

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



**Before the Subcommittee on Oversight and
Investigations, Committee on Financial Services
U.S. House of Representatives**

**Monday July 13, 2009
2:00 p.m.**

Introduction

Good afternoon. Thank you for the opportunity to testify today before this Subcommittee on the subject of “Preventing Unfair Trading by Government Officials” 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. 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 the oversight efforts we have undertaken during the past year. 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 Office of Audits 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.

Over the past year, we have issued numerous audit reports involving issues critical to SEC operations and the investing public, including 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, and providing a detailed examination of the adequacy of the Commission's monitoring of Bear Stearns, including the factors that led to its collapse. In the past few months, we have also completed audits of the \$178 million in disgorgement waivers that the SEC Division of Enforcement (Enforcement) granted between October 2005 and May 2008, and Enforcement's practices and procedures for responding to and processing naked short selling complaints. We anticipate issuing several additional audit reports in the next few months, including a comprehensive analysis of the SEC's oversight of the Nationally Recognized Statistical Rating Organizations.

Our Office of Investigations examines 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 Office of Investigations 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 (FBI) as appropriate.

Several of these investigations conducted by our staff have 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 removals. Specifically, over the past year and a half, we have issued investigative reports regarding, inter alia, claims of improper preferential treatment given to prominent persons, retaliatory termination, the Division of Enforcement's failures to pursue Enforcement investigations vigorously or in a timely manner, perjury by supervisory Commission attorneys, misrepresentation of professional credentials, falsification of personnel forms, lack of impartiality in the performance of official duties, unauthorized disclosure of non-public information related to an Enforcement investigation, and the misuse of official position, government resources and official time.

In addition to the work I just described, we are conducting a wide-ranging investigation and evaluation of matters related to Bernard Madoff and affiliated entities. We have made substantial progress in our investigation and plan to issue shortly a comprehensive investigative report detailing all the examinations and investigations that the SEC conducted of Madoff or Madoff-related entities from 1992 until the present, and analyzing the reasons why the SEC did not uncover the Madoff Ponzi scheme, notwithstanding these examinations and investigations. We have already interviewed over 100 witnesses and reviewed millions of e-mails and documents in connection with these investigative efforts. We also plan to issue two additional reports providing specific and detailed recommendations for improvement of both the SEC's Division of

Enforcement and the Office of Compliance Inspections and Examinations, which will incorporate the findings from our investigative report.

The Investigation of the Securities Transactions of Enforcement Attorneys

It is with this background in mind that I wish to discuss an investigation that we recently concluded relating to the securities transactions of two SEC Enforcement attorneys over a two-year period. Our office received information from the SEC's Ethics Office that a particular Enforcement attorney was trading securities very frequently. As we began investigating this Enforcement attorney's trading activity, we identified another Enforcement attorney who was a friend of this individual and with whom the first attorney often discussed securities transactions and open Enforcement investigations during regular weekly lunches and via e-mail.

We conducted a year-long investigation of these Enforcement attorneys, which encompassed a comprehensive review and analysis of more than two years of brokerage records, ethics filings, securities transaction filings, and e-mail records. We also took sworn, on-the-record testimony of numerous SEC Enforcement attorneys, and conducted interviews of several other SEC staff members.

On March 3, 2009, we issued our report of investigation to the agency. Our investigation revealed suspicious conduct, appearances of improprieties, and evidence of possible trading based on non-public information on the part of the two SEC Enforcement attorneys. Because of the seriousness of the information that our investigation uncovered, we referred the matter to the United States Attorney's Office of the District of Columbia's Fraud and Public Corruption Section, which, together with the FBI, is conducting an investigation of possible criminal and civil violations. Because this

joint U.S. Attorney/FBI investigation is ongoing, I am somewhat limited in my ability to discuss the details of this matter.

In addition to the suspicions of insider trading, our investigation found that the Enforcement attorneys committed numerous violations of the SEC's securities reporting requirements. For example, although SEC rules require employees to file a notification form within five business days of the purchase or sale of every security, these Enforcement lawyers failed to file these forms for certain transactions. Moreover, although the Office of Government Ethics (OGE) Form 450 requires the reporting of an employee's security holdings with a value greater than \$1,000 at the end of each calendar year or that generated income of more than \$200 during the year, the Enforcement attorneys failed to report certain transactions or earnings that were over these limits on their OGE Form 450s during the two-year period we reviewed during our investigation. We also found that the one of the Enforcement attorneys failed to clear numerous stock transactions through an agency database prior to purchasing stocks.

Our investigation further found generally that, although the SEC is charged with prosecuting cases of violations of the federal securities laws, including the investigation and prosecution of insider trading on the part of individuals and companies in the private sector, the SEC had essentially no compliance system in place to ensure that its own employees, with tremendous amounts of non-public information at their disposal, did not engage in insider trading themselves. The existing disclosure requirements and compliance system were based on the honor system, and there was no way to determine if an employee failed to report a securities transaction as required. No spot checks were conducted, and the SEC did not obtain duplicate brokerage account statements. In

addition, there was little to no oversight or checking of the reports that employees filed to determine their accuracy or even whether an employee had reported at all. Moreover, different SEC offices received the various types of reports and did not routinely share that information with each other.

We also found a poor understanding and lax enforcement of the securities transaction reporting requirements. For example, both of the Enforcement attorneys whose trading we investigated testified that no one had ever questioned their reported securities holdings or transactions in the decades they worked at the SEC and traded securities. Moreover, both managers who were responsible for reviewing these attorneys' annual OGE Form 450s testified that they did not recall ever questioning any SEC employees with respect to their reported securities holdings. In addition, we found that the Enforcement attorneys and supervisors who provided information during our investigation lacked a basic understanding of the requirements in place that govern Commission employees' reporting of securities transactions.

Our investigation also found that Enforcement personnel, both managers and staff, had different interpretations of the confidentiality policy regarding Enforcement investigations and whether they could discuss their investigative matters with one another. We found that the Enforcement attorneys we investigated routinely discussed stocks and investment strategies in e-mails and in public. They maintained separate folders entitled, "Stocks," in their SEC e-mail accounts and, on most days, sent e-mails from those accounts about stocks and their own stock transactions. We discovered that one of the Enforcement attorneys traded often, and even testified that the financial markets were her main hobby and passion. We found that this attorney spent much of her

work day e-mailing her co-workers about various stocks. We also found that these Enforcement attorneys shared many of the same investments and had regular weekly lunch meetings where they often discussed the stock market, their own securities transactions, and their SEC work and investigative cases.

Our investigation also disclosed that one of the Enforcement attorneys sent e-mails to his brother and sister-in-law from his SEC e-mail account during the work day recommending particular stocks, and sometimes informing them that the other Enforcement employee had recommended those stocks as well.

Our report recommended that the SEC take disciplinary action against the two Enforcement attorneys who we found violated the SEC's securities transactions requirements. We also provided the Commission with 11 specific recommendations to ensure adequate monitoring of employees' future securities transactions. These recommendations included establishing one primary office to monitor employees' securities transactions; instituting an integrated, computerized system for tracking and reporting purposes; obtaining duplicate copies of brokerage record confirmations for each securities transaction for every SEC employee; requiring employees to certify in writing that they do not have non-public information related to each security transaction they conduct and report; ensuring that the forms SEC employees are required to file are checked with the existing database; requiring SEC employees' supervisor to review a list of pending cases to compare with a list of the securities reported by the employees; conducting regular and thorough spot checks for compliance purposes; developing a clear, written policy on the confidentiality of Enforcement investigations; and

establishing comprehensive and more frequent training on all aspects of the SEC's rules regarding employees' securities transactions.

SEC Response to the OIG's Report of Investigation

Our investigation underscored the need for the SEC to revamp completely its current process for monitoring SEC employees' securities transactions. In response to our report, on May 22, 2009, SEC Chairman Mary Schapiro announced that the SEC would be taking measures to address the problems we identified. These measures include drafting a new set of internal rules governing securities transactions for all SEC employees that will require pre-clearance of all trades and, for the first time, prohibit staff from trading in the securities of companies under SEC investigation regardless of whether the employee has personal knowledge of the investigation. Chairman Schapiro also announced that the SEC was contracting with an outside firm to develop a computer compliance system to track, audit and oversee employees' securities transactions and financial disclosure in real time. Chairman Schapiro further stated that she signed an order consolidating responsibility for oversight of employees' securities transactions and financial disclosure reporting within the Ethics Office and authorized the hiring of a Chief Compliance Officer.

The OIG is pleased that the SEC is planning to take concrete steps to address the serious issues identified by our investigation. These steps, if implemented, would satisfy the concerns raised in our report, and would even, in a few instances, go beyond the OIG's recommended actions. We plan to scrutinize carefully the new processes and system that the SEC intends to implement to ensure that they operate effectively and as planned.

Concluding Remarks

In conclusion, we appreciate the Subcommittee's interest in the SEC and our Office. I believe that the Committee's and Congress's involvement with the SEC is beneficial to strengthen the accountability and effectiveness of the Commission. Thank you.