

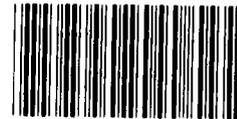
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BY THE COMPTROLLER GENERAL
**Report To The Chairman,
Securities And Exchange Commission**

OF THE UNITED STATES

**Securities And Exchange Commission
Should Improve Procurement
Practices For Market Surveillance
System Development**

The Securities and Exchange Commission's procurement practices in developing an automated market surveillance system may have permitted one firm to gain an advantage over other firms. The Congress has historically required that Government procurement of goods and services be based on full and fair competition to the maximum extent practicable. GAO found that the Commission



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- held discussions on its market surveillance needs with one firm before it publicly asked other firms to bid on the contract to define and design the system,
- used contract provisions which could have limited competition for follow-on contracts to implement the system, and
- failed to issue a required public notice of its intention to award a noncompetitive contract to test the system's operations.

GAO recommends that the Chairman of the Commission strengthen procurement practices to insure compliance with Federal regulations.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-199434

The Honorable Philip A. Loomis, Jr.
Acting Chairman, Securities and Exchange
Commission

Dear Mr. Loomis:

As part of our continuing effort to achieve greater economy in contracting for Government goods and services, we reviewed the procurement practices used by the Securities and Exchange Commission to obtain an automated market surveillance system. This computerized system will be used to support Commission market surveillance efforts which detect trading practices that may violate securities laws and regulations.

The Congress has historically required that Government procurement of goods and services use full and fair competition to the maximum extent practicable. Offering all qualified contractors the same opportunity to compete helps to minimize the appearance of favoritism and provides greater assurance that acceptable supplies and services are obtained at the lowest prices.

Our review showed that the Commission's procurement practices may have permitted one firm to gain an advantage over other interested parties. We conclude that the Commission needs to strengthen its procurement practices and are making several recommendations for doing so. The Commission enters into relatively few contracts of this degree of complexity each year and the weaknesses discussed in this report could be attributable to a lack of experience in handling such procurements under Federal regulations. We believe the Commission's recent actions to increase and upgrade the staffing of its procurement and contracting operations should help to provide the experience and expertise it needs but did not appear to have at the time of our review. Problems noted during our review, which are discussed in appendix I, are summarized below.

--Top Commission officials discussed market surveillance problems at great length with representatives of one firm-- Monchik Weber Associates, Inc.--3 months before the public request for proposals was made. These discussions centered on the Commission's need to improve its market surveillance and the capability of Monchik to assist the Commission in that area. After these discussions, Monchik wrote the Commission saying the firm could be more specific about the tasks involved and provided a task order which had been

reviewed by key members of the Commission. The task order represented a consensus on the approach to the project. The Commission then took steps to award a sole source contract to Monchik, but the Commission's General Counsel questioned the sole source justification. As a result, a competitive negotiated procurement was used to contract for the system's definition and design. Other interested parties who responded to the Commission's request for proposals, however, did not have the same opportunity to obtain the insights of Commission officials and senior staff members. These insights could have been helpful to Monchik in responding to the Commission's request for proposals, which contains only general evaluation criteria.

The Commission subsequently awarded a \$379,380 contract to Monchik, which was later increased to \$567,780, to define and design a market surveillance system. The firm received the contract because its proposal was considered by the Commission to be the most responsive to its needs. Although no bid protest was filed, the Commission's action allowing Monchik to acquire detailed advance information may have given that firm an advantage others did not have and gave the appearance of favoritism.

--The Commission did not include appropriate contract provisions to avoid the creation of an organizational conflict of interest. The definition and design contract awarded to Monchik, which had prior experience in implementing system designs and indicated an interest in implementing the system, should have given the Commission the right to prevent that firm from competing for future contracts to implement the system. Otherwise the successful offeror could develop specifications which could restrict competition for follow-on contracts.

Although there was no Government-wide regulation requiring an organizational conflict of interest provision in contracts, the Office of Management and Budget issued a notice in September 1977--7 months before the Commission issued its request for proposals--calling attention to problems created by such conflicts and proposing remedial regulations. While the proposed regulations were not finalized, the Office of Management and Budget's concern should have alerted the Commission to the potential organizational conflict of interest situation and the need to take appropriate measures to avoid such a conflict.

In this regard, a procurement consultant hired by the Commission to review Monchik's design specifications recommended over 50 changes so that the Commission could conduct more open and competitive procurement for implementation of the system. The Commission intends to use the revised specifications for its future contracts and believes it can exclude Monchik from competing for implementation contracts.

The general policy of the Government is to allow all interested, qualified firms, unless there is a clearly supportable reason for excluding them, an opportunity to participate in its procurements in order to maximize competition. If the recommended changes are included in the request for proposals to implement the system, the potential advantage gained by Monchik may be avoided. Therefore, we believe it would not be appropriate for the Commission to exclude Monchik from competing for the implementation contracts. However, if Monchik agrees to serve as an advisor to the Commission during parts of the implementation phase as was recommended by the Commission's procurement consultant, the Commission could limit the firm's participation.

--The Commission awarded Monchik a \$441,844 noncompetitive contract to test the system it designed. On March 28, 1979, the Commission's procurement consultant proposed that the Commission issue a required public notice before proceeding with a noncompetitive contract award to Monchik to determine if any other firms could meet the Commission's needs. The Commission issued a public notice on September 26, 1979, 7 days after it had already awarded the noncompetitive contract to Monchik. Issuing the public notice before awarding the noncompetitive contract would have provided a factual basis for determining the availability of other firms to meet the Commission's needs.

Complete development of the market surveillance system is expected to take over 5 years and cost approximately \$12 million.

We are recommending that you comply with Federal procurement regulations in future contract awards. Your procurement practices should be strengthened so that

- all interested parties are given the same opportunity to obtain Commission contracts,
- contract provisions do not permit an organizational conflict of interest which could limit competition for follow-on contracts, and
- public notice detailing the Commission's needs is given before a noncompetitive contract is awarded.

In your September 11, 1980, letter commenting on our draft report, you noted that the Commission was generally in accord with our recommendations. Your response, however, contends that our report does not present a fair picture of the Commission's procurement practices for the system's development and raises certain questions regarding the accuracy and completeness of our findings and conclusions.

We have carefully reviewed the facts presented in our report in light of the allegations made in your response and remain of the opinion that our findings show the need for improved procurement practices by the Commission. Monchik Weber Associates, Inc. was also asked to comment on our findings. In an August 15, 1980, letter, Monchik's president said the firm had no comments.

Appendix I provides a detailed discussion of our findings along with a summarization of your comments on those findings. Appendix II presents a more detailed evaluation of your comments. Your letter is presented as appendix III.

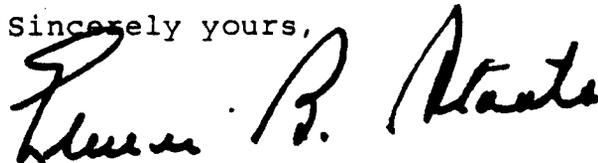
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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report, and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director of the Office of Management and Budget; the Committees mentioned above; the Senate Banking Committee; the House Committee on Energy and Commerce; Congressman Matthew J. Rinaldo, who requested a copy of our report; and other interested parties.

We would appreciate receiving your comments on any actions you take or plan to take on the matters discussed in the report.

Sincerely yours,



Comptroller General
of the United States

GAO FINDINGS AND RECOMMENDATIONSON SECURITIES AND EXCHANGE COMMISSION PROCUREMENTPRACTICES IN DEVELOPING ANAUTOMATED MARKET SURVEILLANCE SYSTEM

The Congress has assigned responsibility for securities industry surveillance to the Securities and Exchange Commission (Commission). The Commission, in compliance with the Securities Exchange Act of 1934, assumed a supervisory role and delegated certain aspects of the day-to-day surveillance of the securities markets to industry groups. These industry groups, which serve as self-regulatory organizations for their members, have implemented programs and systems to provide varying levels of surveillance. Periodically, the Commission reviews industry surveillance activities to assess their effectiveness in detecting trading practices that may violate securities laws and regulations.

In April 1978, the Commission issued a public request for proposals to establish its own comprehensive market surveillance system based upon the latest computer technology. The Commission called for the development of a system under a two-phase approach that would integrate systems presently existing, or to be created by the Commission or industry groups. The first phase was to define a comprehensive market surveillance system. The second phase was to be a report detailing the defined system's specifications and design requirements.

On July 27, 1978, the Commission awarded a \$379,380 contract to Monchik Weber Associates, Inc. (Monchik) for both phases. This contract was amended in September 1979 to increase the contract price to \$567,780. Further, in September 1979, the Commission awarded Monchik a \$441,844 noncompetitive contract to test the system it designed. Monchik originally expected to complete the test by September 1980, but the completion date has been extended.

OBJECTIVE AND SCOPE OF REVIEW

This work is part of our continuing effort to achieve greater economy in contracting for Government goods and services. We reviewed the Commission's contracts for the design, definition, and initial testing of the market surveillance system because these contracts were the first stage of a 5-year multiphase procurement effort, which has an estimated cost of \$12 million. The market surveillance system will affect the Commission's national market activities which we discussed in our September 19, 1979, report. ^{1/} We reviewed Commission procurement files and other records and

^{1/}"Improvements Needed in the Securities and Exchange Commission's Efforts to Establish a National Securities Market" (FGMSD-79-59).

held discussions with officials of the Commission and Monchik Weber Associates, Inc.

COMPETITION AND FAIR TREATMENT
ARE BASIC PROVISIONS FOR
GOVERNMENT PROCUREMENTS

The Federal Property and Administrative Services Act of 1949 authorizes the General Services Administration to issue procurement regulations. The General Services Administration has issued Federal Procurement Regulations which set forth detailed rules for agencies to follow when purchasing supplies and services directly from commercial sources.

Formal advertising and negotiation are the basic methods by which Government purchases are made. The law provides that agency procurements be made by formal advertising whenever feasible and practicable. Negotiation is authorized if the agency head determines that formal advertising is not required. In using either method, agencies are expected to make maximum practicable use of competition and be impartial to insure that all offerors are treated fairly. Noncompetitive procurements are limited to a few specific situations--for example, when an agency can obtain the property or services needed from only one person or firm (sole source of supply).

COMMISSION PROVIDED MONCHIK
DETAILED INFORMATION
ON MARKET SURVEILLANCE PROBLEMS

The Commission provided Monchik detailed advance information on market surveillance problems. Prior to the public announcement requesting proposals to improve its market surveillance activities, Commission officials discussed market surveillance problems at great length with Monchik representatives. Other interested parties did not have the same opportunity to discuss market surveillance problems with Commission officials. Monchik therefore may have been given an advantage. Although Monchik's contract proposal price was third highest out of five acceptable offerors, the firm received the contract award because the Commission determined Monchik's proposal to be most responsive to Commission needs, technical criteria, and price considerations.

In December 1977, representatives of Monchik began meeting with Commission officials to discuss services that the firm could provide. On January 4, 1978, Monchik proposed to develop an automated market surveillance system. During January and early February 1978, the president of Monchik met with top officials and senior staff members of the Commission. According to a senior management official of the Commission, these discussions generally centered on the Commission's need to improve its market surveillance and the capability of Monchik to assist the Commission in this area.

In a February 13, 1978, letter supplementing his firm's January 4, 1978, proposal, the president of Monchik said:

"* * * you and your associates have been kind enough to discuss the market surveillance problem with me at great length. I can therefore be more specific about the tasks involved in a first phase, the costs, and the schedule for such a consulting project.

"I have attached for your review a task order for the first phase. This has been reviewed by key members of the Commission and represents a consensus of views on the project approach."

* * * * *

"We are looking forward to beginning this engagement soon and to working with you on this extremely challenging project."

On February 24, 1978, the Commission began processing a sole source contract for Monchik. In justifying this action, a senior management official of the Commission contended that:

- A detailed work statement was all but impossible to prepare because the developing securities market was entirely new to the Commission and the industry.
- Monchik was the only organization that specialized in systems for the securities industry.
- Monchik had unequalled depth and breadth in all aspects of securities systems and brought background and knowledge to the project area that no other firm could start with.

The procurement files did not indicate, however, that inquiries were made to determine if other firms were interested and qualified to meet the Commission's needs. The Commission's General Counsel also questioned whether the noncompetitive justification was adequately reasoned or supported. As a result of this questioning, the Commission decided to award the contract using competitive negotiated procedures.

The Commission issued a public request for proposals on April 19, 1978, requiring the receipt of offers by May 17, 1978. According to a draft memorandum in the Commission's procurement files, the request for proposal was stated in general terms. The market surveillance proposal request specified that the contractor was to furnish the Commission with

- a definition of a comprehensive market surveillance system and recommendations for implementing the system and
- a design of the defined system.

The request stated that any proposals submitted would be evaluated on the basis of the listed technical criteria and price. The three technical criteria, all to be given relatively equal weight, consisted of

- experience with a variety of securities-industry-related projects involving complex operations and structures for the definition, design, and implementation of information systems;
- key personnel's specific systems experience related to the securities industry; and
- demonstrated ability to apply system analysis techniques to an industrywide project in a complex legal, financial, and technical environment.

Five companies, one of which was Monchik, submitted qualifying technical proposals with prices ranging from \$232,700 to \$731,900. After evaluating these five proposals, the Commission awarded the contract to Monchik which proposed to complete the project for \$379,380. No bid protests were filed questioning the award.

The fact that five qualifying technical proposals were received in response to the public solicitation contradicts the attempted justification to award Monchik a sole source contract because that firm was the only one that specialized in systems for the securities industry. Moreover, the Commission, through its early informal discussions with Monchik, allowed that firm to acquire detailed advance information on the market surveillance needs of the Commission. At least 3 months before the Commission requested proposals from other interested parties, Monchik discussed market surveillance problems with top Commission officials at great length. In contrast, others had only about 30 days to respond to the Commission's proposal and did not have the same opportunity to obtain the insights of Commission officials. As a result, Monchik may have gained an advantage over other offerors which could have placed the firm in a position to demonstrate superior qualifications. Permitting all qualified parties to have the same access to Commission officials and information, as well as a comparable amount of time to prepare and submit their proposals, would have reduced the appearance of favoritism.

Agency comments and our evaluation

In a September 11, 1980, letter commenting on our draft report (see app. III), the Commission acknowledged that informal discussions took place between Monchik and Commission representatives before the public request for proposals was made. It did not agree that these discussions provided Monchik with detailed advance information on the Commission's market surveillance needs. Further,

the Commission believed that even if detailed information was provided to Monchik, the general criteria used to evaluate proposals would have eliminated any advantage that Monchik was given.

In our opinion, informal advance discussions with a selected firm are not conducive to a fair and open competitive procurement. We have issued a number of reports on procurement pointing out the detrimental effects of such discussions. Documents in the Commission's files clearly establish that these discussions centered on the Commission's longstanding need to improve its market surveillance system. As previously stated, these discussions, which involved top officials and senior staff members of the Commission, also considered how the capabilities of Monchik could be used to assist the Commission.

The Commission did use general criteria to evaluate offerors' proposals. However, the results of the informal discussions placed Monchik in a position where its proposal could be directed toward specifying more details than a firm not aware of the Commission's needs. When the Commission requested proposals from the public, the project was divided into definition and design phases. This division subsequently became significant during the negotiations to select the most responsive offeror. Monchik and one other firm were the finalists in the selection process. During negotiations, the Commission questioned the other firm's estimate for its design phase, noting that the system's definition determines the requirements for the design phase. However, Monchik was not similarly questioned about its design during the negotiations even though its price was about \$130,000 higher than the other firm's.

In addition, one firm's proposal was rated unacceptable because the evaluation panel generally found it lacked technical details needed to effectively evaluate it. Another firm that did not submit a proposal wrote to the Commission saying it would have submitted a proposal which could have successfully completed the project if the Commission had provided additional guidance on the purpose of the system, information needs, and how the system would support the Commission's regulatory role. We believe that details on the Commission's market surveillance needs may have been advantageous to Monchik in responding to the Commission's general proposal. Further details of the Commission's comments and our evaluation are on pages 12 to 18 of appendix II.

ORGANIZATIONAL CONFLICT OF INTEREST WAS CREATED

The definition and design contract awarded to Monchik did not contain an organizational conflict of interest provision giving the Commission the right to prevent Monchik from competing for future contracts to make the system operational. The Commission, by not including such a provision in the initial contract,

placed Monchik in a position to orient the design to give itself a competitive advantage or to develop specifications which only certain firms could meet in follow-on contracts for the system's implementation.

Organizational conflicts of interest generally involve a relationship or situation in which a present or prospective contractor has interests that either directly or indirectly relate to the work to be performed under a contract which may (1) adversely affect the contractor's capacity to give impartial, technically sound, objective assistance and advice to the agency or (2) give the contractor an unfair advantage over other contractors with regard to related contracts in the future. An organizational conflict of interest may arise, for example, where a contractor prepares specifications which are to be used in a future contract for the furnishing of products or services. In such a situation the contractor can conceivably develop design specifications which give it an unfair competitive advantage over others when competing for the future contract (for example, restricting the specifications in such a way that only the present contractor can qualify for the future contract).

Although there was no Government-wide regulation requiring an organizational conflict of interest provision in contracts, the Office of Management and Budget issued a notice in September 1977--7 months before the Commission issued its request for proposals--calling attention to problems created by such conflicts and proposing remedial regulations. While the proposed regulations were not finalized, the Office of Management and Budget's concern should have alerted the Commission to the potential organizational conflict of interest situation and the need to take appropriate measures to avoid such a conflict. In our view, an agency confronted with an organizational conflict of interest situation should take the necessary precautions to insure that the contractor is not placed in a position where its judgment might be biased, or where an unfair competitive advantage would result. One precautionary measure is the inclusion of an organizational conflict of interest provision in the design contract. Such a provision may require the contractor to disclose all relevant information regarding a possible conflict of interest, and may give the agency the right to restrict that contractor from participating in related future contracts. Properly used, this type of clause can preclude or otherwise dissuade a contractor from performing the design contract in a biased manner.

On March 5, 1979, the Commission obtained the services of a procurement consultant to assist it in implementing the market surveillance system and to review Monchik's work and other aspects of the system. The procurement consultant determined that the Commission created an organizational conflict of interest in awarding the definition and design contract by not precluding Monchik from competing for implementation contracts. The consultant said

that, as a result, Monchik was in a position to design specifications that only it could fulfill or that would give it a competitive advantage in obtaining additional contracts.

The procurement consultant believed that Monchik would not exploit this situation. However, in later evaluating Monchik's design specifications for hardware and software computer requirements, the consultant found that:

"Very few requirements are stated as desirables--almost all are mandatory and, taken in total, one or more of these mandatory requirements would probably eliminate most of the competition. Modification of some requirements to be functional rather than hardware specific, elimination of a few questionable items or changing them from mandatory to desirable should be sufficient to open the specifications to competition." (Under-scoring added.)

To encourage competition, the Federal Procurement Regulations allow agencies to include desirable features in the solicitation which can be met at the option of the offeror. These features are not mandatory and do not disqualify those who do not meet them.

The procurement consultant provided to the Commission a list of recommended changes to Monchik's design specifications. The consultant recommended that

- four mandatory requirements be made desirable,
- five requirements be eliminated,
- fifteen specific requirements be made functional, and
- twenty-six requirements be clarified.

On September 14, 1979, the Commission requested that Monchik revise the design specifications so that the Commission could conduct a more open and competitive procurement. Monchik submitted revised specifications on October 29, 1979. In commenting on our draft report, the Commission said it intends to use the revised specifications in solicitations for proposals to implement the system. If these revised specifications eliminate any unnecessary requirements, it would appear that the potentially unfair competitive advantage that Monchik may have had as a result of its drafting the design specifications can be avoided.

Since the possibility of future business has value to Monchik, the procurement consultant said the Commission could not expect to restrict Monchik from competing for implementation contracts without Monchik's agreement. The consultant was also concerned about the intangible element of suspicion that an important part of the

Commission's mission might be contracted for in a manner that would not meet the Commission's own regulatory standards of being above suspicion.

The procurement consultant suggested several options for resolving the conflict problem. One option tentatively being considered by the Commission is to use the expertise and background of Monchik in an advisory role by awarding the firm a noncompetitive contract for certain aspects of the system's implementation. The Commission is also considering excluding Monchik from competing for the implementation contracts. When our work was completed Monchik had not agreed or otherwise consented to being excluded from competing for contracts to implement the system.

This report identifies a number of questionable practices in the Commission's procurement of the system. However, the general policy of the Government is to allow all interested qualified firms an opportunity to participate in its procurements in order to maximize competition unless there is a clearly supportable reason for excluding a firm. Since the Commission intends to use the revised specifications to eliminate any unnecessary requirements, we believe it would not be appropriate for the Commission to exclude Monchik from competing for the follow-on implementation contracts. ^{1/} However, if Monchik agrees to serve as an advisor to the Commission during parts of the implementation phase as was recommended by the Commission's procurement consultant, the Commission could limit the firm's participation.

Also, to insure that any such contract is awarded on a competitive basis, the Commission should make sure that the design specifications accurately reflect the Commission's needs and do not unduly favor Monchik or any other firm. Agencies are required to state specifications in terms that will permit the broadest possible field of competition. The Commission should also insure that offerors are provided a reasonable and fair opportunity to assess the Commission's needs and to prepare and submit their proposals.

Agency comments and our evaluation

In its September 11, 1980, letter, the Commission agreed that an organizational conflict of interest clause would have been appropriate in the initial contract award. It emphasized that the procurement regulations do not require the use of a conflict of interest clause and stressed that it retained another consultant to review Monchik's work and recommend action to prevent the exploitation of any conflict situation.

^{1/}John J. McMullen Associates, Inc., B-188703, Oct. 5, 1977, 77-2 CPD 270.

Our report states that there is no Government-wide requirement for a conflict of interest clause. We do not believe, however, that the lack of an express requirement mitigates the need for or precludes its use. For example, the problems caused by organizational conflicts of interest were receiving much attention by other Federal agencies and the Congress in the months prior to the Commission's procurement. Use of contract provisions to insure that Monchik did not benefit from any organizational conflict of interest would have been an appropriate procurement practice. The Commission's hiring of a consultant to review the work of another consultant as a remedial action was not economical. The Commission agreed to pay its procurement consultant between \$50 and \$100 an hour for advice. The use of the conflict of interest clause, even though not required by regulation, would have been a prudent action for the Commission and could have reduced its procurement costs for consultants. Further details of the Commission's comments and our evaluation are on pages 18 to 21 of appendix II.

COMMISSION AWARDED \$441,844
NONCOMPETITIVE CONTRACT
TO TEST SYSTEM'S DESIGN

The Commission did not issue a public notice of its pending award of a noncompetitive contract to Monchik to test the operations of the system they designed. By not providing a preaward public notice to determine if other firms were equally qualified or interested in meeting the Commission's needs, the benefits that could have resulted from a competitive procurement may not have been obtained.

Agencies may award noncompetitive procurements under certain circumstances--for example, where an agency can obtain the property or services needed from only one person or firm (sole source of supply) or where time is of the essence and only one known source can meet the Government's needs within the required time frame. ^{1/} To insure that appropriate competition is obtained on all procurements, the Federal Procurement Regulations require agencies, with certain exceptions, to publicize their needs by placing a notice in a procurement publication of the Department of Commerce 10 days before issuance of the solicitation. This preaward notice provides interested parties with information on Government contracting opportunities.

There are a number of general exceptions to this publication requirement. For example, publication is not required for procurements which are of such unusual and compelling emergency that the Government would be seriously injured if bids or offers were made more than 15 days after the issuance of the invitation for bids or solicitation for proposals.

^{1/}Environmental Protection Agency Sole-Source Procurements 54 Comp. Gen. 58 (1974), 74-2 CPD 59.

The Commission asked that its procurement consultant recommend steps to implement the designed system. On March 28, 1979, the consultant advised the Commission to institute a pilot project to test the system's design. The Commission was told that the award of a noncompetitive contract to Monchik for the pilot could be justified only if the Commission stated the project was one of compelling urgency. The consultant proposed that the Commission issue, as soon as possible, a public notice of its needs before proceeding with a noncompetitive award to determine whether any other firms could perform the pilot project. The procurement consultant could not state whether Monchik was the only firm that could meet the Commission's needs.

Six months after the procurement consultant recommended issuing a public notice, the Commission determined that there was compelling urgency and on September 19, 1979, awarded a noncompetitive contract to Monchik to test the system. In justifying a noncompetitive contract, the Commission found that the urgent need for improved surveillance of option trading could not be delayed. According to procurement files, the Commission believed it would take an estimated 6 to 9 months for the administrative processing of a competitive procurement and for another firm to become knowledgeable about the project and Commission rules.

The Commission did not issue a public notice of its pending procurement action as proposed by its procurement consultant. The Commission was required by the Federal Procurement Regulations to issue notice since none of the exceptions to this requirement appears applicable. On September 26, 1979, the Commission issued a public notice announcing that it had awarded a \$441,844 noncompetitive contract to Monchik on September 19, 1979, to test the operations of the system it designed. Issuing the public notice before awarding the sole source contract would have given other interested firms the opportunity to meet the needs of the Commission and, more importantly, provided the Commission with facts about the availability of other firms to perform the pilot project.

Agency comments and our evaluation

The Commission contends in its September 11, 1980, letter, that it--rather than Monchik--is testing the design developed by that firm. It also stated that the time constraints involved in removing the moratorium on option trading made it impractical to provide advance public notice that the Commission was awarding a noncompetitive contract to Monchik.

We disagree. In its September 1979 notice, the Commission stated that the contract was awarded to Monchik on a noncompetitive basis to test the system's design. The Commission's sole source justification and the contract specifications also indicate that the contract was for testing the design. The contract specifies that Monchik test the computer programs and generate

reports for Commission evaluation. The test is being conducted by Monchik at its New York City computer facilities with the Commission evaluating reports produced by the testing to determine the system's impact on market surveillance areas.

The Commission viewed the need to remove the moratorium on option trading as justification for not issuing the required 10-day preaward notice. Option trading on exchanges was authorized by the Commission in 1973. In 1977 the Commission requested that the exchanges not add any new options to their trading list. This moratorium lasted 3 years, during which time trading of pre-1977 options continued. In discussing compelling emergency, the Federal Procurement Regulations cite fire, flood, or other disasters as examples. Using the removal of the 3-year option moratorium as a compelling emergency justification for not issuing the 10-day notice is not convincing. The Commission should have followed the advice of its procurement consultant who recognized that giving prior notice was the proper approach. Further details of the Commission's comments and our evaluation are included on pages 21 to 24 of appendix II.

CONCLUSIONS

The Commission needs to strengthen its procurement practices. Serious shortcomings in the procurements for a market surveillance system occurred because the Commission did not follow accepted procurement procedures. The Commission should insure that all interested parties are provided the same opportunity to obtain contract awards. In addition, when noncompetitive procurements are considered, adequate public notice should be provided as generally required by procurement regulations. In all procurements, actions that unnecessarily limit competition should be avoided.

RECOMMENDATIONS

We recommend that the Chairman of the Commission, in future contract awards, comply with regulations governing procurements by Federal agencies. Specifically, the Commission's procurement practices should be strengthened so that

- all interested parties are given the same opportunity to obtain Commission contracts,
- contract provisions do not permit an organizational conflict of interest which could limit competition for follow-on contracts, and
- public notice detailing the Commission's needs is given before a noncompetitive contract is awarded.

EVALUATION OF THE SECURITIES AND EXCHANGE COMMISSION
COMMENTS CONCERNING THE PROCUREMENT FOR THE DEVELOPMENT
OF AN AUTOMATED MARKET SURVEILLANCE SYSTEM

The Commission generally agreed with our recommendations in its September 11, 1980, letter commenting on our report but questioned the basis of certain findings. This letter is included as appendix III. After considering the Commission's views, we believe the facts support our findings and see no need to change our position. In this appendix we present our detailed evaluation of the Commission's comments.

COMMISSION PROVIDED MONCHIK
DETAILED INFORMATION ON
MARKET SURVEILLANCE PROBLEMS

The Commission said that informal discussions held with Monchik did not provide that firm with advance information on market surveillance needs. Further, the Commission believed its action in evaluating offerors' proposals did not give Monchik an apparent advantage. The Commission said that it had complied with all procurement regulations for evaluating competitive proposals.

We disagree. The facts firmly support our finding that Commission discussions allowed Monchik to acquire detailed advance information on the Commission's market surveillance needs. With this insight, Monchik was placed in a position to better demonstrate its qualifications for meeting the Commission's general procurement requirements for an improved market surveillance capability. The following details our response to the specific Commission comments on this matter.

Commission comment

The Commission believed the report should emphasize that the market surveillance system is being developed to fulfill statutory responsibilities which cannot be delegated to industry regulatory groups. (See p. 28.)

GAO response

Our review concerned Commission procurement practices and did not assess the statutory responsibilities of the Commission and self-regulatory groups for supervising the securities market operations. Therefore, the report does not discuss whether the market surveillance system will fulfill the Commission's oversight responsibility.

In regard to the delegation of surveillance responsibilities, the Commission has stated that the proposed market surveillance

system is not intended to replace or diminish the responsibilities of the industry self-regulatory groups. Some representatives of the securities industry, however, have expressed concern to the Congress that the proposed system could duplicate or supplant existing surveillance capabilities of the industry's regulatory groups. The two congressional subcommittees that oversee Commission activities have recognized this concern. While acknowledging that the proposed system is needed for the Commission's traditional oversight role, the subcommittees issued reports in May 1980 recommending limitations on Commission efforts to fully implement the system. ^{1/} In addition, they intend to monitor Commission efforts in order to insure that the system is consistent with the parameters of the self-regulatory process and is cost effective. Since the Congress is monitoring Commission efforts and our review did not concern the Commission's delegation authority, it would be inappropriate for the report to comment on the delegation issue.

Commission comment

The Commission did not agree that advance informal discussions it had with Monchik provided that firm with detailed information on market surveillance problems. Further, the Commission said advance knowledge of their market surveillance needs was immaterial since general criteria were used to evaluate proposals. (See p. 29.)

GAO response

Advance discussions with a selected firm are not conducive to fair and open competitive procurement. We have previously taken this position in reports concerning procurement of consultants. ^{2/} The Commission acknowledged that advance informal discussions with Monchik took place. According to Commission documents, these discussions centered on the Commission's longstanding need to improve its market surveillance system and the capability of Monchik to assist the Commission in that critical area.

Although the criteria used in evaluating proposals were not based on specific market surveillance problems but were in more general terms, the results of the advance discussions placed Monchik in a preferred position. The Commission's request for

^{1/}Senate Rep. No. 96-752, 96th Cong., 2d Sess., pp. 3-7 (1980) and House Rep. No. 96-961, 96th Cong., 2d Sess., pp. 3-5 (1980).

^{2/}"Controls Over Consulting Service Contracts At Federal Agencies Need Tightening" (PSAD-80-35, Mar. 20, 1980) and "Competition For Negotiated Government Procurement Can and Should Be Improved" (PSAD-77-152, Sept. 15, 1977).

proposals from the public divided the project into two phases-- definition and design. This breakout subsequently was important in the negotiation process. Two offerors were in the competitive range, Monchik and one other firm. During negotiations, the Commission questioned the other firm's estimates for the design phase, noting that the design depended on how the system definition was eventually determined. However, Monchik was not similarly questioned about its design estimate during the negotiations even though its price was about \$130,000 higher than the other firm's.

With the information obtained during the advance discussions, Monchik was placed in a position where its proposal could be targeted toward specifying more detail than firms not aware of Commission problem areas. Monchik's proposal was found to be far superior in the technical categories. Another offeror, however, had its proposal rated unacceptable because the panel generally found it lacked the level of detail necessary for effective evaluation. Another firm, which did not submit a proposal, believed it could have successfully completed the project if the Commission had provided guidance on the purpose of the system, the information to be gathered, and how the system would support the Commission's regulatory role. To contend that knowing details of the Commission's market surveillance needs was not advantageous to Monchik in responding to the Commission's general proposal is not convincing.

Commission comment

The Commission said the report would be more accurate if it mentioned that Monchik is a Boston and New York based firm and that initial discussions with the firm concerned development of an investment advisors' manual. The Commission noted that it was during these discussions that Monchik's market analysis capabilities were found by staff members to be useful. (See p. 29.)

GAO response

We do not see the need for including background information on Monchik and other discussions the firm had with Commission personnel. Our report concerns possible advantages the Commission gave Monchik in the procurement of a market surveillance system. In that regard, the Commission's comment that discussions took place on Monchik's market analysis capabilities before the Commission's publicly solicited proposals is consistent with our finding that Monchik was in a preferred position to obtain a contract involving the market surveillance system.

Commission comment

The Commission believed that the informal discussions with Monchik "educated" Commission staff as to industry capabilities

in the market analysis area. Having this knowledge, the Commission initially considered awarding a noncompetitive contract to Monchik. However, the Commission said its General Counsel, in conjunction with our General Counsel, determined that a competitive procurement was required. (See p. 29.)

GAO response

Monchik could have educated the Commission's staff, but more importantly, the firm was told of the Commission's market surveillance needs in discussions with top management of the Commission. As previously mentioned, these discussions generally centered on the Commission's longstanding need to improve its market surveillance system and Monchik's capability to assist the Commission.

Commission actions after these discussions showed it did much more than just consider awarding a noncompetitive contract to Monchik to define and design the system. After Monchik submitted a February 13, 1978, proposal concerning market surveillance, a senior management official of the Commission, who had previously met with Monchik's president, directed a subordinate to take all necessary steps to award a noncompetitive contract to Monchik for a market surveillance system. This top manager justified the noncompetitive procurement because:

- A detailed work statement was all but impossible to prepare.
- Monchik was the only organization of its kind, being a consulting firm that specialized in automated systems for the securities industry.
- Monchik had unequalled depth and breadth in all aspects of securities regulation.

The procurement files did not indicate, however, that inquiries were made to determine if other firms were interested and qualified to meet the Commission's need.

The processing of the noncompetitive procurement reached the award stage. On March 1, 1978, the top manager requested a Commission official to attend a "kick-off" meeting to insure that Commission personnel viewed the Monchik project from an agency perspective and not from a divisional outlook. The top manager also informed the official that a possible "snag" had developed. The Commission's Office of General Counsel had not responded to his request to review the justification for the noncompetitive procurement. When the Commission's General Counsel did not agree with the justification, a competitive procurement became necessary. The Commission's September 11, 1980, letter commenting on our report did not mention these significant events.

In addition, the Commission fails to recognize the role played in the ensuing competitive procurement by the top manager who sought to justify a noncompetitive contract to Monchik. This individual

- informed us he was the primary author of the Commission's request to obtain public proposals and was also the contracting officer for the Commission;
- determined the composition of the evaluation panels, appointing four of his subordinates to serve with two other members on the panels;
- made the final decision as to which acceptable offerors were in the competitive range;
- requested his special counsel, who also served as a member of the evaluation panel, to determine if the contract could be awarded without negotiating with offerors found to be in the competitive range;
- conducted negotiations on July 24, 1978, with the two firms in the competitive range, and on July 27, 1978, awarded the contract to Monchik; and
- informed us he should have gone ahead and awarded a non-competitive contract to Monchik because the firm submitted the best proposal anyway and the Government's cost would have been reduced.

Further, the Commission is misrepresenting GAO's role. The Commission contacted a number of Federal agencies, including GAO, to obtain general information about competitive procurement regulations. Our contacts, which for the most part were by telephone, occurred after the Commission and Monchik representatives met to discuss the Commission's market surveillance needs. We were asked by the Commission's Office of General Counsel for advice on procurement requirements for competitive contracting. To imply that GAO was a party to or condoned the Commission's advance discussions with Monchik is incorrect.

Commission comment

The Commission said that the report was not correct in indicating that others did not have Monchik's opportunity to discuss the Commission's market surveillance needs. It noted that another offeror, Arthur Young & Company, had previously completed a contract concerning Commission information requirements and that during this work Commission staff were contacted to discuss their information needs. (See p. 30.)

GAO response

We disagree. Monchik met with top management having a significant role in the Commission's policy and decisionmaking process to discuss market surveillance needs. As Monchik's letter of February 13, 1978, states, the firm's work plan had been reviewed by key personnel of the Commission and represented a consensus of views on the project approach.

Arthur Young's contacts resulted from prior consulting services related to developing an agencywide plan for the automatic data processing requirements of Commission units. We have consistently held in prior procurement decisions that certain firms, such as in the case of Arthur Young, may have an advantage resulting from prior contracts. ^{1/} This advantage, however, does not result from any preferential or unfair action by a Government agency. As a result of advance discussions, the Commission placed Monchik in a preferred position. Any advance knowledge that Arthur Young may have had resulted from its previous work for the Commission. We emphasized, however, that no other offeror had discussions with key Commission management personnel similar to those held with Monchik.

Commission comment

The Commission believed that comparing the amount of time Monchik and other offerors had to develop their proposals is misleading. The Commission states that interested parties were allowed a standard 30 days to respond and that such time was ample since no firm requested an extension. (See p. 30.)

GAO response

Comparing the response time for submission of proposals exemplifies the advantage Monchik gained from prior discussions with Commission personnel as the firm had 3 months leadtime over other offerors in developing its proposal. We did not question the Commission's 30-day period as being inconsistent with procurement regulations. The Federal Procurement Regulations (Section 1-2.202-1) which govern the time allowed to respond to an agency request for proposals are founded on a policy that competition on equal terms is facilitated by allowing interested parties sufficient time to prepare their proposals. These regulations state that not less than 30 days should be allowed when nonstandard items are being procured but more than 30 days may be allowed when firms are required to prepare special designs.

^{1/}ENSEC Service Corp. 55 Comp. Gen. 656 (1976), 76-1 CPD 34.

Commission comment

In order to prevent any misinterpretation, the Commission said our report should make it clear that two other offerors submitted contract prices higher than Monchik's offer. (See p. 31.) Our report was revised to clarify this point.

ORGANIZATIONAL CONFLICT OF INTEREST
WAS CREATED

The Commission agreed that an organizational conflict of interest clause should have been included in the contract. However, it stressed that such a clause is not required and stated that alternative action was taken to insure that Monchik did not exploit any advantage.

Our report states that a conflict of interest provision is not required, but points out, as the Commission agrees, that it would have been prudent to include such a clause. The action taken by the Commission--hiring another consultant to review Monchik's work--is not a satisfactory approach and resulted in increased cost for consulting services. The following details our response to specific Commission comments on this matter.

Commission comment

The Commission recognized that an organizational conflict of interest clause would have been appropriate in the definition and design contract awarded to Monchik. It emphasized, however, that such a clause is not required by Federal Procurement Regulations. (See p. 31.)

GAO response

Our report makes it clear that the inclusion of an organizational conflict of interest clause is not a Government requirement. However, the lack of an express requirement does not mitigate the need for such a clause nor preclude its use. The problems caused by organizational conflicts of interest were receiving much attention by other Federal agencies and the Congress in the months prior to the Commission's procurement. Use of contract provisions to insure that Monchik did not benefit from any organizational conflict of interest would have been an appropriate procurement practice and its use would have been a prudent action.

Commission comment

The Commission said that it made sure Monchik would not have a competitive advantage for implementation contracts by retaining a procurement consultant to review Monchik's performance. The Commission also believes the report misleads the reader by indicating that the procurement consultant discovered the conflict issue. The Commission contended it learned of the conflict and retained the procurement consultant to avoid the appearance of favoritism. (See p. 31.)

GAO response

Contract documents do not indicate that the procurement consultant was retained because the Commission found an organizational conflict and wanted to make sure that Monchik would not exploit any advantage gained from developing the design specifications. The justification for the procurement consultant's contract, the contract itself, and the tasks assigned by the Commission did not specifically mention or require any evaluation of an organizational conflict of interest.

According to the Commission, retaining the procurement consultant in March 1979 was also to prevent even the appearance of favoritism. The initial contract called for two products: (1) a definition of the surveillance system that was completed in October 1978 and (2) design specifications for the system that were originally due in April 1979. The delivery date for the design specifications was extended on April 20, 1979, to July 30, 1979. To contend that the procurement consultant was retained shortly before the original completion date of the contract to prevent the appearance of favoritism is not persuasive.

Moreover, the Commission's remedial action of hiring a consultant to evaluate the work performed by another consultant was not a satisfactory alternative. It was an after-the-fact approach which increased the Government's cost to obtain consulting services. The Commission agreed to pay its procurement consultant between \$50 and \$100 an hour for its procurement expertise with a limitation of \$9,500. The Commission should have adopted the more economical approach of including the organizational conflict clause in the initial Monchik contract.

Commission comment

The Commission contended that our draft report gave the false impression that Monchik exploited its position in developing the design specifications. Citing its procurement consultant's report, the Commission said it successfully prevented any exploitation. It contended our excerpts from the procurement consultant's report were taken out of context and that the deficiencies found by the procurement consultant were in the form of missing or undefined elements which were "not numerous, and may not be difficult to obtain." The Commission quoted the procurement consultant's report as follows:

"Overall, the Lot II Report reflects a great deal of effort and the system design reflects a logical systematic approach. With the additions and modifications recommended and with updating to reflect lessons learned from the pilot system, the Report will serve as the basis for an RFP [Request for Proposal] which will provide a competitive procurement." (See p. 32.)

GAO response

We disagree with the Commission's reading of the procurement consultant's report. The procurement consultant was concerned that the conflict of interest would permit Monchik to write specifications that only it could meet or that Monchik would have an unfair advantage over other firms competing for implementation contracts. The consultant found that Monchik's original design specifications would not permit fair competition with other firms vying for implementation contracts. Moreover, our report does not say that Monchik was exploiting its position. Rather, we refer to the Commission's procurement consultant's statement that Monchik could exploit the organizational conflict.

The first quotation the Commission cites as an example of the appropriate context of the consultant's report reads in full as:

"In summary, our findings are that the Lot II Report as it now stands is not adequate as the basis for preparation of an RFP. The deficiencies, however, are in the form of missing or undefined elements, are not numerous, and may not be difficult to obtain. The specifications appear to be biased in that 'minimum requirements' are so stated that when taken in summary would probably eliminate most vendors." (Emphasis added.)

This quotation clearly points out that the procurement consultant was concerned about whether Monchik's design specifications would permit competition to the maximum extent practicable. The overall statement quoted by the Commission also points out that Monchik's design specifications were deficient and modifications were necessary to permit future competitive procurements. The procurement consultant's report on Monchik's design pointed out over 50 deficiencies. Our report did not take statements from the procurement consultant's report out of context. Additions and other modifications were needed to permit future competitive procurement to implement the system.

Commission comment

The Commission contended that our draft report could lead to an erroneous inference that there cannot be fair and open competition for the implementation contracts. This view results from our opinion that there is no legal basis for excluding Monchik from competing for the implementation contracts. The Commission questions our legal opinion on the basis that its procurement consultant proposed other alternatives. (See p. 33.)

GAO response

We do not agree that erroneous inferences can be derived from our report. However, we have clarified our report to show that

there is no present basis, given the statutory requirement for maximum competition, upon which the Commission can exclude Monchik without the firm's agreement or without properly awarding Monchik an advisory contract. The report also states that the Commission should make sure that the specifications accurately reflect its needs and do not favor Monchik or any other firm. In addition, the report notes that if the Commission adopts the modifications recommended by the procurement consultant it would appear that any competitive advantage Monchik had for the implementation phase could be avoided. The Commission in its response said it is committed to making these revisions.

In view of the Commission's intentions to adopt the modifications proposed by its procurement consultant, there is no basis for excluding Monchik from competing for implementation contracts. The procurement consultant recognized in proposing alternatives that the Commission could not bar the firm from competing on future procurements unless Monchik agreed. To exclude or hinder Monchik from competing for future contracts would be inconsistent with the Government policy of allowing all interested qualified firms an opportunity to participate in procurements. The Commission should have taken steps in the beginning to minimize any unfair advantage that Monchik could have acquired.

COMMISSION AWARDED \$441,844
NONCOMPETITIVE CONTRACT
TO TEST SYSTEM'S DESIGN

The Commission said that it, and not Monchik, is testing the system's design. Further, the Commission believes it complied with procurement regulations since the need to remove the 3-year moratorium on option trading was a compelling urgency which did not require issuing a preaward notice.

We disagree. The Commission's public announcement clearly stated that Monchik was awarded the noncompetitive contract to test the system's design. In addition, the Commission did not comply with Federal Procurement Regulations because it had ample time to issue a 10-day notice that is generally required prior to the award of a contract. The following provides our detailed response to the Commission's comments on this matter.

Commission comment

The Commission said that it, rather than Monchik, is conducting the test as part of a project to determine whether Monchik's design will enable the Commission to fulfill its responsibilities. (See p. 28.)

GAO response

We disagree. The Commission publicly stated in its September 1979 notice that the project "was awarded on a sole-source basis

to test the design previously developed." Monchik designed this system. Moreover, the contract specifies that Monchik test the computer programs and generate certain reports detailed in the system's specifications. The contract indicates that Monchik is responsible for operational testing of the system's design at its New York City computer facilities. The Commission will receive reports generated by the system and will determine how the information will benefit its market surveillance activities.

Commission comment

The Commission acknowledged that its procurement consultant suggested that a preaward public notice be issued. The Commission contends, however, that issuance of a preaward public notice was not required by procurement regulations and, even if it was, notice could not have been issued in March 1979. Also, the Commission believed that the regulations exempted it from the preaward notice since there was a compelling urgency to proceed without delay. Commission personnel believed the 3-year moratorium on options trading would be lifted in 1979 and that testing of the system before option trading expanded would improve their capability to protect investors. (See pp. 33-34.)

GAO response

We disagree. Federal regulations (41 CFR 1-4.1107-3a) for automatic data processing procurements require that synopses for proposed procurements must be publicized in the "Commerce Business Daily" in accordance with Subpart 1-1.10 of those regulations. This subpart requires publication 10 days before a solicitation, except under certain circumstances. The exception, which the Commission is relying on, is for procurements which are of such unusual and compelling emergency that the Government would be seriously injured if bids or offers were permitted more than 15 days after the transmittal date of the synopsis.

The Commission had ample time--6 months--to prepare the information needed to issue a 10-day public notice. March 1979 may have been a premature time for the Commission to issue the public notice required by the Federal Procurement Regulations. However, we do not attach the same immediacy to the phrase "as soon as possible" as does the Commission. Nor can we agree with the Commission's explanation of a compelling urgency for not issuing the preaward notice.

In discussing compelling emergency justifications the Federal Procurement Regulations cite, as an example, services needed at once because of fire, flood, or other disasters. The Commission and the self-regulating organizations have had market surveillance activities on the exchanges for over 45 years. In 1973, the Commission authorized trading in options on the exchanges. In 1977, the Commission stopped the addition of new option trading. Option

trading authorized between 1973 and 1977, however, was continued during this 3-year moratorium. The Commissioners announced on March 26, 1980, the lifting of the options moratorium.

We do not believe that the speculation of the Commission's personnel on the timing for the end of the 3-year moratorium constitutes such a compelling emergency to forego the preaward public notice. We agree with the Commission's procurement consultant that the public notice step would have been a "reasonable conservative approach" and should have been followed by the Commission.

Commission comment

The Commission said that the report does not indicate that its procurement consultant determined that Monchik was the only qualified firm to do the testing on an expedited basis. (See p. 34.)

GAO response

The Commission's comments do not properly represent the conclusions of its procurement consultant. The consultant stated:

"Although it is unlikely that another firm could develop such software for less cost than the price that would be charged by Monchik-Weber Associates, for use of the existing package, this is essentially speculative in nature and another firm could be able to do the job at no increase in cost to SEC." (Underscoring in original.)

As the procurement consultant pointed out to the Commission, the only way to determine whether another firm could meet the Commission's needs was to issue a preaward public notice.

Commission comment

The Commission said that GAO's advice was received on the validity of the noncompetitive award. (See p. 35.)

GAO response

The Commission statement that GAO advised it on the procurement of the test project is erroneous and misleading. The Commission asked about the status of our work and whether we intended to comment on the need for the market surveillance system proposed by Monchik. We informed the Commission that our work centered on the initial procurement of the system and not on whether the system would meet the Commission's needs. Incidental to this discussion we were told that the Commission intended to award a noncompetitive contract to Monchik to test the system's design. This discussion took place 22 days before the award of the noncompetitive contract to Monchik and further supports our conclusion that

the Commission had time to issue the 10-day notice to the public. Notifying the public after the award of the contract, as the Commission did, does little to further public confidence that the Commission is adequately disclosing its procurement needs.



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

September 11, 1980

Mr. D. L. Scantlebury
Director, Division of Financial
and General Management Studies
General Accounting Office
Washington, D.C. 20548

Re: Draft Audit on Practices of the Securities and Exchange Commission
in Procuring an Automated Market Surveillance System

Dear Mr. Scantlebury:

I welcome the opportunity to respond to the General Accounting Office's proposed draft report to the Congress concerning the Securities and Exchange Commission's practices in procuring an automated market oversight surveillance system. Although the draft report identifies potential problems in the procurement of the contracts reviewed by your staff, I am pleased to note, as the draft report indicates, that the Commission's award of the contracts was in accordance with the Federal Procurement Regulations.

As you may know, members of the Commission staff worked informally with members of the GAO staff in the procurement of the initial system definition and design contract. The draft report indicates the need for the Commission and the GAO to continue to consult as the Commission advances toward the development of an automated system to fulfill its market oversight responsibilities. Accordingly, I believe it is important to comment on those areas of the draft report with which we are in agreement, but also to note those findings which appear to be inaccurate or based on incorrect factual premises. The Commission's preliminary comments on the draft report's findings are attached. I would now like to comment briefly on the draft report's conclusions and three recommendations.

The Commission, of course, is committed to the objective of purchasing goods and services on the basis of full and fair competition to the maximum extent practicable. Thus, the Commission took steps to promote competition in the development and design of the oversight surveillance system and is continuing to ensure that the system is designed to permit open competition for its implementation wherever appropriate. Accordingly, the Commission's present practices are consistent with the first recommendation in the draft report that all interested parties be given the same opportunity to obtain Commission contracts.

The Commission also recognizes the desirability of incorporating organizational conflict of interest provisions in contracts for the design of system specifications, such as the initial contract between the Commission and Monchik Weber Associates, Inc. ("Monchik"), although, as the draft GAO report correctly states (at page 5), there is no Government-wide requirement that agencies do so. The Commission did not incorporate such a provision in the initial contract with Monchik, but has taken alternative steps to ensure that Monchik will not derive any undue competitive advantage as a result of having drafted the design specifications. Moreover, where appropriate, future contracts will contain organizational conflict of interest provisions to the greatest extent feasible. Thus, we generally concur with the draft report's second recommendation that contract provisions not permit organizational conflicts of interest that will limit competition for follow-on contracts, although we note that organizational conflict of interest provisions are not required and are only one of several ways an agency may prevent a noncompetitive situation from developing.

The Commission is also cognizant of the general requirement of the Federal Procurement Regulations, referred to in the draft report (at page 9), that agencies provide adequate public notice of pending noncompetitive procurements unless unusual or compelling circumstances make such notice impracticable. In this case, time constraints, associated with completion of the Commission's options study and the discontinuance of the Commission's imposed moratorium on new options trading, did not permit the Commission to give prior notice of its decision to award Monchik a contract to implement a pilot project so that the Commission could evaluate the system design and the impact of expanded options trading. The Commission's normal practice, however, is to give adequate pre-award notice. Thus, the Commission also concurs with the draft report's third recommendation that public notice detailing Commission needs be given before a noncompetitive contract is awarded except in those instances where compelling circumstances preclude such notice.

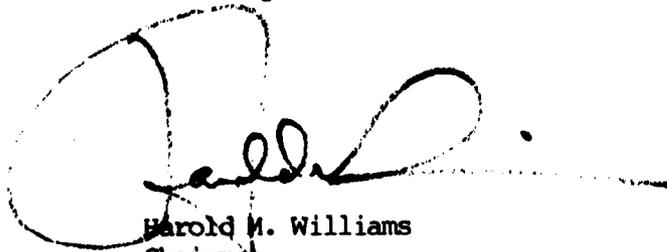
The draft report also concludes that the Commission should strengthen its procurement practices. The Commission is aware that contracts to develop and design complex systems, such as the market oversight surveillance system, require a high level of procurement specialization. Consequently, in the past two years the Commission has increased and upgraded the staffing of its procurement and contracting operations in the Office of Administrative Services, the Office of the Executive Director, and the Office of General Counsel, and we will continue to upgrade the agency's expertise in this area.

For these reasons, the Commission is in accord with the basic recommendations of the GAO draft report. Nonetheless, we are concerned that, in some respects, the draft report is not a fair picture of the Commission's procurement efforts. I have attached to this letter comments on certain specific areas where the Commission believes the accuracy of the findings and conclusions of the report could be improved. I have also attached an annotated copy of the draft report indicating how certain minor revisions might be made to make the final report more accurate.

I hope that these preliminary comments are useful to you in producing a final report that is an accurate and complete study of the manner in which the Commission accomplished the initial contracting steps in this major and extremely complex procurement effort. I am confident that the inaccuracies or omissions identified in my staff's review of the draft GAO report can be rectified. To the extent that the final report is not amended in accordance with the Commission's comments, however, I request that my letter and the relevant portions of the enclosed comments be incorporated in full in the report that you transmit to the Congress.

Again, I appreciate the opportunity to review and comment on the report while it is in draft form. If I can be of further assistance, please let me know.

Sincerely,

A handwritten signature in cursive script, appearing to read "Harold M. Williams". The signature is written in dark ink on a light background.

Harold M. Williams
Chairman

Enclosures

GAO note: We did not include the Commission's annotated copy of the draft report since we did not believe our conclusions needed revision.

PRELIMINARY COMMENTS OF THE SECURITIES AND EXCHANGE
COMMISSION ON THE GAO FINDINGS AND RECOMMENDATIONS ON
THE COMMISSION'S PROCUREMENT PRACTICES FOR THE DEVELOPMENT
OF AN AUTOMATED MARKET OVERSIGHT SURVEILLANCE SYSTEM

I. Preliminary findings of GAO draft report.

The draft report, entitled "GAO findings and recommendations on Securities and Exchange Commission procurement practices for the development of an automated market surveillance system," enclosed with the letter from the Comptroller General, correctly states (at page 1) that some aspects of surveillance of the securities markets have been delegated to the industry's self-regulatory organizations. The draft report, however, in stating (at page 1) that the Commission then issued a request for proposals to establish "its own comprehensive market surveillance system," implies that the Commission's objectives may be duplicative of the surveillance objectives delegated to the self-regulatory organizations. The final report should make clear that the Commission is developing a comprehensive market surveillance system to fulfill its statutory oversight responsibilities — responsibilities which have not been and could not be delegated to the self-regulatory organizations. 1/ In the attached copy of the draft report, we have suggested certain changes that we are satisfied will clarify this point.

The draft report further states (at page 1) that, "in September 1979, the Commission awarded Monchik a * * * non-competitive contract to test the system they [had] designed" (emphasis added). It is the Commission, however, which is testing the system that Monchik has designed. The agency has awarded a contract to Monchik to implement a pilot project to serve as the basis on which the Commission will evaluate whether the system Monchik has designed is satisfactory to fulfill the Commission's oversight responsibilities. Thus, the contract should be described only as one to implement a pilot project to enable the Commission to test the system. Revised language to this effect has been inserted in the attached copy of the draft report. You may also wish to consider, as we did, and comment upon whether another firm could have implemented the project as quickly, effectively or economically.

II. Staff discussions with Monchik on market oversight problems did not give Monchik an unfair advantage in competing for the system definition and design contract.

The draft report considers (at pages 2-4) Monchik's informal discussions with high-level Commission officials and the implications of these discussions on Monchik's ability to compete successfully for the award of the contract to define and design the system. The draft report concludes (at page 4) that "the Commission, through its early informal discussions with Monchik, allowed that firm to acquire detailed advance information on the market surveillance needs of the Commission."

1/ See, e.g., S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-23, 34-36 (1975).

We do not agree with the conclusion that these informal discussions provided Monchik with "detailed advance information" on the agency's market surveillance needs. But even if the discussions had afforded Monchik advance information, they could not have given Monchik an advantage in competing for the initial definition and design contract. The technical criteria on which bidders for this contract were evaluated did not require the proposal of actual system specifications, but rather sought information to appraise the bidders' general capabilities to develop and design a complex automated system to evaluate securities market data. Thus, the technical criteria considered factors such as experience in the securities and systems design areas and the qualifications of the bidders' key personnel. Advance knowledge of the Commission's market surveillance needs could not affect these criteria. 2/

Additionally, the draft report would be more accurate if these informal discussions were described in the context in which they occurred. Monchik Weber is a New York and Boston based investment advisor registered with the Commission. In this capacity, Monchik initially had discussions with the staff of the Commission's Boston Regional Office concerning services that the firm could provide in developing an investment advisors manual. In the course of these discussions, the Commission staff learned that Monchik had certain market analysis capabilities that could be useful to the staff in discharging the Commission's market oversight responsibilities.

Conversations concerning a market oversight surveillance system thus occurred informally as a result of the early discussions with staff members concerning the investment advisor examination program, and, by letters dated January 3, 1978, and January 4, 1978, supplemented by a letter dated February 13, 1978, Monchik submitted unsolicited proposals outlining a revision of the investment advisor examination manual and a procedure for exploring the feasibility of developing a general market oversight system. In sum, these informal discussions, coupled with Monchik's unsolicited letters, educated the Commission staff concerning industry capability generally in the market analysis area. This resulted in the Commission's decision to proceed, in

2/ The draft report also suggests that Monchik may have been given an advantage because the request for proposals was stated in general terms. To the contrary, the Commission drafted the request in generic form to open the competition to all firms that had expertise in the general field of automated systems using securities market data. Moreover, the request contained adequate guidance for the bidders to respond, as is evidenced by the fact that they submitted very few requests for clarifying comments.

April 1978, on a competitive basis 3/ with a request for proposals for bids from other potentially interested firms to state their qualifications to define the overall parameters of a comprehensive market oversight surveillance system and, in a second phase, to design detailed specifications for the implementation of the system. 4/ We have suggested the inclusion of these explanatory background facts in the attached copy of the draft report.

With respect to the draft report's suggestion that Monchik had an advantage over other bidders because Monchik had several months to formulate its proposal whereas, "in contrast, others had only about 30 days to respond to the Commission's proposal" (at page 4), the final report should also inform the Congress that thirty days is the standard response period for requests of this type. 5/ The fact that none of the six bidders in this case requested an extension of time is further indication that the response time was ample. 6/ Thus, the statement

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- 3/ The draft report is correct insofar as it states that Commission staff members initially considered awarding the definition and design contract to Monchik on a noncompetitive basis. The draft report gives insufficient emphasis, however, to the fact that the Commission, on the advice of its Office of General Counsel, and in conjunction with GAO's general counsel, determined that the contract could be procured competitively and, accordingly, issued a request for proposals and negotiated with all the bidders that were within the competitive range.
- 4/ The draft report's suggestion that other interested parties did not have an opportunity to discuss an automated oversight system with the Commission staff is also inaccurate. For example, Arthur Young & Company, one of the bidders that responded to the Commission's request for proposals, as a result of its contacts with the Commission staff concerning, among other things, the Commission's information requirements, had extensive access to Commission staff members and was intimately familiar with the Commission's needs and capabilities prior to the time Monchik had informal discussions with the Commission staff.
- 5/ It is standard procurement procedure to request the submission of proposals within either 20 days for standard items or 30 days for complex items.
- 6/ It is not uncommon for bidders to request extensions of time when the proposal called for is too complex to be developed within the thirty-day period.

in the draft report (at page 4) that, "having such an apparent advantage, Monchik was placed in a position in which it could better demonstrate that it had superior technical qualification, price considered, than the other four companies," should be deleted. 7/ Again, we have indicated minor changes in the attached copy of the draft report to improve the final report's accuracy with respect to these matters.

III. The Commission has effectively cured any potential organizational conflict of interest.

The draft report discusses (at pages 4-7) a potential problem of an organizational conflict of interest created by the initial Monchik contract. As noted above, we agree with the report's recommendation that the Commission incorporate organizational conflict of interest clauses in future contracts where appropriate. Further, we recognize that an organizational conflict of interest provision, although not required, would not have been inappropriate in the initial contract awarded to Monchik. The final report should emphasize, however, as the draft report now states, that agencies are not required to include an organizational conflict of interest provision in a contract. The inclusion of such a provision is only one of several ways an agency may prevent exploitation in a potential conflict situation.

In this instance, the draft report does not make clear that the Commission utilized a different method to ensure that Monchik would not derive any undue competitive advantage as a result of having drafted the design specifications. the system designed by Monchik. When the Commission staff became aware of a possible conflict situation, the Commission retained an expert in the procurement of automated data processing systems, Government Sales Consultants, Inc. ("GSCI"), to

7/ We are also concerned that the statement on page 2 of the draft report to the effect that Monchik received the contract award because its proposal was the most responsive to the Commission's needs "although Monchik's contract price was higher than two other bidders," could be misinterpreted to imply that Monchik was the highest bidder. The final report should state that there were six bidders, five of which were technically qualified; of those five, two submitted a contract price higher than Monchik's.

The final report should also indicate that the Commission complied with all the procurement regulations concerning the evaluation of the five technically qualified proposals and that the award was made to Monchik because, on a combined evaluation of the technical criteria and the cost criteria, its offer was the most favorable to the Government.

Changes curing the possible misinterpretations that might arise from the draft report's current presentation are indicated on the attached copy of the draft report.

oversee the procurement and Monchik's performance. 8/ The final report should state directly that the Commission's actions were in conformance with the Federal Procurement Regulations in this area and were successful in preventing exploitation by Monchik in its design of the system specifications.

As the draft report correctly states, GSCI found that Monchik did not exploit the potential conflict situation. Nevertheless, the draft report, in stating that GSCI later found serious problems with the specifications designed by Monchik, creates the false impression that Monchik was, in fact, exploiting its position. As indicated on the attached copy of the draft report, this misleading suggestion can be corrected by placing the quoted statements from the August 29, 1979, GSCI report in context with other statements in that report. For example, GSCI states, on page one of the August report, "the deficiencies, however, are in the form of missing or undefined elements, are not numerous, and may not be difficult to obtain" (emphasis supplied). GSCI also concludes in that same report (at page 3) that

"overall, the Lot II Report reflects a great deal of effort and the system design reflects a logical systematic approach. With the additions and modifications recommended and with updating to reflect lessons learned from the pilot system, the Report will serve as the basis for an RFP which will provide a competitive procurement."

Thus, GSCI's evaluation of the system specifications confirmed its earlier opinion that Monchik did not exploit a potential opportunity to obtain an advantage in the system design and that Monchik's specifications, with a small number of changes, would permit fair and open competition for the system's implementation.

8/ The report's suggestion that GSCI discovered the conflict situation (at page 6) is not accurate. The Commission's awareness of the potential conflict situation was one factor in its decision to retain GSCI. GSCI then confirmed that Monchik was in a position to design specifications that only it had the capability to fulfill.

Another reason the Commission retained GSCI to review the contract award process and the specifications developed by Monchik was to prevent even the appearance of favoritism. The draft report (at page 7), suggests that it was GSCI which alerted the Commission to the fact that the Commission's procurement practices might not appear to be consistent with the Commission's own regulatory standards. This suggestion is inaccurate. If it is determined that such a statement is necessary in the final report, it should be clarified to state that it was the Commission that was first concerned that its procurement practices meet the highest standards, and this concern was a primary factor in its decision to retain GSCI.

In referring to GSCI's conclusions, the draft report asserts (at page 6) that, if the revised specifications are incorporated into the implementation request for proposals, "it would appear that the potentially unfair competitive advantage that Monchik may have had as a result of its drafting the design specifications could be avoided." At the Commission's request, Monchik has revised its specifications in accordance with the GSCI report and the Commission will employ the revised specifications as the basis for its request for proposals on the system implementation. These additional facts should be incorporated in the final GAO report. 9/

IV. The Commission's award of a competitive contract to Monchik for a pilot project was made on the basis of compelling urgency and prior public notice was impracticable.

The draft report also considers the Commission's noncompetitive award to Monchik of a contract to implement a pilot project to facilitate the Commission's testing of the system. The report's criticism of the Commission's failure to issue a prior public notice of this award fails to consider the time constraints facing the Commission at the time a decision was made to go forward with a pilot project and omits certain pertinent facts.

First, the draft report states (at page 8) that "the Consultant [GSCI] recommended that the Commission issue as soon as possible a public notice of its needs before proceeding with a noncompetitive award to determine whether other firms could perform the pilot project." This misconstrues GSCI's recommendation. GSCI recommended that the Commission award, on a noncompetitive basis, a pilot project contract to Monchik. GSCI suggested that a more cautious approach, if time permitted, would be to issue a public notice, but noted that this ap-

9/ The statement in the draft report that there is no present legal basis upon which the Commission can exclude Monchik from bidding on any contract to implement the market oversight surveillance system permits an erroneous inference that there cannot be open and fair competition for the implementation contracts. As the GAO report correctly points out (at page 7), however, the Commission's procurement consultant, GSCI, has proposed several alternatives for resolving this problem in a manner to accord with the competitive principles of the Federal Procurement Regulations. The Commission is still exploring these alternatives.

Moreover, the Commission is not in complete agreement with the legal conclusion stated. As we indicate on the attached copy of the draft report, certain relatively minor changes would alleviate the Commission's concern with respect to the report's findings concerning future competition.

proach was not required by the Federal Procurement Regulations and would involve delay in implementing a pilot project if the Commission should later determine that such a project was necessary and desirable.

It would have been premature for the Commission to issue a public notice in March 1979, concerning a pilot project, as the draft report suggests. At that time, the Commission had not made a firm decision to implement the system designed by Monchik. It was not until well after March 1979, that the Commission, having had a chance to study the lengthy and complex proposal submitted by Monchik, could make a determination to go forward with a pilot project. 10/

During the summer of 1979, after the Commission had an opportunity to review Monchik's complex technical proposal and to make an informed decision to go forward with a pilot project, the staff then reviewed the time constraints facing the Commission and determined at that time that there was compelling urgency to proceed expeditiously. One of the factors behind this determination was the staff's estimate that the then-existing moratorium on options trading would be lifted in October or November of 1979, and the staff's belief that investor protection would be greatly enhanced if a pilot project were in operation before options trading was expanded.

In fact, GSCI, in its March 1979, report had recognized the stringent deadlines that the Commission might well encounter and stated, "we understand that [lengthy] delays in putting a Market Surveillance System in operation are not acceptable * * * If [the] SEC determines that its needs are such that these delays are unacceptable (as we have presumed), then a noncompetitive award appears to be justified." 11/ Thus, the Commission awarded a noncompetitive contract to Monchik to implement a pilot project in ac-

10/ The draft report also fails to state that GSCI observed that public notice of the procurement would have to include "a functional description of the data collection software including the composition of the data base already accommodated so that other firms who might possess such software could be evaluated" (March GSCI report at page 3). Since no such functional description had yet been developed, the Commission, in the spring of 1979, could not have issued the public notice urged in the GAO draft report.

11/ The report also fails to state, that GSCI determined that Monchik was the only qualified firm that could implement a pilot project on an expedited basis (see March GSCI report at page 3).

The draft report simply states (at page 8) that, with regard only to pure technical capability, "the procurement consultant could not state whether Monchik was the only firm who could meet the Commission's needs."

cordance with the accepted procurement practices for exigent circumstances. ^{12/}
It is also noteworthy that the Commission informally sought and received
advice from GAO on the validity of awarding the pilot project to Monchik
Weber on a sole source basis. As we have done with our comments on
other areas of the draft report we have indicated on the attached copy of
the draft report certain changes that we believe are appropriate and
necessary to make the final report accurate and complete with respect to
this award.

^{12/} The Commission promptly placed a notice of the award in the Commerce
Business Daily, as required by the regulations.

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