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## **REPORT OF INVESTIGATION**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
OFFICE OF INSPECTOR GENERAL**

**Case No. OIG-496**

**Allegations of Conflict of Interest, Improper Use of Non-Public Information  
and Failure to Take Sufficient Action Against Fraudulent Company**

**January 8, 2010**

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# Report of Investigation

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## REPORT OF INVESTIGATION

### UNITED STATES SECURITIES AND EXCHANGE COMMISSION OFFICE OF INSPECTOR GENERAL

Case No. OIG-496

#### Allegations of Conflict of Interest, Improper Use of Non-Public Information and Failure to Take Sufficient Action Against Fraudulent Company

##### Introduction and Summary of Results of Investigation

On July 10, 2008, the Securities and Exchange Commission ("SEC" or "Commission") Office of Inspector General ("OIG") opened an investigation after SEC Chairman Christopher Cox's former Chief of Staff asked the OIG to review allegations against a former Division of Enforcement ("Enforcement") attorney. The allegations were outlined in a *Wall Street Journal* article about hedge fund Greenlight Capital LLC ("Greenlight Capital") manager David Einhorn's ("Einhorn") then soon-to-be released book, *Fooling Some of the People All of the Time - A Long Short Story* ("Einhorn's book"). The article stated that one of Einhorn's complaints was that [REDACTED] who aggressively questioned Einhorn about his short-selling of Allied Capital Corporation ("Allied") stock, became a registered [REDACTED] for Allied after he left the SEC. In addition, the article noted that Allied obtained purloined copies of Einhorn's telephone records. The former Chief of Staff was concerned, *inter alia*, that [REDACTED] may have engaged in illegal activity and taken non-public SEC investigatory materials, including Einhorn's telephone records.

In 2005, the OIG conducted a brief preliminary inquiry into similar allegations outlined in a letter from Einhorn's counsel, Richard Zabel ("Zabel"), to the OIG.<sup>1</sup> The 2005 inquiry

<sup>1</sup> That letter alleged that [REDACTED] may have been: (1) [REDACTED] Congress regarding the Commission's investigation of Allied, which Zabel claimed [REDACTED] participated in, and (2) using to Allied's advantage non-public information about Einhorn and Einhorn's hedge fund Greenlight Capital, which [REDACTED] learned through his participation in the Enforcement investigation of Allied. Zabel attached the form which registered [REDACTED] as a [REDACTED] for Allied. Zabel claimed that [REDACTED] may have violated a criminal statute, Commission rules, and/or attorney bar rules.



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found that an Enforcement investigation into Allied was opened after [REDACTED] left the Commission but that there was no specific violation of any law, rule, regulation or statute by [REDACTED]. After reviewing the information provided in 2008 by then Chief of Staff, the OIG reopened the issues in that inquiry and broadened its investigation to include additional allegations Einhorn made in his book. Published in mid-2008, Einhorn's book recounted the much-publicized heated feud between Einhorn and Allied, which continues today. The feud began in May 2002 when Einhorn gave a negative speech at a conference about Allied and described why Greenlight Capital had a short position in Allied. Einhorn's speech compelled many to also short and sell Allied's stock the next day. Allied responded, according to Einhorn, in a "Washington, D.C.-style spin job," attacking Einhorn.

Einhorn's book included allegations of the SEC's failure to take appropriate action related to Allied's wrongdoing. Einhorn wrote that he sent about a dozen letters with detailed information and evidence related to his allegations of wrongdoing at Allied to several SEC officials, but never received a telephone call or written response. Einhorn stated that he did not have any idea whether anyone at the SEC followed up on the information he provided. In those letters, and in his book, Einhorn claimed that Allied overvalued many of its investments. Einhorn also stated that he believed he was investigated by the SEC at the behest of Allied, noting the unusual timing of receiving a subpoena for his testimony and documents after Enforcement attorneys called him the same day he asked Allied a question on a conference call.

The OIG conducted a comprehensive investigation of the allegations in Einhorn's book. The investigation revealed that Allied successfully lobbied the SEC to begin investigating Einhorn and his hedge fund Greenlight Capital without specific evidence of wrongdoing, after Einhorn's negative speech about Allied in May 2002. The OIG investigation found that Enforcement's investigation of Einhorn and his hedge fund, among other hedge funds including [REDACTED], was commenced shortly after Allied met with Enforcement officials in June 2002. The [REDACTED] investigation was supervised by [REDACTED], who just over a year later left the Commission and became a [REDACTED] for Allied. We found that during the [REDACTED] investigation, [REDACTED] aggressively questioned Einhorn in testimony, subpoenaed several boxes of documents and sought Einhorn's telephone records and list of his clients. We also found that [REDACTED] made numerous, successful efforts to learn about Allied during the course of the [REDACTED] investigation.

The OIG investigation further revealed that during the same time Allied was able to convince the SEC to investigate Einhorn, even without any evidence of wrongdoing, Einhorn was submitting specific and detailed letters to the SEC outlining evidence of Allied's overvalued investments and requesting the SEC to investigate Allied. We found that although the SEC's Office of Compliance Inspections and Examinations ("OCIE") had begun an examination of

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Allied based upon Einhorn's allegations, Enforcement staff was unaware that OCIE was examining Allied and the lead Enforcement attorney was prevented from contacting a Senior Official to learn that Einhorn began submitting letters outlining evidence of Allied's wrongdoing.

The OIG investigation also found that very soon after Enforcement began looking at the allegations against Einhorn, they concluded that there was no credible evidence to demonstrate that the activities of his hedge fund violated any federal securities laws. However, although the investigation against Einhorn was as a practical matter completed by mid-2003, the investigation was not formally closed until December 2006 and Einhorn was never notified that he was no longer a subject of investigation despite his request for such notification.

We further found that in 2003, while supervising the investigation against Einhorn and others, [REDACTED] was asked to leave Enforcement because of performance problems. In [REDACTED] immediately after leaving the SEC, [REDACTED] joined the law firm of Venable LLP ("Venable"). In October 2004, [REDACTED] formally registered as a [REDACTED] for Allied. The OIG investigation disclosed that [REDACTED] obtained clearance from the Commission's Ethics Office to register as a [REDACTED] for Allied based on representations he made that he had not worked on any Allied-related matters while working at the SEC. In fact, the evidence showed that [REDACTED] had worked on the investigation of Einhorn which Allied had lobbied for, and in the course of this investigation, learned a substantial amount of sensitive, non-public information regarding Einhorn and Allied. However, the OIG found no evidence that [REDACTED] took any non-public or case-related documents with him when he left the SEC. Nor did we obtain evidence that [REDACTED] received any non-public information from any SEC employee after leaving the SEC.

The OIG investigation revealed that in March 2005, Einhorn raised concerns that Allied illegally gained access to his telephone records. In 2007, after a grand jury was convened, Allied informed the SEC and United States Attorney's Office ("USAO") that [REDACTED] had engaged in the offense of pretexting (impersonating someone to obtain their telephone records) against Einhorn on behalf of Allied. Allied then filed an SEC Form "10-Q" acknowledging that one of its agents had illegally obtained Einhorn's telephone records, although it claimed not to have authorized the pretexting. The OIG found that the SEC took no action against Allied related to the pretexting.

Moreover, although Enforcement found no evidence of wrongdoing against Einhorn based upon Allied's unsupported allegations, Einhorn's claims against Allied were validated to a great extent by OCIE's examination. However, the record shows that OCIE's examination, prolonged by delays, was unusual in many ways. Specifically, it was conducted primarily by only one headquarters' examiner with very close supervision by the Associate Director in OCIE.

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In addition, although the exam lasted for 18 months, there was no visit to Allied's offices, even though they were located just blocks from the SEC. We also found that the Associate Director supervising the exam knew [Allied Officer 1], who formerly worked at the SEC, and indicated that he trusted [redacted] and had the view that anyone who had worked at the SEC was "not going to be doing anything illegal."

The examiner on the Allied examination testified that she received considerable "pushback" from the Associate Director with regard to her findings against Allied. Specifically, the examiner expressed concerns about the method that Allied utilized to raise cash to pay dividends, noting that Allied had not had sufficient cash from earnings to pay dividends since 1999 without the issuance of additional stock. The examiner was concerned that the manner in which Allied was financing its dividends was akin to a "Ponzi scheme." Moreover, all of the work papers from that examination were later inexplicably deleted from the OCIE shared computer drive.

In April 2004, the record shows that OCIE referred three findings from its examination of Allied to Enforcement, including the concern about how Allied financed its dividends with which the Associate Director disagreed. The OIG determined that the issue of how Allied financed its dividends was never investigated by Enforcement. In May 2004, Enforcement finally began its investigation of the claims raised by Einhorn in May and June 2002. We found that Enforcement determined by mid-2006 that more than a dozen of Allied's investments had significant problems with the calculation of their value and that Allied had materially overstated its net book income on SEC Forms "10-K" for several years.

However, after investigating the matter for three years, in June 2007, just after Allied told the SEC its agent engaged in pretexting, the Commission entered into a settlement agreement with Allied. In that agreement, Allied agreed to continue to employ a Chief Valuation Officer to oversee its quarterly valuation process and third-party valuation consultants to assist in its quarterly valuation process for two years. No penalty was assessed against Allied or any of its officers or directors. The OIG investigation further disclosed that Allied's counsel had requested and obtained a "pre-Wells" meeting with Enforcement in which a former SEC Enforcement Director, and other attorneys representing Allied, successfully lobbied Enforcement not to bring fraud charges against Allied or [Allied Officer 2], who Enforcement found to have overvalued some of Allied's investments, but instead to have Allied accept a "books and records" charge. We further found that under the settlement with Allied there were no efforts made by the Commission, or even provisions in the settlement order, to monitor compliance by Allied with that agreement.

Finally, we found that after the OIG initiated its investigation and Einhorn's book was published about his experiences with Allied and the SEC, [redacted]

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Examination

In all, the OIG's findings during this investigation raise concerns about how decisions were made within the SEC with regard to the initiating and concluding of the examination and investigations. While we did not find any evidence of specific wrongdoing on the part of current SEC employees, we found that serious and credible allegations against Allied were not initially investigated, and instead Allied was able to successfully lobby the SEC to look into allegations against its rival Einhorn without any specific evidence of wrongdoing.

We also found that there was a lack of communication between OCIE and Enforcement with respect to pending examinations and investigations. Moreover, a former Enforcement manager (who had such significant performance problems he was asked to leave Enforcement) was able to obtain a significant amount of sensitive information he may have disclosed to Allied when he became a registered Personal Information for Allied a year after leaving the SEC. Further, we found concerns with both the OCIE examination of Allied and the resulting Enforcement investigation, and believe there are questions about the extent to which Allied's SEC connections and aggressive tactics may have influenced Enforcement's and OCIE's decisions in these matters.

We are recommending that the Directors of OCIE and Enforcement carefully review this report of investigation and the history of the examination and investigations that are described in this report and give consideration to promulgating and/or clarifying procedures with regard to:

- (1) how examinations and investigations are initiated where there are requests from outside persons or entities, including whether specific allegations of wrongdoing have been provided, in determining whether to commence an examination or investigation;
- (2) informing individuals and entities under investigation that they are no longer subjects of an investigation in a timely manner, as required by the Enforcement Manual;
- (3) ensuring that other than traditional Wells meetings are not utilized by aggressive counsel to influence decisions in Enforcement actions;
- (4) incorporating provisions in Enforcement settlement agreements that ensure requirements are adequately monitored for compliance;
- (5) limiting the ability of OCIE personnel to delete examination work papers from OCIE computer systems;

