drafted principally to broaden the nature of wrongdoing for which whistleblowers could receive a bounty. In our efforts to craft this new program, however, great care was taken to address and avoid problems identified with the insider trading bounty program, including our desire to establish a formal program with dedicated staff and state-of-the-art policies and procedures. If the proposed legislation is enacted, the new

whistleblower program would not be an extension of the current insider trading bounty program. Instead, it would subsume the existing program and, thereby, constitute an entirely new program based on the structure and best practices of other successful whistleblower programs.

We also have taken other steps that we believe will address some of the recommendations. As indicated in the Draft Strategic Plan for 2010-2015, the Commission is centralizing the process for receiving, reviewing, and acting upon tips, complaints and referrals (TCRs) so they can be handled consistently and appropriately, including through examinations or enforcement investigations. In connection with this effort, the Commission hired the MITRE Corporation to assist in revamping our intake, triage and analysis of TCRs, and has adopted a new agency-wide policy for handling TCRs, embodied in *Tips, Complaints, and Referrals Intake Policy*, Securities Exchange Commission Regulation 3-2, March 10, 2010 (SECR 3-2). The Division has adopted supplemental guidance to implement this policy. Division of Enforcement, *Interim Policies and Procedures for Handling Tips, Complaints and Referrals (TCRs)* (March 24, 2010).

The Division's new Office of Market Intelligence (OMI) will consolidate the Division's handling of TCRs in accordance with SECR 3-2 and our supplemental guidance. The principal functions of OMI will include coordination, consolidation and management of the Division's processes with respect to TCRs that come to the Division's attention from any internal or external source. Tips received through the insider trading bounty program will be covered by the Commission's new TCR policy, as will the tips and complaints covered by the proposed new whistleblower legislation. We have considered OIG's report in light of these developments.

While we concur with the recommendations, it is our hope that pending legislation before the Congress, as noted above, will create a new program wholly replacing the current one. In such a case, we believe it would be appropriate to address many of the recommendations below through enactment of policies and procedures involving the agency's new authority as opposed to embarking upon modifications of the current insider trading bounty program, which we hope will soon be superseded.

Recommendation 1 relates to communicating information about the bounty program, both externally and internally. We concur and will develop a plan consistent with this recommendation.

Recommendation 2 relates to the development of a form for requesting information from whistleblowers. We concur with this recommendation. In connection with the revamped TCR system, the electronic form in which information is collected will be updated, and we expect to have a form directed specifically to whistleblowers.

Recommendation 3 relates to policies for follow-up with whistleblowers to obtain any additional information they may have. We concur with this recommendation. The Division will be developing processes and procedures for follow up with whistleblowers.

Recommendation 4 relates to the criteria for recommending the award of bounties. We concur with this recommendation. The Division will develop criteria consistent with this recommendation.

Recommendation 5 relates to the examination of ways to provide notice to whistleblowers as to the status of their bounty requests. We concur with this recommendation. The Division will work with the Office of General Counsel to address this recommendation.

Recommendation 6 relates to controls for tracking tips and complaints from whistleblowers. We concur with this recommendation. The Commission's TCR project has already focused on particular capabilities necessary to track whistleblower tips and complaints, and the system currently in development will incorporate controls to ensure that tips are reviewed and track whether timely decisions are made whether to pursue tips.

Recommendation 7 relates to maintenance of whistleblower complaint files. We concur with this recommendation. The Division will adopt procedures for creation and retention of information relevant to a whistleblower complaint.

Recommendation 8 relates to incorporation of best practices from the Department of Justice and the Internal Revenue Service with respect to bounty applications. We concur with this recommendation. As the report notes, the Division has already met with these agencies to identify best practices. The Division will adopt best practices for the existing insider trading bounty program or will incorporate such practices into any new program should the proposed legislation be enacted.

Recommendation 9 relates to formulation of a timeline for policies and procedures for the existing bounty program. We concur with this recommendation. The Division will develop an appropriate timeline.

Office of Inspector General
Response to Management's Comments

We are pleased that Enforcement fully concurred with all nine of the report's recommendations and are encouraged that the SEC has begun to take steps to correct the identified deficiencies.

Enforcement noted in its response that it believes the principal reason that the current bounty program has not yielded more rewards derives more from its relatively narrow scope and the confidential nature of insider trading violations than from procedural shortcomings that it recognizes exists. Enforcement further stated that the newly proposed whistleblower legislation was drafted principally to broaden the nature of wrongdoing for which whistleblowers could receive a bounty.

As we discussed in our report, although we noted the limitations in scope, we also found that the minimal use of the SEC bounty program can be attributed to the fact that the program has not been widely publicized and that information on the SEC's public website was misleading and may have deterred prospective whistleblowers from applying. We also found that more frequent communication with whistleblowers would encourage applications.

We believe it is critical for the SEC to implement the report's recommendations to ensure that it has a fully functioning and successful bounty program in place as its authority is potentially expanded.

Audit Requests and Ideas

The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

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Attn: Assistant Inspector General, Audits (Audit Requests/Ideas)
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