Written Testimony of H. David Kotz
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Securities and Exchange Commission

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the Committee on Financial Services,
U.S. House of Representatives

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Introduction

Thank you for the opportunity to testify before this Committee on the subject of "The Stanford Ponzi Scheme: Lessons for Protecting Investors from the Next Securities Fraud." I appreciate the interest of the Chairman, the Ranking Member, and the other members of the Subcommittee, 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 OIG is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. The SEC OIG 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 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 three 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 reports have included an examination of the Commission's oversight of Bear Stearns and the factors that led to its collapse, an audit of the Division of Enforcement's (Enforcement) practices related to naked short selling complaints and referrals, a review of the SEC's bounty program for whistleblowers, an analysis of the SEC's oversight of credit rating agencies, and audits of the SEC's real property and leasing procurement process, compliance with Homeland Security Presidential Directive 12, and oversight of the Securities Investment Protection Corporation's activities. In addition, following the OIG's investigative report related to the Madoff Ponzi scheme described below, we performed three comprehensive reviews providing the SEC with 69 specific and concrete recommendations to improve the

operations of both Enforcement and the SEC's 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, Members of Congress, 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, post-employment violations, unauthorized disclosure of nonpublic information, procurement violations, 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 compensatory time for travel, abusive conduct and the misuse of official position and government resources.

As noted above, 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. In March 2010, 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) $8 billion alleged Ponzi scheme.

Commencement of the OIG's Stanford Investigation

On October 13, 2009, we opened an investigation into the handling of the SEC's investigation into Robert Allen Stanford and his various companies, including the history and conduct of all the SEC's investigations and examinations regarding Stanford. Between October 13, 2009 and February 16, 2010, our 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 Fort Worth 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 Enforcement 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 concerning 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 all the witnesses in this investigation.

Specifically, we conducted on-the-record and under oath testimony of 28 individuals, including all 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, SEC examiner Julie Preuitt, who is a witness in this hearing,

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, Ms. Preuitt and the examination team concluded that Stanford International Bank's statements promoting the CDs appeared to be misrepresentations. They 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.

Ms. Preuitt 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 for examinations, the Fort Worth Broker-Dealer Examination group characterized its conclusion from the 1997 examination of Stanford Group Company as "Possible misrepresentations. Possible Ponzi scheme." We found in our investigation that the Examination staff determined in 1997, as a result of

their findings, that an investigation of Stanford by the 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 Ms. Preuitt 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 came to the same conclusions as the broker-dealer examination, finding very suspicious Stanford's "extremely high interest rates and extremely generous compensation" in the form of annual recurring referral fees, and the fact that Stanford Group Company was so "extremely dependent upon that compensation to conduct its day-to-day operations."

In November 2002, the 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 did not match up 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 in the complaint.

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 Assistance (OIEA), 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. 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 Examination staff conducted its 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, and particularly Ms. Preuitt, made multiple efforts after each examination to convince the Enforcement group to open and conduct an investigation of Stanford, we found that no meaningful effort was made by the Enforcement group to investigate the potential fraud 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 Ms. Preuitt and the Fort Worth Examination group, 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 bring an action against Stanford Group Company for its admitted failure to conduct any due diligence regarding Stanford's investment portfolio, which could have potentially completely stopped 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 in the investment advisers' 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 on the part 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 within the Enforcement group did factor into its 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. Specific testimonial evidence obtained in our investigation showed that, as a result of this emphasis on "stats," cases that were not considered "quick-hit" or slam-dunk" cases were discouraged. The OIG investigation concluded that because Stanford "was not going to be a quick hit," it was not considered to be as high a priority as other, easier cases.

The OIG also found that the 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.

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) 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 bluntly inform senior Examination staff after a presentation was made on Stanford at a quarterly summit meeting that Stanford was not a matter the Enforcement group 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 occasion on 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."

Thus, our investigation found 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.

Recommendations of the OIG's Stanford Report of Investigation

We provided our Report of Investigation on Stanford to the Chairman of the SEC with the recommendation that the Chairman carefully review its 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 bring 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 bring 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.

OIG Follow-up Efforts and Subsequent Audit

We have followed up with Enforcement and OCIE regarding the recommendations to improve operations that we made in our Stanford report. All of these recommendations have been implemented and closed to our satisfaction.

In addition, in response to the request of former Chairman of the Senate Banking Committee, the Honorable Christopher Dodd (D - Connecticut), we recently completed an audit of the process by which OCIE refers examination results to Enforcement in all of the SEC's regional offices to determine if the concerns about the Fort Worth Regional Office found in the Stanford report also existed in other SEC regional offices.

Our audit found that examiners across the SEC regional offices are generally satisfied with their Enforcement attorney counterparts. For example, we found through a survey of all OCIE examiners throughout the SEC's regional offices that most survey respondents indicated that they are either "completely satisfied" or "somewhat satisfied" with actions taken by Enforcement in response to examination-related referrals. We further found that where there was dissatisfaction with the referral process, the level of concern dramatically dropped over time and particularly in fiscal year 2010, with some respondents identifying the newly-created Asset Management Unit in Enforcement as having significantly assisted with the acceptance rate of OCIE referrals. We also found that the large majority of examiners do not believe that Enforcement will only take referrals that involve high dollar value amounts and cases that can easily be brought against the violator. In addition, many of the survey participants who indicated that they did believe that Enforcement was particularly concerned with dollar thresholds or "stats" noted that this approach was more evident in the past, i.e., "prior to Madoff."

Our audit did find that certain aspects of the referral process that could be improved. We found that OCIE sometimes presented referrals informally to Enforcement prior to proceeding with the formal referral process. As a result, there was a concern that not all referral-worthy matters may be recorded and tracked. We also found that internal

concerns over incentives and metrics with regard to the percentage of OCIE referrals being accepted by Enforcement may have led OCIE senior officials to request that a particular referral not be recorded in the Tips, Complaints, and Referrals (TCR) system to avoid the risk of having large numbers of outstanding referrals. Additionally, we noted that the level of communication between OCIE and Enforcement after a referral is not always consistent in the regional offices. We made seven additional recommendations to address the areas of improvement identified and are currently following up to ensure that these recommendations are implemented.

Results of an Investigation of Retaliatory Personnel Actions

In September 2009, we completed another investigation involving the SEC's Fort Worth office and Ms. Preuitt. In this investigation, we found that Ms. Preuitt and a former colleague in the SEC's Fort Worth office voiced their differences about programmatic issues at a planning meeting concerning management's initiative to begin conducting a certain type of examination. Shortly thereafter, Ms. Preuitt's supervisor called her into several meetings and admonished Ms. Preuitt for her opposition to the office's examination initiative. A few months later, Ms. Preuitt's supervisor issued her a letter of reprimand for, among other things, her efforts to undermine management's authority and frustrate the implementation of the new examination initiative. Shortly thereafter, Ms. Preuitt was involuntarily transferred to non-supervisory duties.

Ms. Preuitt's former colleague, who also voiced opposition to the new examination initiative, complained to senior management at SEC headquarters about the new initiative and about the treatment of Ms. Preuitt. Shortly after he sent his complaint, he was issued a performance counseling memorandum for, among other things, being

openly adversarial toward key examination goals. Less than a month later, the colleague was issued a letter of reprimand, for, among other things, discussing purported "unfounded and inaccurate allegations" with SEC senior management.

Our investigation concluded that the complaints made both by Ms. Preuitt and her colleague improperly led to actions being taken against them. We found that it was improper for Fort Worth management to take action against employees for voicing opposition to a program initiative and for bringing complaints to senior SEC management. Based upon our investigative findings, we recommended the consideration of performance-based or disciplinary action against two Fort Worth senior management officials.

Conclusion

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