

Written Testimony of H. David Kotz

**Before the TARP, Financial Services and Bailouts of
Public and Private Programs Subcommittee of the
Committee on Oversight and Government Reform
U.S. House of Representatives**

**Tuesday April 17, 2012
10:00 a.m.**

Introduction

Thank you for the opportunity to testify before this Subcommittee on the subject of “The SEC’s Aversion to Cost-Benefit Analysis.” I served as the Inspector General for the Securities and Exchange Commission (SEC) from December 2007 through January 2012. I am currently the Managing Director of a private investigations firm called Gryphon Strategies. In my testimony, the views that I express are not necessarily reflective of the views of the Commission or any Commissioners.

Office of Inspector General Reports on Cost-Benefit Analyses

Prior to my leaving the SEC, on January 27, 2012, my former office issued a report entitled, “Follow-up Review of Cost-Benefit Analyses in Selected Dodd-Frank Act Rulemakings.” This report was the second report my former office issued relating to cost-benefit analyses conducted by the SEC for Dodd-Frank rulemakings. On June 13, 2011, my former office released a report in response to a May 4, 2011 letter from several members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requesting a review of the cost-benefit analyses performed by the SEC in connection with six specific rulemaking initiatives pursuant to the Dodd-Frank Act.

In the June 13, 2011 report, we concluded that the SEC had conducted a systematic cost-benefit analysis for each of the six rules, but found that the level of involvement of the Division of Risk, Strategy and Financial Innovation (RiskFin) varied considerably from rulemaking to rulemaking. We decided to issue a follow-up report in which we could examine in greater detail the cost-benefit analyses the SEC performed and retained an expert, Dr. Albert S. Kyle to assist with our review.

In the follow-up review, our objectives were to assess whether the SEC was

performing cost-benefit analyses for rulemaking initiatives that were statutorily required under the Dodd-Frank Act in a consistent manner and determine whether problematic areas existed where rigorous cost-benefit analyses were not performed and where improvements were needed and best practices could be identified to enhance the overall methodology used to perform cost-benefit analyses.

In the follow-up review which culminated in the January 27, 2012 report, we found that although the SEC is not subject to an express statutory requirement to conduct cost-benefit analyses for its rulemakings, it is subject to statutory requirements to consider factors such as the effects on competition and the needs of small entities. We further found that the SEC must generally also provide the public with notice of and opportunity to comment on its rulemakings. Moreover, SEC Chairmen previously committed to Congress that the SEC would conduct cost-benefit analyses in connection with its rulemaking activities, and it has consistently performed such analyses in its rulemakings. According to senior SEC management, the SEC shares the goals of and adheres to many of the requirements of executive orders that call for executive agencies to perform cost benefit analyses for rulemakings, and SEC staff use internal compliance guidance that provides a detailed overview and an extensive list of best practices for use by SEC rulemaking divisions and offices in preparing cost-benefit analyses.

In the course of the review, we learned that when questions arose in 2010 about the extent to which cost-benefit analyses should be conducted for Dodd-Frank Act rulemakings, rulemaking teams and RiskFin consulted with the then-SEC General Counsel. On September 27, 2010, following these consultations, the former General Counsel, in a memorandum to rulemaking teams and RiskFin, advised the following

approach with respect to which rulemakings or portions of rulemakings should discuss and quantify costs and benefits:

Where the Commission has a degree of discretion, the release should identify the discretion the Commission is exercising, the choices being made, and the rationale for those choices. To the extent that the Commission is exercising discretion, the release should discuss the costs and benefits of the choices proposed or adopted, including where possible, a quantification of the costs and benefits. With respect to those choices made by Congress, the release generally should cite to the legislative record to support and explain the benefits Congress intended by enacting the provision, but only as a matter of citation and not as a matter of assertion by the Commission.

Where the Commission has no discretion, the release should say so. Because the Commission is making no policy choices, there are no choices to analyze or explain.

We found that the approach articulated by the former General Counsel dovetailed with the approach utilized by the SEC rulemaking teams in the cost-benefit analyses we reviewed. For example, the introduction to the cost-benefit analysis section of the adopting release for the Shareholder Approval of Executive Compensation and Golden Parachute Compensation Rule stated the following: “The discussion below focuses on the costs and benefits of the amendments made by the Commission to implement the Act within its permitted discretion, rather than the costs and benefits of the Act itself.”

The January 27, 2012 report describes how pursuant to Office of Management and Budget (OMB) guidance, a cost-benefit analysis is intended to inform the public and other parts of the government, including Congress and the regulating entity itself, of the effects of alternative regulatory actions. This OMB guidance also specifies that agencies should establish a baseline for use in defining the costs and benefits of alternative regulatory actions and the baseline will be a no-action or pre-statute baseline.

We found that to the extent that the SEC performs cost-benefit analyses only for discretionary rulemaking activities without a pre-statute baseline, the SEC may not be providing a full picture of whether the benefits of a regulatory action are likely to justify its costs and which regulatory alternatives would be the most cost-effective.

The report examined two Dodd-Frank Act rulemakings that considered only the costs and benefits of discretionary components and did not establish a pre-statute baseline. In the first example, the Shareholder Approval of Executive Compensation and Golden Parachute Compensation rulemaking, we found that the SEC's cost-benefit analysis was confined to the costs and benefits of the provisions that went beyond the requirements of the Act. The SEC's cost-benefit analysis did not discuss the costs and benefits of "say-on-pay" votes, frequency votes or disclosures and votes on golden parachute compensation that are mandated by the Dodd-Frank Act. Similarly, in the rulemaking related to Issuer Review of Assets in Offerings of Asset-Backed Securities, we found that the SEC cost-benefit analysis did not discuss the costs and benefits of the requirement for issuers to perform a review of the underlying assets and disclose the nature of the review. The report explained that had the SEC analysis included a calculation of the costs of the mandatory provisions of the rulemaking, both Congress and the public might use this information to consider whether to seek to repeal or weaken the mandatory provisions.

In addition, based on an examination of several Dodd-Frank Act rulemakings, the review found that the SEC sometimes used multiple baselines in its cost-benefit analyses that were ambiguous or internally inconsistent. For example, in the SEC's interim final temporary rule for registration of municipal advisors, portions of the cost-benefit analysis

assumed as a baseline a minimal registration process that would allow municipal advisors to continue their usual activities with limited disruption. However, other parts of the cost-benefit analysis assumed that municipal advisors would be required to cease their advisory activities in the absence of a registration process, resulting in a shutdown of the municipal advisory market. The review also found that there was often considerable overlap between the cost-benefit analyses and efficiency, competition, and capital formation sections of the releases for Dodd-Frank Act regulations, and that redundancy could be reduced by combining these two sections. Further, we found that some SEC Dodd-Frank Act rulemakings lacked clear, explicit explanations of the justification for regulatory action. The report found that a more focused discussion of market failure in cost benefit analyses would lay out the rationale for regulation more clearly to Congress, the general public, and the SEC itself. Finally, the review found that although some of the SEC's Dodd-Frank Act rulemakings may result in significant costs or benefits to the Commission itself, internal costs and benefits were rarely addressed in the cost-benefit analyses.

Based on the results of our review, the report made several recommendations for improvements to the SEC's practices. These recommendations included: (1) considering ways for economists to provide additional input into cost-benefit analyses of SEC rulemakings to assist in including both quantitative and qualitative information; (2) reconsidering the approach that the SEC only perform cost-benefit analyses for rulemaking activities to the extent that the SEC exercises discretion and considering whether a pre-statute baseline should be used whenever possible; (3) using a single, consistent baseline in the cost-benefit analyses with such baseline being specified at the

beginning of the cost-benefit analysis section; (4) discontinuing the practice of drafting separate cost-benefit analysis and efficiency, competition, and capital formation sections and instead provide a more integrated discussion of these issues in rule releases; (5) directing rulemaking teams to explicitly discuss market failure as a justification for regulatory action in the cost-benefit analysis of each rule; and (6) including internal costs and benefits in the cost-benefit analyses of rulemakings.

SEC management concurred with all but one of the report's recommendations and indicated that they welcomed the constructive recommendations for improvements to SEC practices contained in the January 27, 2012 report. While I left the Commission shortly after the report was issued, I understand that the SEC has taken steps to implement the report's recommendations.

Conclusion

In conclusion, I appreciate the interest of the Chairman, the Ranking Member, and the Subcommittee in my former Office's report and in the cost-benefit analyses conducted by the SEC. 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.

H. David Kotz

H. David Kotz joined Gryphon Strategies in January 2012 after serving for four years as the Inspector General for the Securities and Exchange Commission (SEC). Kotz heads Gryphon's Washington, D.C. office, where he uses his experience in leading complex internal investigations and audits to focus on corporate fraud investigations, litigation support and a variety of other investigative matters.

Under Kotz's leadership, the SEC Office of Inspector General issued numerous investigative and audit reports involving issues critical to SEC operations and the investing public. In 2008, Kotz led a team examining the SEC's oversight of Bear Stearns and the factors that led to its collapse and issued a comprehensive report that was cited on numerous occasions by Congress in its work to determine the causes of the financial crisis and led to significant legislation being enacted including the Dodd Frank Wall Street Reform and Protection Act. Other audits he led, included an assessment of practices related to naked short selling complaints and referrals, an analysis of the SEC's oversight role over credit rating agencies and a review of the SEC's whistleblower/bounty program.

In August 2009, Kotz issued a 457-page report of investigation (with over 500 exhibits) analyzing the reasons that the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. The investigation was conducted in 9 months by Kotz and a small team who reviewed approximately 3.7 million e-mails, thousands of pages of documentary evidence and interviewed 122 individuals (including an interview of Bernard Madoff himself while he was in the New York Correctional facility.)

Two other examples of the many high-profile reports issued by Kotz were a 151-page report of investigation issued in March 2010 regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's \$7 billion Ponzi scheme and an investigation report issued in May 2011, into the circumstances surrounding the SEC's decision to lease approximately 900,000 square feet of office space at a newly-renovated office building known as Constitution Center at a cost of over \$500 million.

Prior to joining the SEC, Kotz served as the Inspector General for the Peace Corps. In that capacity, Kotz was responsible for overseeing the internal operations of Peace Corps programs in Washington, D.C., at 11 regional offices, and in nearly 70 countries around the world. While at the Peace Corps, Kotz led the investigation and prosecution of all violent crimes against Peace Corps Volunteers, achieving numerous prosecutions of rape and sexual assault cases all around the world and undertaking several high-profile investigations of missing or deceased Volunteers. During his tenure as Inspector General at the Peace Corps, Kotz also served as Inspector General on a part-time basis for the U.S. Commission on Civil Rights (USCCR) from July 2006 until March 2007, assisting the USCCR in developing and evaluating internal policies and procedures as recommended by the Government Accountability Office (GAO).

Before being named Inspector General for the Peace Corps, Kotz served for over three years as Associate General Counsel for Litigation for the Peace Corps and was responsible for overseeing

all agency litigation, including administrative and Federal court proceedings, labor arbitrations and employee grievances.

Kotz is a graduate of the University of Maryland, completing a Bachelor's of Arts degree in political science with the honors of cum laude and Phi Beta Kappa. After graduating from the Cornell Law School in 1990, he worked for nearly 10 years for the international law firms of Graham & James in New York City and Pepper Hamilton LLP in Washington, D.C. While working in private practice, Kotz represented Fortune 500 companies in commercial litigation matters and successfully defended large N.Y. companies in complex enforcement proceedings brought by the U.S. Department of Justice. He also successfully represented Universities and Fortune 500 companies in racial and gender discrimination, sexual harassment, hostile environment, retaliation, and other EEO proceedings in state and federal court.

Fax Cover Sheet

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Name: H. David kotz

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None

2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

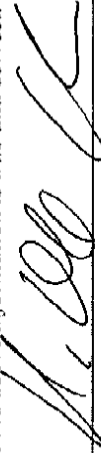
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