

**Testimony of H. David Kotz
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Securities and Exchange Commission**



**Before the Subcommittee on Government
Management, Organization, and Procurement,
Committee on Oversight and Government Reform,
U.S. House of Representatives**

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2:00 p.m.**

Introduction

Good afternoon. Thank you for the opportunity to testify today before this Subcommittee on the subject of “The Roles and Responsibilities of Inspectors General within Financial Regulatory Agencies” as the Inspector General of the Securities and Exchange Commission (“SEC” or “Commission”). I appreciate the interest of the members of the Subcommittee in the SEC and the Office of Inspector General at this critical time for the financial markets. In my testimony today, I am representing the Office of Inspector General, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

I would like to begin my remarks this afternoon by discussing the role of my Office and, in particular, the increased oversight efforts we have undertaken since I was appointed as the Inspector General of the SEC a little over one year ago, in late December 2007.

The mission of the Office of Inspector General is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. This mission has become increasingly important in light of the current economic crisis facing our nation. I firmly believe that this mission is best achieved by having a vigorous and independent Office of Inspector General to investigate and audit Commission activities and to keep the Commission and Congress informed of significant issues and findings.

The SEC Office of Inspector General includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates and supervises independent audits and

inspections related to the Commission's internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office's investigations unit responds to allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations into allegations received in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation as appropriate.

Audit Reports

My philosophy as an Inspector General is to focus on the significant issues and high risk areas, i.e, looking at "big picture" items, relating to whether the programs and operations in the Agency are working effectively, rather than simply identifying isolated minor infractions or procedural violations. I believe that this approach is particularly important in light of the significant challenges facing the SEC and the other government

agencies that regulate our financial markets. In this time of financial crisis, it is my view that as the agency charged with being the investor's advocate and protecting the integrity of our capital markets, the SEC must engage in critical self-analysis and address a number of difficult and complex issues. Current market conditions have created many new and unexpected challenges that need to be addressed and examined expeditiously. Therefore, it is more important than ever that financial regulatory agencies such as the SEC have an independent, effective and fully-funded Office of Inspector General to assist the Commission in confronting these challenges.

I am proud to report that over the past 14 months that I have served as the SEC's Inspector General, our Office has risen to these challenges and then some. Notwithstanding a small staff, over this short period of time, we have issued numerous detailed audit and investigative reports discussing issues critical to SEC operations and the investing public and making significant recommendations for improvement. Many of these reports have been critical of SEC operations, programs and management, and I have not always been the most popular individual at my agency. Nonetheless, I feel it is my duty to the Commission, the Congress and the investing public, particularly in these challenging times, to conduct independent audits and investigations and to issue thoughtful, unbiased and frank reports. Thus, whenever we find that criticism of the SEC is warranted and supported by the facts, we do not hesitate to report the facts and conclusions as we find them.

I will provide you with just a few examples of recent activities undertaken by my Office, some at the request of Congressional Committees. In September 2008, our audit unit issued a comprehensive report analyzing the Commission's oversight of the SEC's

Consolidated Supervised Entity (CSE) program, which included Bear Stearns, Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers. In order to give enhanced credibility to our findings, we retained the services of a recognized expert on capital markets, and market microstructure in particular. Our report provided a detailed examination of the adequacy of the Commission's monitoring of Bear Stearns, including the factors that led to its collapse. The audit identified deficiencies in the CSE program that warranted improvement and provided 26 recommendations that, if implemented, would have significantly improved the Commission's oversight of the CSE firms. In response to the report's findings, former SEC Chairman Christopher Cox announced the end of the CSE program and promised to review and move to aggressively implement the report's recommendations.

The Office of Inspector General's audit unit also issued a second report during the same time period, analyzing the Commission's Broker-Dealer Risk Assessment program. This program operates pursuant to SEC rules requiring broker-dealers that are part of a holding company structure with at least \$20 million in capital to register with the Commission, and provide information on the broker-dealer, the holding company, and other entities within the holding company system. The audit found that the SEC was not fulfilling all of its obligations in connection with the Broker-Dealer Risk Assessment Program and made several recommendations to improve the program.

Just recently, my Office has issued several other significant audit reports. In February, we issued an audit report that analyzed the \$178 million in disgorgement waivers that the Division of Enforcement (Enforcement) granted between October 2005 and May 2008. These waivers of disgorgements required to be paid by individuals or

entities that violate the Federal securities laws were granted based upon an assertion by a defendant of an inability to pay. We found that proper procedures were not always followed in recommending waivers, and the SEC did not always ensure there was appropriate documentation to confirm representations made by defendants concerning their financial condition. We provided several recommendations designed to improve the process.

Just last week, we issued a comprehensive audit report on Enforcement's practices and procedures for responding to and processing naked short selling complaints. Our report concluded that Enforcement's existing complaint receipt and processing procedures hinder its ability to respond effectively to naked short selling complaints and referrals, and Enforcement's procedures result in naked short selling complaints being treated differently than other types of complaints received by Enforcement. We also analyzed in a broader sense Enforcement's complaints, tips and referral process and provided numerous recommendations to improve the manner in which Enforcement receives and processes complaints.

We are also currently working on several additional audit reports that we plan to issue in the upcoming months that address issues currently of concern to the Commission and the investing public, including a comprehensive analysis of the SEC's oversight of the Nationally Recognized Statistical Rating Organizations. These rating organizations, also referred to as credit rating agencies, may have played a critical role in the current economic crisis and some of the financial frauds in the earlier part of this decade. We intend to identify processes that will aid with the Commission's oversight of these credit reporting agencies.

Investigative Reports

We also have a vibrant and vigorous investigative unit that under my direction is conducting, or has completed, over 50 comprehensive investigations of allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the Commission, Congressional officials and the general public. Where appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removals from the Federal service. Specifically, over the past year, we have issued investigative reports regarding a myriad of allegations, including claims of improper preferential treatment given to prominent persons, retaliatory termination, Enforcement's failure to vigorously pursue an Enforcement investigation, conflict of interest and solicitation of favors from an outside contractor, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms, and the misuse of official position and government resources. These investigative reports have been issued without management influence or pressure, and have focused on all level of employees and contractors, including senior SEC staff. Where appropriate, we have also referred our investigative findings to the Department of Justice for possible criminal prosecution. We are continuing to follow up with the Department and the Federal Bureau of Investigation on several ongoing criminal matters.

Bernard Madoff Investigation

In addition to the work I just described, we are conducting a comprehensive investigation and evaluation of matters related to Bernard Madoff and affiliated entities.

On the late evening of December 16, 2008, former SEC Chairman Christopher Cox contacted me and asked my Office to undertake an investigation into complaints received by the SEC regarding Mr. Madoff, going back ten years, and the reasons why the agency found these complaints lacked credibility. The Chairman also asked that we inquire into the SEC's internal policies that govern when allegations of fraudulent activity should be brought to the Commission's attention, whether those policies were followed in the Madoff matter, and whether improvements to those policies are necessary. In addition, Chairman Cox requested that the investigation include a review of all SEC staff contact and relationships with the Madoff family and firm, and any impact such relationships had on staff decisions regarding the firm.

Early on December 17, 2008, we opened an official investigation into the Madoff matter. Since that time, we have been working at a rapid pace to perform this important work and have made substantial progress to date.

Based upon the work conducted to date, we have determined that the matters that must be analyzed regarding the SEC and Bernard Madoff go well beyond the specific issues that former Chairman Cox asked us to investigate. Therefore, in addition to conducting a thorough and comprehensive investigation of issues raised by former Chairman Cox, our oversight efforts will include an evaluation of broader issues regarding the overall operations of Enforcement and the Office of Compliance, Inspections and Evaluations as they relate to the specific questions we are examining. As a result of those efforts, we intend to provide overarching and comprehensive recommendations to ensure that the Commission fulfills its mission of protecting

investors, facilitating capital formation and maintaining fair, orderly and efficient markets.

At the conclusion of our investigative efforts related to the Madoff matter, in addition to recommending disciplinary action for specific individuals as may be appropriate, we plan to provide concrete and specific recommendations to ensure the SEC has sufficient systems and resources to enable it to respond quickly and effectively to complaints and detect fraud through its examinations and inspections.

Coordinated Efforts Among Financial Regulatory IGs

In addition to the work conducted by the Office of Inspector General at the SEC, in order to strengthen the oversight of the Federal financial regulatory structure as a whole, we work in tandem with other Federal financial regulatory Inspectors General to provide coordinated oversight. For example, I currently serve on the Troubled Asset Relief Program (TARP) Inspector General Council, along with the Special Inspector General for the TARP, Neil Barofsky, and Inspectors General from the Department of Treasury, Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, the Department of Housing and Urban Development, the Federal Housing Finance Agency, the Small Business Administration, and representatives of the GAO. We meet on a monthly basis to discuss coordination of TARP-related activities and oversight efforts.

I also meet every month with the Inspectors General for the Department of Treasury, FDIC, Federal Reserve Board, the Pension Benefit Guaranty Corporation, the Federal Housing Finance Board, the Commodity Futures Trading Corporation, and the National Credit Union Administration to discuss coordinated oversight efforts among the financial regulatory IGs. I believe that these coordinated efforts are crucial to ensure a

united and common approach to the oversight of the Federal financial regulators during this time of economic crisis.

Congressional Efforts to Assist Inspectors General

I greatly appreciate the Subcommittee's interest in assisting the Inspectors General in performing their critical work and the willingness in particular to assist the efforts of my Office. With increasing pressure on the Federal financial regulators, having sufficient funds and resources to conduct oversight, as well as the requisite degree of independence, is more vital than ever.

The recently-enacted amendments to the Inspector General Act made great strides in enhancing Inspector General independence and ensuring that the Inspectors General receive sufficient appropriated funds to achieve their mission. In particular, Section 8 of the Inspector General Reform Act requires agencies to include in their budget submissions to the Office of Management and Budget (OMB) a specific breakout for Inspector General funding, as well as any comments of the affected Inspector General with respect to the proposal. Furthermore, OMB must include in the President's budget, among other things, the amount of funding requested by the President for each IG and any comments by an Inspector General who determines that the budget submitted by the President would substantially inhibit the performance of the Inspector General's mission. Other significant improvements to enhance Inspector General independence made by the Inspector General Reform Act include Section 3's requirement of 30 days advance notice to Congress of the removal or transfer of an Inspector General, as well as the provisions prohibiting cash awards or bonuses to Inspectors General and establishing the pay of both Presidentially-appointed and Designated Federal Entity (DFE) Inspectors General.

Since I began my tenure as Inspector General of the SEC in December 2007, my Office's staffing levels have increased by nearly 80%, and I have requested an increase of our overall budget of nearly 30% for Fiscal Year 2009, which I understand will be processed as soon as the funds are available. Notwithstanding these increases, additional resources would greatly assist my Office in continuing its important work. I specifically suggest that to the extent Congress provides additional appropriations to agencies such as the SEC for increased enforcement efforts, there be a commensurate and proportionate funding to the corresponding Offices of Inspectors General to provide for oversight of the additional funds allotted to the agency. There may also be other mechanisms pursuant to which appropriated funds may be directed specifically to an Office of Inspector General for oversight efforts.

Additionally, the legislation recently passed by the Senate to provide the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) with additional authorities and responsibilities is illustrative of other types of measures that may be enacted to enhance Inspector General independence and effectiveness. For example, the SIGTARP legislation requires the Secretary of the Treasury to take action to address deficiencies identified by a report or investigation of the SIGTARP, or to certify to the appropriate Committees of Congress that no action is necessary or appropriate. That legislation also provides the SIGTARP with enhanced audit, investigation and personnel authorities.

Finally, I respectfully offer my opinion that converting Inspectors General from DFE Inspectors General to Presidentially-appointed Inspectors General is not necessary and, in my view, would not improve the current level of DFE Inspector General

oversight. Having been an Inspector General at two DFEs, at the Peace Corps and now at the SEC, I can state without any hesitation, that one can be a completely independent and effective Inspector General within the DFE structure. Although I have issued numerous reports at both agencies that have been critical of those agencies' operations and management and often controversial, no one has ever attempted to impair, or question, my independence. I believe that DFE Inspectors General are able to fulfill their duties to provide meaningful and independent oversight free from any outside influences, including political ones.

In my personal situation, my Office's reports and approach to oversight have not diminished in any way with the recent change in administration and appointment of a new SEC Chairman. I can report that politics play absolutely no role in my Office's decisions and, as a DFE Inspector General, I am completely unaffected by political considerations or processes. For this reason, I do have some concerns that converting the Inspector General of the SEC, or the Inspectors General of other financial regulatory agencies, from DFE to Presidentially-appointed Inspectors Generals could result in an unnecessary "politicization" of the Office of Inspector General. There are additional potential drawbacks to the Presidentially-appointed Inspector General process, including the often lengthy vetting and confirmation process that may lead to the Inspector General position being vacant for a significant period of time. During this time of financial crisis, it is more important than ever that there is continuity of the operations and oversight activities currently undertaken by Inspectors General of financial regulatory agencies.

Concluding Remarks

In conclusion, I greatly appreciate the Subcommittee's interest in the SEC and my Office. I believe that the Subcommittee's and Congress's involvement with the SEC is extremely important to strengthen the accountability and effectiveness of the Commission. I also believe very strongly that a dynamic and effective Office of Inspector General is critical to achieving the mission of all Federal agencies, including the SEC. I take very seriously my Office's responsibility to detect and report waste, fraud and abuse, as well as the concern and interest of this Subcommittee in the efficiency and effectiveness of my Office and the SEC. Thank you.