Judiciary Committee Hearing: Illegal Insider Trading: How Widespread is the Problem and is there Adequate Criminal Enforcement?
Questions for the Hearing Record
Questions from Senator Grassley:

For Ms. Linda Thomsen
Director, Enforcement Division
U.S Securities and Exchange Commission

Introductory Statement

Thank you for the opportunity to respond to questions concerning the Division of Enforcement's decision to terminate the employment of probationary employee Gary Aguirre. Before answering your specific inquiries, I would like to put in context the favorable evaluation Mr. Aguirre received and his subsequent termination.

In considering Aguirre's formal evaluation for merit pay purposes, it is important to bear in mind that he was, first and foremost, a probationary employee throughout the relevant period. As a probationary employee, Aguirre was not yet entitled to have his performance evaluated solely in accordance with the formal evaluation processes applicable to permanent employees. Until he completed his probationary period, Aguirre could be terminated at any time, for any lawful reason, regardless of the formal evaluation process. During the first year of SEC service, an employee's probationary status trumps the evaluation procedures that would otherwise apply to him as a permanent employee.

Aguirre's employment with the SEC was terminated on September 1, 2005, at the end of his probationary period. The end of the probationary period is a fixed calendar date marking the end of the first year of service. It cannot be extended or changed and is independent of any other evaluative or work process the employee may be engaged in. By happenstance, Aguirre's termination at the end of his probationary period came within a month of a merit pay evaluation awarding him a 2-step pay increase. However, the merit pay evaluation was actually for the period ending April 30, 2005, and Aguirre's performance deteriorated between May and August.

In any event, Aguirre's overall performance through even April 30, 2005, did not warrant a 2-step merit pay increase and it should not have been awarded to him. That pay increase resulted from a combination of lapses in communication when Aguirre transferred between branches, a desire on the part of the agency and Aguirre's supervisors to give him a "fresh start" in his new branch, and certain aspects of the applicable SEC merit pay system, which have since been revised.

Aguirre's original Branch Chief, Charles Cain, believed that his overall performance was poor. By the end of Aguirre's tenure in Cain's branch on January 17, 2005, Cain thought Aguirre should be fired immediately rather than transferred. However, part of the SEC's impetus for granting Aguirre's request to transfer was to give him a "fresh start." For that reason, Aguirre's new branch chief, Robert Hanson, did not consult Cain about Aguirre's prior performance. Hanson based his merit pay evaluation solely on the period of about three months Aguirre had been in his new branch before the end of the rating period on April 30th. The SEC has never questioned Aguirre's basic competence as an attorney or his commitment and work ethic as demonstrated in the Pequot investigation, and those factors were considered by Hanson in awarding him a merit pay increase.

In April 2005, the SEC's merit pay system had been in place for little more than a year and was still a work-in-progress. At that time, the merit pay system involved an initial pass/fail evaluation on four basic elements of performance. However, in the initial pass/fail review, the standard of acceptable performance was set at an extremely low level. Nearly every SEC employee was rated acceptable on all four elements. A probationary employee's failure to meet the exceedingly low standard of "acceptable" on any one of the four elements would almost surely have resulted in immediate termination.

After the pass/fail review, a second level of review was conducted for purposes of setting merit pay. The review was initiated by the employee, who drafted a statement regarding his or her contributions to the agency during the rating period. The employee's supervisor then reviewed the employee's assessment, and submitted his or her own statement indicating agreement or disagreement with the employee's statement. Significantly, in 2005, the merit pay system considered only positive contributions; areas of poor performance or the need for improvement could not be considered in setting merit pay, though they could be considered for other purposes. Further, the results of the merit pay evaluation for the period ending April 30, 2005 were not collated and approved by the Division of Enforcement's Review Committee until July 18, 2005. The results were communicated to Human Resources and supervisors on August 1 and to employees later in August. Thus, there was a substantial time lag between the conduct reflected in the evaluation and the date the resulting pay increases became effective. Numerous elements of the merit pay system, including the extent of the time lag and the consideration of only positive contributions, have since been revised and improved upon by the SEC's Office of Human Resources.

On August 1, 2005, Associate Director Paul Berger discussed with Hanson the favorable evaluation that Hanson and Assistant Director Mark Kreitman had given of Aguirre's performance. Hanson and Kreitman had previously expressed to Berger concerns about Aguirre's conduct. Berger asked whether the rating Hanson had given Aguirre was appropriate. Hanson stated he did not believe in retrospect that the rating was appropriate. Berger asked Hanson to consider whether Aguirre's evaluation should be supplemented to include some of the concerns about Aguirre's behavior. After meeting with Berger, Hanson met with Kreitman and they agreed that a supplement to the evaluation was appropriate. Kreitman drafted a supplemental evaluation, solicited Hanson's comments, and forwarded the final Supplemental Evaluation to Berger that same day. The Supplemental Evaluation stated:

> "Aguirre: Gary works very hard, puts in long hours, and is dedicated to his work. But he is resistant to supervision and insufficiently cognizant of institutional protocol and possible programmatic impact of his investigative methods."

After citing an instance in which Aguirre drafted subpoenas that had to be revised to avoid violation of privacy laws, the Supplemental Evaluation went on to state:

> "His manner has, on more than a few occasions, drawn complaints from opposing counsel which . . . raises a question because of their frequency and consistency. Other staff attorneys find it difficult to work with him; his desire to maintain complete control of his single investigation seems to preclude full and open sharing of his legal analyses. He has difficulty explaining the significance of evidence his investigation has uncovered in linear fashion and expresses resentment at what he inaccurately perceives as attempts by his supervisors to thwart his success."

All of Kreitman's observations had been amply demonstrated by Aguirre's conduct during the course of his employment.

When Kreitman forwarded the Supplemental Evaluation to Berger, he assumed that Berger would then forward it to the Compensation Committee if he concurred in it. Berger reviewed the Supplemental Evaluation and concurred in it, but he believed that Kreitman would forward it to the Compensation Committee for further consideration and inclusion in Aguirre's personnel file. After Aguirre's termination and his subsequent request for his personnel file, it became clear that the Supplemental Evaluation had not been considered by the Compensation Committee or included in the personnel file as Berger intended. After these facts came to my attention, I concurred in the determination that the Supplemental Evaluation should be included in Aguirre's personnel file if the SEC's Office of Human Resources approved of that action and I further directed that any dates relating to the document be accurately recorded.

Shortly after the Supplemental Evaluation, Aguirre left on vacation in mid-August 2005. By then he had tendered, and subsequently revoked, his written resignation. Aguirre also informed his supervisors that while he intended to finish the Pequot investigation, he had no intention of drafting the customary action memo laying out the facts and specific evidence that had been discovered. Drafting this memorandum is often the most difficult and time-consuming aspect of an investigation. Given his key role in the investigation, assigning the task to anyone other than Aguirre would be duplicative, inefficient and unduly burdensome to other staff.

Aguirre's refusal to complete his primary case responsibility by drafting the action memo was also a breach of agency procedure. Staff attorneys with primary responsibility for an investigation always have primary responsibility for completing the action memo; they do not have the option of declining that duty. Aguirre's refusal to complete his duties demonstrated, once again, Aguirre's inability to work with (and indifference to) other staff and disregard for SEC procedures.

After being notified in late August that Aguirre's probationary period would soon end, Berger spoke with Kreitman and Hanson about whether to retain Aguirre. Based on the many concerns they had developed about Aguirre's conduct, which were described at the recent hearing and in their written statements, Kreitman and Hanson recommended that Aguirre be terminated from his employment position. Berger agreed with that recommendation, and Berger, Kreitman, and Hanson subsequently met with me to discuss it. I made the final decision.

By letter dated September 1, 2005, which I signed, Aguirre was informed that his employment was terminated during his trial period "based upon your demonstrated inability to work effectively with other staff members and his unwillingness to operate within the Securities and Exchange Commission (SEC) process." The letter further stated that the termination would be effective at the close of business on Friday, September 2, 2005. Aguirre was also given the reasons for his termination, which had already been brought to his attention by his supervisors. Among other things the letter stated,

> "Several times throughout your trial period, your supervisors advised you that your conduct was inappropriate. You were permitted to transfer from one Assistant Director Group to another after assuring your Associate Director that problems that had occurred, including personality conflicts and resistance to standard supervision, would not recur. However, you have continued to have conflicts with other staff attorneys, your branch chief and a Trial Attorney assigned to your primary case responsibility. You have continually expressed dissatisfaction with the supervisory structure and ignored the Chain of Command in the Division."

With respect to the Pequot investigation, the letter stated that Aguirre "indicated that you were uninterested in participating in the preparation of your primary case responsibility beyond the investigative stage. While your work substantive work generally has been good, the problems that have occurred in other areas are so significant that they far outweigh the value of that work." The letter notes that all three of Aguirre's SEC supervisors had met with him repeatedly "to explain to you the importance of working together with other staff members to achieve consensual goals and the importance of operating within the SEC process." For the reasons previously set forth and because Aguirre's conduct had not improved to a level that would warrant retaining him beyond his probationary period, the SEC exercised its right to terminate his employment before the probationary period expired.

(1) According to documents produced by the SEC, the Merit pay schedule for 2005 consisted of the following seminal dates:

July 18, 2005 – Compensation Committee review beginning at 9:00

July 19, 2005 – Linda Thomsen receives Compensation Committee recommendations

July 27, 2005 – Linda Thomsen, the Deciding Official, finishes merit pay process for Division of Enforcement

August 1, 2005 – Division of Enforcement transmits final results to Office of Human Resources

(a) Did you receive the merit pay schedule increases on July 19, 2005?

Yes.

(b) Did you finish reviewing them as noted on July 27, 2005?

Yes.

(c) Based upon this schedule, all decisions by the Compensation Committee were due to the Office of Human Resources on August 1, 2005. Were you aware of any changes to the schedule as approved by the Compensation Committee and you after July 27, 2005?

No.

(d) Were any proposed alterations, amendments, or changes circulated for review after the July 27 but not accepted by either the Compensation Committee or yourself? If so, please provide a detailed explanation outline dates, times, and parties involved.

No. As noted above, a Supplemental Evaluation of Mr. Aguirre's performance was drafted after July 27. The Supplemental Evaluation was intended to be inserted into Mr. Aguirre's personnel file and circulated to the Compensation Committee in connection with the Committee's merit pay decisions, but it was not placed in the personnel file or circulated to the Committee when drafted because of a logistical misunderstanding. When I became aware of the Supplemental Evaluation and the logistical error, I concurred in the determination that the Supplemental Evaluation should be included in Mr. Aguirre's personnel file so long as the Office of Human Resources also concurred in that determination, and I further directed that all dates regarding the document and its inclusion in the file be recorded accurately.

(e) In your capacity as director of the Enforcement Division, how many supplemental re-evaluations of staff have you seen once they were approved for a merit pay increase?

Since I became Director of the Division of Enforcement in May 2005, I have seen two formal supplemental re-evaluations of employees.

(2) Much discussion in this matter has surrounded Mr. Aguirre's issuance of subpoenas without his supervisor's approval. In fact, during your testimony you stated that Mr. Aguirre issued, "without his supervisors review or approval, subpoenas that violated federal privacy law, which were withdrawn after his supervisors learned of them. But for the supervisors' corrective actions, the former employee's work product could have been extremely damaging to the SEC."

(a) Does the SEC have any written policies that surround the chain of command for the issuance of a subpoena?

Yes.

i. Is this information provided to Attorney's when they are hired?

Yes.

ii. How is this information presented (e.g. orally or in writing)?

Generally, the information is presently both orally and in writing.

iii. Please provide any written policy that exists at SEC for issuing subpoenas, or any training materials (e.g. a SEC manual comparable to the U.S. Attorney's manual).

New SEC staff attorneys are provided with both oral and written guidelines and other training regarding the issuance of subpoenas in connection with an investigation. The SEC's staff structure is hierarchical and features multiple layers of supervision. In the first few days on the job, a new staff attorney will be introduced to two or three levels of supervisors, including their Branch Chief, their Assistant Director, and their Associate Director. New attorneys are often trained by their Branch Chief or other more senior staff attorneys regarding the SEC chain of command and other appropriate protocols in the conduct of an investigation. This hands-on training generally takes place in the context of the new staff attorneys' first few investigations, with the Branch Chief or other superior leading the new hire through all required tasks in the course of an investigation, and reviewing any written work product created by the new hire. A new hire is trained to expect that his or her written work product will be reviewed by one or more supervisors or senior SEC staff attorneys. It is generally considered inappropriate for staff attorneys to send out written work product that has not been reviewed by at least one supervisor or a more senior team member.

In addition to on the job training by more senior attorneys, new hires are also provided with extensive written guidelines and other training materials. New hires are given an Enforcement Orientation Manual and an Enforcement Training Program Manual. These materials are provided in connection with an annual multi-day Enforcement Training/Orientation Program. New staff attorneys are also granted access to the Enforcenet database, which contains, among other things, extensive information on the proper conduct of investigations; a privacy manual and other specific information to ensure compliance with federal privacy laws; a guide to "red-flag" issues including privacy and privileges; ethics guidance; and guidelines for subpoenas. With respect to subpoenas, the guidelines include a standard subpoena cover letter, guidelines on special subpoenas to telephone and internet companies; business record certifications, and materials regarding special considerations in the issuance of subpoenas, such as compliance with applicable privacy statutes, subpoenas for immediate production of documents, issuance of subpoenas in relation to pending litigation and issuance of subpoenas to members of the news media.

(b) Was Mr. Hanson informed by Mr. Aguirre that he intended to issue the subpoenas in question? If so, please describe.

Yes. Aguirre notified Hanson he wanted to send out these and other subpoenas.

(c) Did Mr. Hanson ever respond to Mr. Aguirre with concerns regarding the subpoenas?

Yes. Hanson believed the subpoenas could be improper. He directed that Aguirre speak with the Internet Enforcement unit of the Division of Enforcement, which had experience in this area, concerning the subpoenas.

(d) Which supervisors of Mr. Aguirre took the "corrective actions"?

Hanson.

(e) What "corrective actions" were taken?

When Hanson subsequently learned Aguirre had issued the subpoenas, he told Aguirre he should not have done that and the problem must be resolved. Later, Aguirre told Hanson he had withdrawn the subpoenas. Aguirre was casual and smiling about this matter, which Hanson considered serious.

(f) Is there any documentary evidence that describes or relates to the aforementioned "corrective actions"? If so, please provide all documents. In the event this production includes documents not previously produced, provide a narrative explanation as to why it was not previously produced.

We have not located among the files Aguirre left upon termination any confirmation of his withdrawal of the subpoenas.

(3) Has the SEC filed an insider trading case during the last five years when the statute of limitations period as specified in Section 20A(b)(4) of the Securities Exchange Act of 1934 has expired? If so, please specify the name of the case, court where filed, and case number. Additionally, please list any other agreements, settlements, and/or other adjudications that may have occurred following the

expiration of the statute of limitations. In complying with this request please respond in detail and list each enumerated response separately.

The SEC has the authority to file actions after the expiration of the limitations period specified in Section 20A(b)(4) of the Securities Exchange Act of 1934, and has done so in some instances, though I am unaware of any such cases involving insider trading during the last five years. In such cases, despite the expiration of the statute of limitations, the SEC is authorized to obtain injunctions, cease-and-desist orders and restitution, but not penalties or industry bars. There have also been numerous instances in which the Commission has entered into tolling agreements with potential respondents to avoid the expiration of the statute of limitations and there have been numerous instances in which matters subject to such agreements have been settled or otherwise resolved after the statute of limitations would have expired in the absence of such an agreement.

(4) What facts did the SEC learn following September 2, 2005 that led the SEC to believe that John Mack had gone "over the wall", in accordance with the perquisite required by Mr. Kreitman, that led the SEC to take the testimony of John Mack?

The question assumes that the SEC believed John Mack had gone "over the wall" and that Mr. Kreitman's request for such evidence was dispositive in the Division of Enforcement's decision regarding whether to take Mack's testimony. Neither assumption is accurate. Before any final decision could be made about taking Mack's testimony in the ordinary course of the Pequot investigation after Aguirre's termination, the New York Times published Aguirre's allegations that the SEC blocked him from taking Mack's testimony because of his political connections. Aguirre styled himself as a whistleblower and claimed he was fired because of his insistence on taking Mack's testimony. Aguirre's allegations generated media interest, the commencement of the present inquiry by this Committee, and an initial round of public hearings in which only Aguirre's side of the story was told. Contrary to custom, the Division of Enforcement had become embroiled in, and indeed was the subject of, a public controversy. Under these circumstances, the SEC had little choice but to take Mack's testimony in order to dispel Aguirre's false allegations about Mack and to quell the public controversy.

To make a final decision on taking Mack's testimony, Aguirre's three supervisors—Berger, Kreitman and Hanson—met with my two Deputy Directors, Walter Ricciardi and Peter Bresnan. Since I signed Aguirre's termination letter, I did not participate in the meeting. Because Mack was a public figure and the SEC is a public agency, my Deputies decided that Mack's testimony should be taken in the interests of allowing Mack to clear himself, to dispel Aguirre's false allegations and to avoid any appearance, however false or unwarranted, that information was allegedly withheld or testimony was allegedly blocked by the agency based on Mack's political connections. If the agency did not take Mack's testimony, it would always be subject to the unfounded public accusation that it had not done so because of Mack's political connections. There would also be no testimonial record of the fact that Mack did not know about the GE/HF deal before it was publicly announced. Because of the public controversy and the public interest in truth and full disclosure, my Deputies decided that taking Mack's testimony would serve the best interests of the Division of Enforcement and the investing public.

Once the decision to take Mack's testimony had been made, the Pequot team first completed their review of the relevant documents and then took the testimony of other witnesses from CSFB. After completion of these preparatory steps, Mack's testimony was taken for approximately four hours on September 1, 2005. The examination of Mr. Mack was thorough and comprehensive. We understand that the transcript of his testimony has been made available to the Committee. When asked, in several different ways, whether he had knowledge of the GE/HF deal before it was publicly announced, Mr. Mack consistently denied any knowledge of the deal and we are unaware of any other evidence that would suggest anything to the contrary.