

**Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the U.S. House of Representatives  
Committee on Financial Services**

**Monday, January 5, 2009  
2:00 p.m.**

## **Introduction**

Good afternoon. Thank you for the opportunity to testify today before this Committee on the subject of “Assessing the Madoff Ponzi Scheme” as the Inspector General of the Securities and Exchange Commission (“SEC” or “Commission”). I appreciate the interest of the Chairman, as well as the other members of the Committee, in the SEC and the Office of Inspector General. 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 brief remarks this afternoon by discussing the role of my Office and the oversight efforts that we have undertaken since I was appointed as the Inspector General of the SEC approximately 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 Securities and Exchange Commission. 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 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 evaluations 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 National Investigative Quality Standards. 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**

I am proud to report that notwithstanding a small staff, the Office of Inspector General at the SEC has issued numerous audit and investigative reports over the past year involving issues critical to SEC operations and the investing public.

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. The 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 identified 26 recommendations that, if implemented, would have significantly improved the Commission's oversight of the CSE firms. The Office of Inspector General 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 which require 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.

The Office of Inspector General's audit unit has also issued numerous other reports over the past year relating to issues such as the Self-Regulatory Organization (SRO) rule filing process, the Commission's Personnel Security/Suitability program, the Division of Enforcement's oversight of receivers and distribution agents and its case-management system, the SEC government purchase card program, the Office of Financial Management's controls over premium travel, the Commission's student loan repayment program, and numerous Office of Information Technology issues such as information security, enterprise architecture, and appropriate controls over laptop computers. These audits are described in our semiannual reports to Congress and the individual audit reports are available on our website.

## **Investigative Reports**

We also have a vibrant and vigorous investigative unit that 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 employees 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 terminations. Specifically, over the past year, we have issued investigative reports regarding claims of improper preferential treatment given to prominent persons, retaliatory termination, the failure by the Division of Enforcement to vigorously pursue an Enforcement investigation, conflicts of interest involving an Enforcement investigation and concerning the solicitation of services by an outside contractor, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms and the misuse of official positions and government resources. 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 Investigations on several ongoing criminal matters.

## **The Madoff Investigation**

It is with this background in mind that I wish to discuss our planned efforts to investigate matters related to Bernard Madoff and affiliated entities. On the late evening of December 16, 2008, SEC Chairman Christopher Cox contacted me and asked my

office to undertake an investigation into allegations made to the SEC regarding Mr. Madoff, going back to at least 1999, and the reasons that these allegations were found to be not credible. The Chairman also asked that we investigate the SEC's internal policies that govern when allegations of fraudulent activity should be brought to the Commission, whether those policies were followed, and whether improvements to those policies are necessary. In addition, he requested that the investigation include all 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 then, we have been working at a rapid pace to begin this important work. On December 18, 2008, we issued a document preservation notice to the entire Commission informing them that the Office of Inspector General has initiated an investigation regarding all Commission examinations, investigations or inquiries involving Bernard L. Madoff Investment Securities, LLC, and any related individuals or entities. We formally requested that each employee and contractor in the Commission preserve all electronically-stored information and paper records related to Bernard L. Madoff Investment Securities, LLC in their original format.

Over the next few days, we met with senior officials from the Commission's Division of Enforcement and the Office of Compliance Inspections and Examinations, known as "OCIE," to ensure their cooperation in our investigation and our ability to gain access to their files and records. We also met with the Chairman's office to seek information and documentation relevant to the investigation.

On December 24, 2008, we sent comprehensive document requests to both the Division of Enforcement and OCIE specifying the documents and records we required to be produced for the investigation. We requested that all responsive documents be provided to our Office by January 16, 2009. In addition, we made several formal expedited requests to the SEC's Office of Information Technology for searches of the e-mails of former and current employees and contractors for information relevant to the investigation, both at headquarters and the New York and Boston Regional Offices, and have already received and are in the process of reviewing these e-mails.

We have also already begun efforts to obtain additional resources to assist the Office in undertaking this investigation. We are securing additional office space and administrative assistance and hope to add four new investigators to our Office's current investigative team.

We have also begun identifying the particular issues that need to be investigated and are reviewing and updating daily the list of witnesses that we plan to interview. We intend to begin conducting these interviews immediately and, for example, have already scheduled a meeting with Harry Markopoulos for later this month for an in-depth interview on the record. We have also already met and spoken with numerous individuals informally as part of our initial investigative efforts.

It is our opinion that the matters that must be analyzed regarding the SEC and Bernard Madoff may go beyond the specific issues that SEC Chairman Cox has asked us to investigate. We believe that in addition to conducting a thorough and comprehensive investigation of the specific complaints that were allegedly brought to the SEC's attention regarding Mr. Madoff and the reasons for the SEC's apparent failure to act upon these

complaints, as well as the staff's contact and relationships with the Madoff family and firm and their impact on Commission decisions regarding Mr. Madoff, our oversight efforts must include an evaluation of broader issues regarding the overall operations of the Division of Enforcement and OCIE that would bear on the specific questions we are examining, and 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 this early stage, I thought it would be useful to identify the specific issues related to Bernard Madoff that, as a preliminary matter, we intend to investigate or review. Obviously, as the investigative efforts are just beginning, I am not in a position to provide any conclusions or findings with regard to the allegations that have been raised and do not wish to make any preliminary judgments before we have had a chance to analyze all the information. In addition, as underlying evidence relevant to the work of the Office of Inspector General could also be relevant to the pending criminal or SEC investigations into possible violations of the securities laws, I am being mindful not to comment on anything that may affect or interfere with those investigations.

The following are specific issues that we currently intend to investigate:

(a) The SEC's response to complaints it received regarding the activities of Bernard Madoff, including any complaints sent to the Division of Enforcement, OCIE, the Office of Risk Assessment and/or the Office of Investor Education and Advocacy. We plan to trace the path of these complaints through the Commission from inception, reviewing what, if any, investigative or other work was conducted with respect to these allegations, and analyze whether the complaints were handled in accordance with



Commission policies and procedures and whether further work should have been conducted;

(b) Allegations of conflicts of interest regarding relationships between any SEC officials or staff and members of the Madoff family, including examining the role a former SEC official who allegedly had a personal relationship with a Madoff family member may have played in the examination or other work conducted by the SEC with respect to Bernard Madoff or related entities, and whether such role or such relationship in any way affected the manner in which the SEC conducted its regulatory oversight of Bernard Madoff and any related entities;

(c) The conduct of examinations and/or inspections of Bernard Madoff Investment Securities LLC by the SEC and an analysis of whether there were “red flags” that were overlooked by SEC examiners and inspectors (which may have been identified by other entities conducting due diligence), that could have led to a more comprehensive examination and inspection, including a review of whether the SEC violated its own policies and procedures by not conducting timely reviews or examinations of Bernard Madoff’s activities and filings; and

(d) The extent to which the reputation and status of Bernard Madoff and the fact that he served on SEC Advisory Committees, participated on securities industry boards and panels, and had social and professional relationships with SEC officials, may have affected Commission decisions regarding investigations, examinations and inspections of his firm.

In addition to these specific issues and depending upon the information that we learn during the course of our investigation, we plan to consider analyzing the following broader issues, as appropriate:

(a) The complaint handling procedures of the Division of Enforcement, including a review of how complaints are processed, internal incentives that may affect the decision whether to take action with respect to a complaint, an analysis of which complaints are brought to the Commissioners' and Chairman's attention, and whether tangible and specific complaints are being reviewed and followed-up on appropriately;

(b) The OCIE examination and inspection procedures, including an analysis of what policies and procedures were then and are currently in place, whether these policies and procedures are being followed and/or whether there are gaps in these policies and procedures relating to operations involving voluntary private investment pools, such as hedge funds, because they are subject to limited oversight by the SEC, and whether any such gaps may lead to fraudulent activities not being detected; and

(c) The relationships between different divisions and offices within the Commission and whether there is sufficient intra-agency collaboration and communication between the Agency components to ensure comprehensive oversight of regulated entities.

Obviously, this is an ambitious investigative agenda, but I firmly believe that the circumstances surrounding the Bernard Madoff matter may very well dictate a more expansive analysis of Commission operations. Moreover, it is my view that at the end of these investigative efforts, there needs to be more than just the potential identification of individuals who may have engaged in inappropriate behavior or potentially failed to

follow-up appropriately on complaints, but rather an attempt to provide the Commission with concrete and specific recommendations as appropriate to ensure that the SEC has sufficient systems and resources to enable it to respond appropriately and effectively to complaints and detect fraud through its examinations and inspections.

Of course, even with a limited staff and with many of our auditors and investigators already engaged in ongoing matters, some of which should simply not be halted even in the face of a significant priority such as this one, I understand that it is critical that our investigative efforts be conducted expeditiously. I fully understand that it is crucial for the Commission, the Congress and the investing public that answers be given to the very serious questions regarding the SEC's earlier efforts relating to Mr. Madoff in a prompt and swift manner. For this reason, as I mentioned, I am mobilizing additional resources to ensure that our Office makes every possible effort to conclude our investigations and reviews as soon as possible. We are considering preparing reports on a "rolling basis" – assuming that we can identify discrete issues that may be resolved separately and expeditiously – so that some conclusions may be provided very shortly.

Finally, I can assure you that our investigation and review will be independent and as hard-hitting as necessary. While we approach these efforts with an open mind and at this stage of the investigation we have not reached any conclusions or made any findings, the matters that have been brought to our attention require careful scrutiny and review. We will conduct our work in a comprehensive and thorough manner and, if we find that criticism of the SEC is warranted and supported by the facts, we will not hesitate to report the facts and conclusions as we find them. I think that if you review the reports issued by our office over the past year, you will see that where we have found that

criticism of the SEC or SEC officials to be warranted, we have reported our findings and concerns in a frank, yet constructive manner.

### **Concluding Remarks**

In conclusion, we appreciate the Chairman's and the Committee's interest in the SEC and our Office. I believe that the Committee's and Congress's involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. I believe very strongly that a dynamic and effective Office of Inspector General is critical to achieving the aims of all federal agencies, including the SEC, and take very seriously our Office's responsibility to promote efficiency and effectiveness within the Commission and to detect and report waste, fraud and abuse. We intend to conduct our investigative efforts promptly and thoroughly. Thank you.