

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



**Before the U.S. Senate
Committee on Banking, Housing and Urban Affairs**

**Wednesday, September 22, 2010
10:00 a.m.**

Introduction

Thank you for the opportunity to testify before this Committee on the subject of “Oversight of the SEC’s Inspector General’s Report on the ‘Investigation of the SEC’s Response to Concerns Regarding Robert Allen Stanford’s Alleged Ponzi Scheme’ and Improving SEC Performance.” I appreciate the interest of the Chairman, the Ranking Member, as well as the other members of the Committee, in the Securities and Exchange Commission (SEC or Commission) and the Office of Inspector General (OIG). In my testimony, I am representing the OIG, 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 by briefly discussing the role of my Office and the oversight efforts we have undertaken during the past few years. 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. 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 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 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

Over the past 2½ years since I became the Inspector General of the SEC, our audit unit has issued numerous reports involving matters critical to SEC programs and operations and the investing public. These have included an examination of the Commission's oversight of Bear Stearns and the factors that led to its collapse, an audit of the SEC Division of Enforcement's (Enforcement's) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, and an analysis of the SEC's oversight of credit rating agencies. In addition, following a comprehensive investigative report related to the Madoff Ponzi scheme in which our Office identified systematic breakdowns in the manner in which the SEC conducted its examinations and investigations (discussed in more detail below), we performed three comprehensive reviews providing the SEC with 69 specific and concrete

recommendations to improve the operations of both Enforcement and the Office of Compliance Inspections and Examinations (OCIE).

Investigative Reports

The Office's investigations unit has also conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as 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 removal of employees from the Federal service, as well as recommendations for improvements in agency policies, procedures and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of failures by Enforcement to pursue investigations vigorously or in a timely manner, improper securities trading by Commission employees, conflicts of interest by Commission staff members, unauthorized disclosure of non-public information, whistleblower allegations of contract fraud, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, failure of SEC attorneys to maintain active bar status, falsification of federal documents, and the misuse of official position, government resources and official time. In August 2009, we issued a 457-page report of investigation analyzing the reasons why the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. More recently, we issued

a thorough and comprehensive report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's (Stanford's) \$8 billion alleged Ponzi scheme. The report is discussed in detail below and is the subject of this hearing.

Commencement of Stanford Investigation

On October 9, 2009, I received a letter from the Ranking Member of this Committee, the Honorable Richard Shelby, and the Honorable David Vitter requesting a comprehensive investigation of the handling of the SEC's investigation into Robert Allen Stanford and his various companies, including the history of all the SEC's investigations and examinations regarding Stanford. On October 13, 2009, the OIG opened our investigation into the Stanford matter.

Document and E-mail Review

Between October 13, 2009 and February 16, 2010, the OIG investigative team made numerous requests to the SEC's Office of Information Technology (OIT) for the e-mails of current and former SEC employees for various periods of time pertinent to the investigation. The e-mails were received, loaded onto computers with specialized search tools and searched on a continuous basis throughout the course of our investigation.

In all, OIT provided e-mails for a total of 42 current and former SEC employees for various time periods pertinent to the investigation, ranging from 1997 to 2009. We estimate that we obtained and searched over 2.7 million e-mails during the course of the investigation.

On October 27, 2009, we sent comprehensive document requests to both Enforcement and OCIE specifying the documents and records we required to be produced

for the investigation. We carefully reviewed and analyzed the information we received as a result of our document production requests. These documents included all records relating to the SEC's Fort Worth office's examinations in 1997 of Stanford Group Company's Broker-Dealer, in 1998 of Stanford Group Company's Investment Advisor, in 2002 of Stanford Group Company's Investment Advisor, and in 2004 of Stanford Group Company's Broker-Dealer. These also included investigative records relating to the Fort Worth office's 1998 inquiry regarding Stanford Group Company and its investigation of Stanford Group Company, which was opened in 2006.

We also sought and reviewed documents from the Financial Industry Regulatory Authority (FINRA), including documents concerning communications between FINRA or its predecessor, the National Association of Securities Dealers (NASD), and the SEC concerning Stanford, and FINRA documents pertaining to the SEC's examinations and inquiries regarding Stanford.

Testimony and Interviews

The OIG conducted 51 testimonies and interviews of 48 individuals with knowledge of facts or circumstances surrounding the SEC's examinations and/or investigations of Stanford and his firms. I personally led the questioning in the testimony and interviews of the witnesses in this investigation.

Specifically, we conducted on-the-record and under oath testimony of 28 individuals, including all of the relevant examiners and investigators who worked on SEC matters relating to Stanford. We also conducted interviews of 20 other witnesses, including former SEC employees, whistleblowers, victims of the alleged Ponzi scheme, and officials from the Texas State Securities Board.

Issuance of Comprehensive Report of Investigation

On March 31, 2010, we issued to the Chairman of the SEC a comprehensive report of our investigation in the Stanford matter containing over 150 pages of analysis and 200 exhibits. The report of investigation detailed all of the SEC's examinations and investigations of Stanford from 1997 through 2009 and the agency's response to all complaints it received regarding the activities of Stanford's companies, tracing the path of these complaints through the Commission from their inception and reviewing what, if any, investigative or examination work was conducted with respect to the allegations in the complaints.

Results of the OIG's Stanford Investigation

The OIG's investigation determined that the SEC's Fort Worth office was aware since 1997 that Robert Allen Stanford was likely operating a Ponzi scheme, having come to that conclusion a mere two years after Stanford Group Company, Stanford's investment adviser, registered with the SEC in 1995. We found that over the next eight years, the SEC's Fort Worth Examination group conducted four examinations of Stanford's operations, finding in each examination that the certificates of deposit (CDs) Stanford was promoting could not have been "legitimate," and that it was "highly unlikely" that the returns Stanford claimed to generate could have been achieved with the purported conservative investment approach utilized. The SEC's Fort Worth examiners conducted examinations of Stanford in 1997, 1998, 2002 and 2004, concluding in each instance that Stanford's CDs were likely a Ponzi scheme or similar fraudulent scheme. The only significant difference in the examination group's findings over the years was that the potential fraud was growing exponentially, from \$250 million to \$1.5 billion.

The first SEC examination occurred in 1997, just two years after Stanford Group Company began operations. After reviewing Stanford Group Company's annual audited financial statements in 1997, a former branch chief in the Fort Worth Broker-Dealer Examination group stated that, based simply on her review of the financial statements, she "became very concerned" about the "extraordinary revenue" from the CDs and immediately suspected the CD sales were fraudulent. In August 1997, after just six days of field work in an examination of Stanford, the examiners concluded that Stanford International Bank's statements promoting the CDs appeared to be misrepresentations. The examiners noted that while the CD products were promoted as being safe and secure, with investments in "investment-grade bonds," the interest rate, combined with referral fees of between 11% and 13.75% annually, was simply too high to be achieved through the purported low-risk investments.

The branch chief concluded after the 1997 examination was finished that the CDs declared above-market returns were "absolutely ludicrous" and that the high referral fees paid for selling the CDs indicated that they were not "legitimate CDs." The Assistant District Administrator for the Fort Worth Examination program concurred, noting that there were "red flags" about Stanford's operations that caused her to believe Stanford Group Company was operating a Ponzi scheme, specifically noting the fact that the interest being paid on these CDs "was significantly higher than what you could get on a CD in the United States." She further concluded that it was "highly unlikely" that the returns Stanford claimed to generate could be achieved with the conservative investment approach Stanford claimed to be using.

In the SEC's internal tracking database, where it recorded information about its examinations, the Broker-Dealer Examination group characterized its conclusion from the 1997 examination of Stanford Group Company as "Possible misrepresentations. Possible Ponzi scheme." Our investigation found that in 1997, the examination staff determined, as a result of their findings, that an investigation of Stanford by the Fort Worth Enforcement group was warranted, and referred a copy of their examination report to the Enforcement group for review and disposition. In fact, when the former Assistant District Administrator for the Fort Worth Examination program retired in 1997, her "parting words" to the aforementioned branch chief were to "keep your eye on these people [referring to Stanford] because this looks like a Ponzi scheme to me and some day it's going to blow up."

We also found that in June 1998, the Investment Adviser Examination group in Fort Worth began another examination of Stanford Group Company. This Investment Adviser examination arrived at the same conclusions that the broker-dealer examination had reached. The Investment Adviser examiners found very suspicious Stanford's "extremely high interest rates and extremely generous compensation" in the form of annual recurring referral fees, as well as the fact that Stanford Group Company was so "extremely dependent upon that compensation to conduct its day-to-day operations."

In November 2002, the SEC's Investment Adviser Examination group conducted yet another examination of Stanford Group Company. In this examination, the staff identified the same red flags that had been noted in the previous two examinations, including the fact that "the consistent, above-market reported returns" were "very unlikely" to be able to be achieved with Stanford's investments.

The Investment Adviser examiners also found that the list of investors provided by Stanford Group Company was inaccurate, as the list they received of the CD holders was inconsistent with the total CDs outstanding based upon referral fees. The examiners noted that although they did follow up with Stanford Group Company about this discrepancy, they never obtained “a satisfactory response, and a full list of investors.”

After the examiners began this third examination of Stanford, the SEC received multiple complaints from outside entities reinforcing and bolstering the examiners’ suspicions about Stanford’s operations. However, the SEC failed to follow up on these complaints or take any action to investigate them. On December 5, 2002, the SEC received a complaint from a citizen of Mexico, who raised the same concerns the examination staff had raised. While the examiners characterized the concerns expressed in this complaint as “legitimate,” we found that the SEC did not respond to the complaint and did not take any action to investigate the claims made therein.

In 2003, the SEC Enforcement staff received two new complaints that Stanford was a Ponzi scheme, but we found that nothing was done to pursue either of them. On August 4, 2003, the SEC was forwarded a letter that discussed several similarities between a known Ponzi scheme and Stanford’s operations. Then, on October 10, 2003, the NASD forwarded a letter dated September 1, 2003, from an anonymous Stanford insider to the SEC’s Office of Investor Education and Advocacy, which stated, in pertinent part:

STANFORD FINANCIAL IS THE SUBJECT OF A
LINGERING CORPORATE FRAUD SCANDAL
PERPETUATED AS A “MASSIVE PONZI SCHEME”
THAT WILL DESTROY THE LIFE SAVINGS OF
MANY; DAMAGE THE REPUTATION OF ALL
ASSOCIATED PARTIES, RIDICULE SECURITIES

AND BANKING AUTHORITIES, AND SHAME THE
UNITED STATES OF AMERICA.

Our investigation found that while this letter was minimally reviewed by various Enforcement staff, the Enforcement group decided not to open an investigation or even an inquiry into the complaint. The Enforcement branch chief responsible for the decision explained his rationale as follows:

[R]ather than spend a lot of resources on something that could end up being something that we could not bring, the decision was made to – to not go forward at that time, or at least to – to not spend the significant resources and – and wait and see if something else would come up.

In October 2004, the Fort Worth Examination staff conducted a fourth examination of Stanford Group Company. The examiners once again analyzed the CD returns using data about the past performance of the equity markets and concluded that Stanford Group Company's sales of the CDs violated numerous federal securities laws.

While the Fort Worth Examination group made multiple efforts after each examination of Stanford Group Company to convince the Enforcement group to open and conduct an investigation of Stanford, we found that the Enforcement group made no meaningful effort to investigate the potential fraud or to consider an action to attempt to stop it until late 2005. In 1998, the Enforcement group opened a brief inquiry, but then closed it after only three months, when Stanford failed to produce documents evidencing fraud in response to a voluntary document request. In 2002, no investigation was opened even after the examiners specifically identified in an examination report multiple violations of securities laws by Stanford. In 2003, after receiving the three separate complaints about Stanford's operations, the Enforcement group decided not to open up an

investigation or even an inquiry, and did not follow up to obtain more information about the complaints.

In late 2005, after a change in leadership in the Enforcement group and in response to the continuing pleas by the Fort Worth examiners, who had been watching the potential fraud grow in examination after examination, the Enforcement group finally agreed to seek a formal order from the Commission to investigate Stanford. However, even at that time, the Enforcement group missed an opportunity to have the SEC bring an action against Stanford Group Company for its admitted failure to conduct any due diligence regarding Stanford's investment portfolio. Such an action could have potentially halted the sales of the Stanford International Bank CDs through the Stanford Group Company investment adviser, and would have provided investors and prospective investors with notice that the SEC considered Stanford Group Company's sales of the CDs to be fraudulent. We found that this particular action was not considered, partially because the new head of the Enforcement group in Fort Worth was not aware of the findings of the Investment Adviser group's examinations in 1998 and 2002, or even that Stanford Group Company had registered as an investment adviser, a fact she learned for the first time in the course of our investigation in January 2010.

We did not find that the reluctance of the SEC's Fort Worth Enforcement group to investigate Stanford was related to any improper professional, social or financial relationship on the part of any current or former SEC employee. We found evidence, however, that SEC-wide institutional influence did factor into the Enforcement group's repeated decisions not to undertake a full and thorough investigation of Stanford, notwithstanding staff awareness that the potential fraud was growing. We found that

senior Fort Worth officials perceived that they were being judged on the numbers of cases they brought, so-called “stats,” and communicated to the Enforcement staff that novel or complex cases were disfavored. As a result, cases like Stanford, which were not considered “quick-hit” or “slam-dunk” cases, were not encouraged.

We also found that a former head of Enforcement in Fort Worth, who played a significant role in multiple decisions over the years to quash investigations of Stanford, sought to represent Stanford on three separate occasions after he left the Commission, and in fact, represented Stanford briefly in 2006 before he was informed by the SEC Ethics Office that it was improper for him to do so.

Our investigation revealed that this individual while working at the SEC was responsible for decisions: (1) in 1998 to close an inquiry opened regarding Stanford after the 1997 examination; (2) in 2002, in lieu of responding to a complaint or investigating the issues it raised, to forward it to the Texas State Securities Board; (3) also in 2002, not to act on the Examination staff’s referral of Stanford for investigation after its Investment Adviser examination; (4) in 2003, not to investigate Stanford after a complaint was received comparing Stanford’s operations to a known fraud; (5) also in 2003, not to investigate Stanford after receiving a complaint from an anonymous insider alleging that Stanford was engaged in a “massive Ponzi scheme;” and (6) in 2005, to summarily inform senior Examination staff after a presentation was made on Stanford at a quarterly summit meeting that Stanford was not a matter they planned to investigate.

Yet, in June 2005, a mere two months after leaving the SEC, this former head of the Enforcement group in Fort Worth e-mailed the SEC Ethics Office that he had been “approached about representing [Stanford] . . . in connection with (what appears to be) a

preliminary inquiry by the Fort Worth office.” He further stated, “I am not aware of any conflicts and I do not remember any matters pending on Stanford while I was at the Commission.”

After the SEC Ethics Office denied the former head of Enforcement in Fort Worth’s June 2005 request, in September 2006, Stanford retained this individual to assist with inquiries Stanford was receiving from regulatory authorities, including the SEC. The former head of Enforcement in Fort Worth met with Stanford Financial Group’s General Counsel in Stanford’s Miami office and billed Stanford for his time on this representation. In late November 2006, he called his former subordinate, the Assistant Director working on the Stanford matter in Fort Worth, who asked him during the conversation, “[C]an you work on this?,” and in fact told him, “I’m not sure you’re able to work on this.” After this call, the former head of Enforcement in Fort Worth belatedly sought permission from the SEC’s Ethics Office to represent Stanford. The SEC Ethics Office replied that he could not represent Stanford for the same reasons given a year earlier and he discontinued his representation.

In February 2009, immediately after the SEC sued Stanford, this same former head of Enforcement in Fort Worth contacted the SEC Ethics Office a third time about representing Stanford in connection with the SEC matter – this time to defend Stanford against the lawsuit filed by the SEC. An SEC Ethics official testified that he could not recall another instance in which a former SEC employee contacted the Ethics Office on three separate occasions trying to represent a client in the same matter. After the SEC Ethics Office informed the former head of Enforcement in Fort Worth for a third time that he could not represent Stanford, he became upset with the decision, arguing that the

matter pending in 2009 “was new and was different and unrelated to the matter that had occurred before he left.” When asked during our investigation why he was so insistent on representing Stanford, he replied, “Every lawyer in Texas and beyond is going to get rich over this case. Okay? And I hated being on the sidelines.”

Based upon this evidence, our investigation determined that the former head of Enforcement in Fort Worth’s representation of Stanford appeared to violate state bar rules that prohibit a former government employee from working on matters in which that individual participated as a government employee.

In summary, our report of investigation concluded overall that the SEC’s Fort Worth office was aware since 1997 that Stanford was likely operating a Ponzi scheme after conducting examination after examination for a period of eight years, but merely watched the alleged fraud grow, and failed to take any action to stop it.

Recommendations of the OIG’s Stanford Report of Investigation

We provided our Report of Investigation on the SEC’s handling of the Stanford matter to the Chairman of the SEC on March 31, 2010. We recommended that the Chairman carefully review the Report’s findings and share with Enforcement management the portions of the Report that related to the performance failures by those employees who still work at the SEC, so that appropriate action (which may include performance-based action, if applicable) would be taken, on an employee-by-employee basis, to ensure that future decisions about when to open an investigation and when to recommend that the Commission take action are made in a more appropriate and timely manner.

We also made numerous recommendations to improve the operations of several divisions and offices within the SEC. Specifically, we recommended that:

- (1) Enforcement ensure that the potential harm to investors if no action is taken is considered as a factor when deciding whether to recommend an enforcement action, including consideration of whether this factor, in certain situations, outweighs other factors such as litigation risk;
- (2) Enforcement emphasize the significance of bringing cases that are difficult, but important to the protection of investors, in evaluating the performance of an Enforcement staff member or a regional office;
- (3) Enforcement consider the significance of the presence or absence of United States investors in determining whether to open an investigation or recommend an enforcement action that otherwise meets jurisdictional requirements;
- (4) There be improved coordination between the Enforcement and OCIE on investigations, particularly those investigations initiated by an OCIE referral to Enforcement;
- (5) Enforcement re-evaluate the factors utilized to determine when referral of a matter to state securities regulators, in lieu of an SEC investigation, is appropriate;
- (6) There be additional training of Enforcement staff to strengthen their understanding of the laws governing broker-dealers and investment advisers; and
- (7) Enforcement emphasize the need to coordinate with the Office of International Affairs and the Division of Risk, Strategy, and Financial Innovation, as appropriate, early in the course of investigations.

We also referred our Report of Investigation to the Commission's Ethics Counsel for referral to the Bar Counsel offices in the two states in which the former head of Enforcement in Fort Worth was admitted to practice law.

Follow-up on Recommendations

My Office is committed to following up with respect to all of the recommendations made in our Stanford report to ensure that appropriate changes and improvements are made in the SEC's operations as a result of our findings. We are aware that many improvements have already been undertaken under the direction of Chairman Schapiro and Enforcement Director Khuzami as a result of the findings and many recommendations we made as a result of our Madoff investigation. We note that Enforcement has indicated that it has taken action on the recommendations of our Stanford report, and we are in the process of reviewing those actions to ensure that they are adequate and fully address the OIG's concerns. We are confident that under Chairman Schapiro's leadership, the SEC will carefully take the appropriate steps to implement fully our Stanford recommendations and ensure that fundamental changes are made in the SEC's operations so that the errors and failings we found in our investigation are properly remedied and not repeated in the future.

Similarities to Failures in the Madoff Matter

While my Office has not conducted any formal analysis of similarities between the findings in our Madoff and Stanford reports, we have identified some striking parallels between the two situations. First, in both cases, the SEC received credible and substantive complaints about possible fraud, but failed to follow up appropriately on these complaints. Second, in both the Madoff and Stanford matters, the SEC had in its

possession ample evidence of potential fraud, which should have triggered thorough and comprehensive Enforcement investigations and actions. Third, and most unfortunately, in both situations, prompt and effective action on the part of the SEC could have potentially uncovered fraud and prevented investors from losing billions of dollars.

Our Office intends to remain vigilant to ensure that the SEC benefits from the lessons learned as a result of its failures in both these cases and makes the necessary improvements to ensure that such failures do not occur again in the future.

Conclusion

In conclusion, I appreciate the interest of the Chairman, the Ranking Member and the Committee in the SEC and my Office and, in particular, in the facts and circumstances pertinent to our Stanford report. I believe that the Committee's and Congress's continued involvement with the SEC is helpful to strengthen the accountability and effectiveness of the Commission. Thank you.