

Title: 2009's SEC Inspector General Audit: "Practices Related to Naked Short Selling Complaints & Referrals" Finds Significant Issues with Enforcement Divisions' Handling of Naked Short Complaints; Enforcement D. References "Threat Posed by Naked Short Selling as Wildly Exaggerated" in Response & Agrees

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to 1 of 11 Recommendations (End of Title)

Obligatory - I am not a financial advisor and none of the information below is to be considered financial advice.

****TL;DR**** In 2009, the SEC's Office of the Inspector General (OIG) did a study on the SEC Enforcement Division's handling of naked short complaints, tips, and referrals (CTRs) and made 11 recommendations for the Enforcement side to better handle naked short selling CTRs. The Enforcement Division agreed to 1 of the 11 recommendations and stated in their response back, *******"there is hardly unanimity in the investment community or the financial media on either the prevalence, or the dangers, of 'naked' short selling," and references the view held by some that "the threat posed by 'naked' short selling is wildly exaggerated"*******

OIG Responded to the Enforcement Division, *******"In adopting a naked short selling antifraud rule, Rule 10b-21, in October 2008, the Commission stated, "We have been concerned about 'naked' short selling and, in particular, abusive 'naked' short selling, for some time." In this report, we determined that Enforcement's current policies and procedures appear to limit significantly the referral of naked short selling complaints, and that its written policies and procedures result in naked short selling complaints being treated differently from other types of complaints of securities law violations."*******

It seems these separate divisions have very different takes on the impact of naked short selling and how tips/complaints regarding naked short sales should be dealt with.

It's a very in-depth read to cover all the necessary details, but I've tried my best to use the highlights of the document in the summary below. The shortfalls listed, and the lack of care from the Enforcement Division would be astounding if you weren't aware of the cesspool that is the US Stock Market.

<https://preview.redd.it/ncml7qnicc91.jpg?width=624&format=pjpg&auto=webp&s=9f8d3e1dc985bbd66663427cc16a49008803b5ea>

Here is the link to the OIG Audit List: [Office of Inspector General - Audit Evaluation Reports](<https://www.sec.gov/oig/Article/issued-reports.html#2009>)

Link to the PDF file of the audit: [Practices Related to Naked Short Selling Complaints and Referrals](<https://www.sec.gov/about/offices/oig/reports/audits/2009/450.pdf>)

End TL;DR

Office of Inspector General: Practices Related to Naked Short Selling Complaints and Referrals

In 2009, The Office of the Inspector General (OIG) (an independent office within the SEC) conducted an audit on the Enforcement Division of the SEC regarding Practices Related to Naked Short Selling Complaints and Referrals. OIG came up with 11 recommendations for how the Enforcement Division could better handle naked short selling complaints due to *******numerous complaints, particularly since December 2007, alleging that Enforcement has failed to take sufficient action regarding naked short selling. Many of these complaints asserted that investors and companies lost billions of dollars because Enforcement has not taken sufficient action against naked short selling practices. ******* Better yet, OIG didn't even need to hire expensive consultants to write the report.

However, Enforcement strongly disagreed with the report, the recommendations within the report (aside from 1 of the 11) and seemed to strongly disagree with the negative impacts that naked shorting has on the market. Here are the highlights of the report (These are all copy/paste from the report, ****emphasis**** added by me):

* Because Enforcement does not have separate procedures and processes for handling complaints about naked short selling, our audit examined Enforcement's general complaint receipt and processing procedures as they applied to the receipt and referral of naked short selling complaints.

* The OIG received numerous complaints alleging that Enforcement failed to take sufficient action regarding naked short selling.

* ****Our audit disclosed that despite the tremendous amount of attention the practice of naked short selling has generated in recent years, Enforcement has brought very few enforcement actions based on conduct involving abusive or manipulative naked short selling.****

* Of approximately 5,000 naked short selling complaints received in the ECC between January 1, 2007 and June 1, 2008, only 123 **** (approximately 2.5 percent) were forwarded for further investigation.****

* ****Moreover, we found that these complaints were forwarded only because the complaint subjects were involved in ongoing Enforcement investigations. None of the forwarded complaints resulted in enforcement actions**, though one of the complaints referenced a pending enforcement action involving naked short selling. **Furthermore, only six of the approximately 1,900 complaints entered into Enforcement's CTR database during the period we examined, alleged naked short selling. Based on the data available to us, these complaints led to no enforcement actions.****

* Also, we were informed that ****none of the approximately 900 SRO referrals received by OMS between January 1, 2007 and June 1, 2008 involved naked short selling.****

* ****Our audit determined that Enforcement's existing complaint receipt and processing procedures hinder Enforcement's ability to respond effectively to naked short selling complaints and referrals.****

* ****We found that the Enforcement Complaint Center's (ECC) written policies and procedures do not include specific triage** **steps for naked short selling complaints**, while they do include procedures for the in-depth analysis of several other categories of complaints, e.g., spam driven manipulations, unregistered online offerings and insider trading. **These procedures, we believe, have the effect of naked short selling complaints being treated differently than other types of complaints.****

* ****The ECC's policies and procedures expressly instruct staff, as a general matter, not to forward for further investigation complaints based on data obtained from "Level II" trading terminals.**** Because many investor complaints of naked short selling are based on information obtained from Level II trading screens, no triage is performed on these complaints and they are automatically not forwarded to Enforcement staff, unless they pertain to an existing Enforcement matter.

* ****Our audit also disclosed a risk that naked short selling complaints with potential merit may be eliminated from further consideration during the initial complaint screening process because no supervisory review is performed of the initial screening.****

* Enforcement maintains that naked short selling complaints are not being treated differently than other types of complaints and that the naked short selling complaints it receives generally do not provide sufficient information to warrant pursuit of the complaint. Enforcement, therefore, states that it is reluctant to expend additional resources to investigate such complaints and indicated that the high volume of incoming complaints precludes supervisory review of the initial screening of all e-mail complaints.

* ****Given the heightened public and Commission focus on naked short selling and guidance provided to the public leading them to believe these complaints will be taken seriously and appropriately evaluated, we believe the ECC's current policies and procedures should be improved to ensure that naked short selling complaints are addressed appropriately.****

* ****We found that there is currently no uniform set of procedures for the receipt and processing of CTRs and no division-level oversight of the CTR program.****

* ****We also found that Regional Office procedures are inconsistent as to when and whether complaints are entered into the CTR database.**** The lack of uniform procedures and Division-level oversight can lead to the inconsistent treatment of complaints, including those involving naked short selling, depending on where within the Commission the complaint is received.

* ****The majority of the CTR packages we reviewed were incomplete:**** Sixty-seven percent (55 of 82) were missing the response to the complainant; forty percent (33 of 82) were missing the CTR data form; and ten

percent (8 of 82) were missing the original complaint itself. We also found that one of these CTRs was not entered into the CTR database, and another CTR was only partially entered. **We learned during our audit that the Office of Internet Enforcement (OIE) does not follow up with Enforcement staff to ensure the CTR package is complete, resulting in OIE oftentimes lacking adequate documentation of a complaint.**

* Existing CTR policies and procedures applicable to the Regional Offices require the performance of monthly reviews of a Regional Office's CTRs by supervisors at the Senior Officer (SES-equivalent) level.

The responses to our questionnaire revealed that, of the 11 Regional Offices, only five Regional Offices performed the required monthly CTR reviews. **Two Regional Offices performed the reviews on a less frequent basis. Three Regional Offices did not perform the monthly reviews because senior officials were involved with the CTRs throughout the process, or lower level officials were considered to be responsible for CTR judgments.**

* **Our audit also found that Enforcement's current automated complaint tracking systems, primarily the ECC complaint mailbox and the CTR database, require improvements to ensure the appropriate processing and tracking of complaints.**

* In addition, we learned during our audit that a database previously developed by OIE to track the results of complaint referrals was no longer in use due to technical difficulties encountered with the system. As a consequence, **OIE has no current ability to track electronically which types of complaints referred to Enforcement staff result in the opening of an informal inquiry or a formal investigation.**

OIG List of Recommendations

1. The Division of Enforcement should develop written in-depth triage analysis steps for naked short selling complaints, as it has for complaints involving other types of securities law violations, such as spam-driven manipulations and insider trading.
2. The Division of Enforcement should revise its written guidance to the Enforcement Complaint Center staff to ensure that naked short selling complaints based on information obtained from "Level II" computer screens are given a proper level of scrutiny and referred for further investigation where appropriate.
3. The Division of Enforcement should add naked short selling to the list of categories of complaints on the Commission's public webpage that solicits complaints from the public and should develop an online complaint form specifically tailored to naked short selling complaints.
4. The Division of Enforcement's Enforcement Complaint Center should develop and implement policies and procedures providing for supervisory review of a sample of e-mails that are not forwarded for further review as a result of the initial screening process.
5. The Division of Enforcement should develop uniform written policies and procedures for the Complaints, Tips and Referrals (CTR) Program at Headquarters and the Regional Offices. These policies and procedures should include a requirement for when complaints should be entered into the CTR database, e.g., upon receipt, and should provide for consistent, periodic supervisory reviews of CTRs.
6. The Division of Enforcement should designate an office or individual at Headquarters to provide nationwide oversight for the Complaints, Tips and Referrals program.
7. The Division of Enforcement should require that the Office of Internet Enforcement (OIE) performs the necessary follow-up to ensure that all Complaints, Tips, and Referrals (CTR) packages forwarded to OIE contain complete documentation concerning a complaint, and that all CTRs are entered into the CTR database.
8. The Division of Enforcement should require that Regional Office senior officials perform monthly reviews of Complaints, Tips and Referrals (CTR), as is required by the Regional Office CTR procedures.
9. The Division of Enforcement should improve the analytical capabilities of the Enforcement Complaint Center's e-mail complaint system, including its search and report generation capabilities, as well as its ability to translate foreign-language e-mails.
10. The Division of Enforcement should improve the Complaints, Tips and Referrals database to include additional information about, and to better track, complaints, e.g., by adding data fields to document supervisory and senior staff review, and improving its searching and report generating capabilities, and should resolve problems with Regional Office access to the database.
11. The Division of Enforcement should ensure that the Office of Internet Enforcement updates and resumes using its previous complaint referral tracking system, or develops a new system for tracking information on the results of complaint referrals.

Enforcement Division Response to Audit

* As the Report confirms, "naked" short sales, *i.e.*, selling short without having borrowed the securities to

make delivery, can occur for legitimate reasons, without any sort of manipulative intent. In addition, the mere fact that a stock may experience “failures to deliver” does not imply a violation of the federal securities laws. Indeed, a fail may occur as a result of a long sale (i.e., a sale of owned securities) as well as a short sale.

* **In recent months, a small but vocal cadre of advocates has emerged decrying the practice and suggesting that it has damaging market effects. But there is hardly unanimity in the investment community or the financial media on either the prevalence, or the dangers, of “naked” short selling. The Commission has repeatedly stressed the fact that the practice can provide needed market liquidity in certain circumstances.** **For instance, market makers sometimes engage in legitimate “naked” short selling when there is high buying demand in a security.**

* **Still others view the threat posed by “naked” short selling as wildly exaggerated, and point to instances in which allegations of abusive “naked” shortselling were used to cover up other management malfeasance**, like the dumping on the market of large blocks of unregistered shares. We have recently alleged such behavior in the widely-discussed *CMKM Diamonds* litigation. Other fraud defendants have also attempted to portray depressed stock prices as the work of clandestine short sellers.

* Despite its assertions regarding the potential danger of “naked” short selling and the growing interest in the subject, the Report can cite to no *bona fide* studies or empirical data regarding the practice’s market impact. **The Division of Trading and Markets debunks the theory that NSS creates “counterfeit” or “phantom” shares.**

* As noted above, there may be legitimate reasons for fails to deliver, including mechanical errors or processing delays. Thus, while the Commission has recognized that timely settlement of trades is important for market integrity and investor confidence, the Commission’s recent rulemaking in this area recognizes that trades do fail (whether from long sales or short sales) but that **fails should not persist.**

* The Division of Enforcement is called upon to **police the massive U.S. securities markets with decidedly limited resources** **and, in order to fulfill** our mission of investor protection, we must intelligently leverage those resources. As manager of the Enforcement Complaint Center (ECC), the Office of Internet Enforcement (OIE) is under the same mandate with respect to its limited staff.

* This is accomplished **by focusing on complaints with a high likelihood of accuracy and credibility (like those of purported insiders or scam victims), those whose information can be readily vetted (****i.e****., visible price swings in a possible manipulation or insider trading allegation), or those involving demonstrated, immediate investor hazard in the current market environment (Ponzi schemes, improper sales of auction-rate securities).**

* **So-called “Level II” complaints – that is, assertions of market manipulation or distortion from retail investors based purely on observations of private computer terminals – rely on simple trading snapshots and are really no more reliable an indicator of fraud than a dart tossed at a dartboard full of company names.** Other types of complaints, like those based on direct in-person or electronic solicitation, for example, are far more likely to paint a coherent picture for investigators.

* **The best sources for information on violations relating to “naked” short selling is the SRO, which has primary responsibility for surveillance of its trading.**

* **It is telling that, of the 900 SRO referrals Enforcement received during the Report’s 18-month survey period, none involved the practice of “naked” short selling. That is to say, the people closest to the trading, with the deepest understanding of and access to the data, did not see and refer any of the large-scale, damaging “naked” short sale abuse about which the Report hypothesizes.**

* **Regarding Recommendations 1 – 3: the Division believes that these are not optimal uses for Commission resources and are not calculated to yield a higher quality of investigative referrals to Enforcement attorneys in the Home Office and Regions.**

* Regarding Recommendation 4: Suggesting supervisory sampling and review of complaints that do not survive “first stage” triage review, we concur and will draft and implement suitable policies and procedures.

* Regarding Recommendations 5 – 11: As you know, a new Chairman has taken office, and her staff is currently engaged in an agency-wide effort to determine how tips and complaints are handled in the various Divisions and Offices. No doubt this effort will result in important changes to the agency’s approach, and will likely address the principles discussed in the Report. **Division believes that the best way forward on Recommendations 5-11 is to cooperate fully in the Commission’s review, and to implement its recommendations, along with the rest of the agency, in a coordinated fashion.**

OIG Response to Enforcement Division Response

(This is the entire response)

****We are disappointed that the Division of Enforcement (Enforcement) only concurred with one of the 11 recommendations in this audit report. **** ****We are particularly concerned that Enforcement did not concur with the report's first three recommendations that it develop written in-depth triage analysis steps for naked short selling complaints, as it has for other complaints**;** that it revise its written guidance to the Enforcement Complaint Center staff to ensure that naked short selling complaints are given a proper level of scrutiny and referred for further investigation; ****and that it add naked short selling to the list of categories of complaints on the Commission's public webpage and develop an online complaint form specifically tailored to naked short selling complaints.****

As we discussed in our report, ****the SEC has repeatedly recognized that naked short selling can depress stock prices and have harmful effects on the market.**** In adopting a naked short selling antifraud rule, Rule 10b-21, in October 2008, the Commission stated, *****"We have been concerned about 'naked' short selling and, in particular, abusive 'naked' short selling, for some time."***** In this report, we determined that ****Enforcement's current policies and procedures appear to limit significantly the referral of naked short selling complaints, and that its written policies and procedures result in naked short selling complaints being treated differently from other types of complaints of securities law violations.**** Notwithstanding the Commission's previous statement and our findings, Enforcement responded to our report by stating that "there is hardly unanimity in the investment community or the financial media on either the prevalence, or the dangers, of 'naked' short selling," and references the view held by some that "the threat posed by 'naked' short selling is wildly exaggerated" ****Accordingly, Enforcement concludes that the report's recommendations, which are intended to allow for more thorough investigations of naked short selling complaints, are not optimal uses of Commission resources.**** We would hope that Enforcement reconsiders this position in light of the Commission's stated concerns about the effect of naked short selling on the market.

****We are also disappointed that Enforcement does not intend to implement immediately our specific recommendations (Nos. 5-11) designed to improve its complaints, tips and referral process. We understand that the SEC's new Chairman has announced the enlisting of a contractor** to conduct a comprehensive review of internal procedures used to evaluate tips, complaints, and referrals for the entire agency, and we will certainly work closely with the contractor to assist with this review. **Nonetheless, we believe that implementation of our recommended improvements should begin now, in coordination with the contractor's review, to ensure that the implementation of necessary improvements to Enforcement's complaint system is not unduly delayed.****

I'm sure Enforcement has cleared up all of these deficiencies since this report. /s

Tanks fo reedin