

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

In the Matter of: )  
 ) File No. OIG-509  
OIG-509 )



WITNESS: Number 28  
PAGES: 1 through 42  
PLACE: Securities and Exchange Commission  
100 F Street, Northeast  
Washington, D.C. 20549  
DATE: Tuesday, April 21, 2009

The above-entitled matter came on for hearing,  
pursuant to notice, at 12:45 p.m.

Diversified Reporting Services, Inc.

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1 APPEARANCES:

2

3 On behalf of the Securities and Exchange Commission:

4

5 APPEARANCES:

6

7 On behalf of the Securities and Exchange Commission:

8 H. DAVID KOTZ, Inspector General

9 HEIDI STEIBER, Investigator

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23 On behalf of the Witness:

24 STEWART MAYHEW, PRO SE

25

P R O C E E D I N G S

1  
2 MR. KOTZ: We are on the record at 12:45 p.m. It  
3 is April 21, 2009 at the United States Securities and  
4 Exchange Commission Office of Inspector General.

5 I am going to swear you in.

6 Whereupon,

7 STEWART MAYHEW

8 was called as a witness and, having been previously duly  
9 sworn, was examined and testified as follows:

10 EXAMINATION

11 BY MR. KOTZ:

12 Q Can you state and spell your full name for the  
13 record?

14 A Stewart Mayhew. S-t-e-w-a-r-t, M-a-y-h-e-w.

15 Q My name is David Kotz. I am the Inspector General  
16 for the United States Securities and Exchange Commission. I  
17 have my colleagues here with me: David Fielder, David  
18 Witherspoon, and Heidi Steiber. This is an investigation by  
19 the Office of Inspector General, case number OIG-509.

20 I am going to ask you certain questions and you  
21 will have to provide answer under oath. The court reporter  
22 will record and later transcribe everything that is said.  
23 Please provide verbal answers to the questions. A nod of the  
24 head or other non-verbal responses will not be able to be  
25 picked up by the court reporter. So the record will be

1 A January 2000.

2 Q Until when?

3 A I came to visit the SEC in August 2002 and that was  
4 the last time I had lived at Georgia. I severed ties with  
5 the University in, I believe, August 2004. For my first two  
6 years working at the Commission I was a visiting academic  
7 scholar and I still retained a position at the University of  
8 Georgia.

9 Q What was your first position at the SEC in 2002?

10 A Visiting academic scholar, which is a contractor  
11 position. The nature of the position was I was still  
12 officially an employee of the University and worked as an  
13 on-site contractor.

14 Q Which division did you work for as a contractor?

15 A Office of Economic Analysis performing the same  
16 function as a financial economists, but a different title.

17 Q And that was until 2004?

18 A Yes.

19 Q What happened in 2004?

20 A In 2004 I resigned from Georgia and took a position  
21 at the SEC with a permanent contract. At that same time I  
22 was named assistant chief economist in the Office of Economic  
23 Analysis.

24 Q Was that an employee or contractor position at that  
25 time?

1 A That was an employee position.

2 Q Is that still the position you hold today?

3 A No. I am now deputy chief economist.

4 Q When did your position change from assistant chief  
5 economist to deputy?

6 A I believe in July 2008.

7 BY MS. STEIBER:

8 Q Have you written any books about options or  
9 articles about options?

10 A I have not written any books that have been  
11 published. I have written many academic articles that are  
12 published in academic journals on options. Some of them are  
13 option market structure, some of them are on empirical option  
14 pricing, some of them are on volatility estimation. That  
15 would include four articles in the Journal of Finance, which  
16 is probably the premiere journal in the field. Also in  
17 various other journals. Approximately 10 or 11 public  
18 published articles.

19 BY MR. KOTZ:

20 Q Who is your current supervisor?

21 A The chief economist, Jim Overdahl.

22 Q And who was your supervisor in the 2006 and 2007  
23 timeframe before you became the deputy?

24 A Personal Privacy, who was the chief economist at that  
25 time.

1 Q This was for an enforcement case?

2 A He did not tell me that it was an enforcement case.  
3 He said it was questions from the enforcement division.

4 Q So he came to you because of your particular  
5 expertise?

6 A Because of my expertise on options.

7 Q So you were the person in that office who had that  
8 expertise?

9 A Yes.

10 Q You agreed and then what happened after that?

11 A He asked me if I was available to go to a meeting.  
12 I believe the meeting was on May 3rd. The meeting referred  
13 to on this. I told Bill, to the best of my recollection,  
14 that I was unable to make the meeting and I did not go to  
15 that meeting.

16 Q Do you know who that meeting was with?

17 A At the time I assumed that it was with the people  
18 that were cc'd on this email.

19 Q With the folks in New York? Was it a phone call or  
20 a personal meeting?

21 A I do not remember that Bill told me whether D.C. or  
22 New York staff.

23 Q So you could not make the meeting and the meeting  
24 went on without you.

25 A Yes, to the best of my recollection.

1 Q Then what happened?

2 A Then I got this email seen in Exhibit 3 on May 4th.  
3 To the best of my recollection, I spent approximately 20  
4 minutes looking at these attached documents with the goal of  
5 answering a question from Bill as to whether this strategy  
6 would be likely to earn significantly high returns in excess  
7 of a market return.

8 Q And that strategy was Bernard Madoff's strategy?

9 A I presume it was. I was asked to opine as to  
10 whether the strategy described in the attachment, the split  
11 strike forward conversion strategy, could beat the market.  
12 Based on what I read in the email, I presumed that was the  
13 strategy that Madoff was following.

14 Q And what did you conclude after your review?

15 A I concluded that was not a strategy that would be  
16 expected to earn significant returns in excess of the market.

17 Q And that took you 20 minutes to figure out?

18 A Yes. Prior to coming to the Commission I had been  
19 retained as a consultant by an investment advisor in Georgia  
20 who was interested in implementing a strategy similar to, but  
21 not identical to, this split strike forward conversion. I  
22 spent quite a bit of time analyzing that strategy for him and  
23 quite a bit of time trying to convince him that this was not  
24 a magic pill that would beat the market. I had done quite a  
25 bit of work on this basic type of strategy prior to this

1 time.

2 Q Is it fair to say that you concluded that the  
3 strategy that Madoff was purporting to use was not actually  
4 the strategy that he was using?

5 A I was not asked to give an opinion on that. At the  
6 time I did not know anything about Madoff. At the time I was  
7 approached I did not even know that he was involved with  
8 asset management. I knew his reputation as a broker-dealer.

9 Q So all you were asked to do was look at the  
10 attachments to this email from Simona Suh dated May 4, 2006  
11 12:38 p.m. and determine whether the strategy that was  
12 described in these attachments could actually beat the  
13 market?

14 A Yes. I did know that some of the details from the  
15 questions from the enforcement division involved Madoff and  
16 that the claim was that Madoff's returns were extremely high.  
17 I did know the context of the question was Madoff was  
18 claiming to earn high returns with this strategy.

19 Q So you determined that those high returns could not  
20 have been accomplished with this strategy?

21 A Basically, yes.

22 Q You then informed Mr. Dale of that?

23 A Yes.

24 Q And then what happened?

25 A To the best of my recollection I continued to talk

1 with Bill Dale about Madoff in general and described some of  
2 the innovations that he had done earlier with respect to  
3 payment forwarded flow as a broker-dealer. I described him  
4 as very clever, very knowledgeable about how markets worked.

5 Q Why would you provide that information to Mr. Dale?

6 A I provided that information to him because I  
7 thought that there was a chance that if Madoff was earning  
8 extremely high returns, that perhaps it was due to some other  
9 type of clever activity he may be doing involving his  
10 broker-dealer business. Perhaps illegal, but I did not have  
11 any specific ideas about what Madoff may be doing other than  
12 he may be doing something illegal or abusive that would  
13 channel money away from brokerage clients to investment  
14 clients.

15 Q Were you ever made aware of the possibility or the  
16 allegation that Madoff was engaged in a Ponzi scheme?

17 A No.

18 BY MS. STEIBER:

19 Q Did anyone provide you with the Harry Markolopos  
20 complaint?

21 A Not until after the Madoff scandal had broken in  
22 2008.

23 Q So then at that point you read the Harry Markolopos  
24 complaint?

25 A I scanned it quickly when I first received it and

1 then subsequently read it.

2 (SEC Exhibit No. 4 was marked for  
3 identification.)

4 BY MR. KOTZ:

5 Q Let me show you another document. We are going to  
6 mark this as Exhibit 4. This is an email from Simona Suh to  
7 Anthony Vance and you on 5/9/06 at 2:43 p.m. This is five  
8 days after the previous email. Do you remember receiving a  
9 spreadsheet from Peter Lamoore?

10 A I do not recall this email.

11 Q Do you recall doing any additional work other than  
12 the one that you described in your review of the documents  
13 attached to the May 4, 2006 email?

14 A What was the question? Do I recall doing any  
15 additional work? I do not recall doing any additional work.

16 Q I am going to give you a few minutes to look at  
17 that.

18 A Now that I am looking at it I have a very vague  
19 recollection from three years ago of seeing this. I believe  
20 I must have not saved this in my saved documents folder. I  
21 did not notice this when I was reviewing for this meeting.

22 Q But you think you might have actually received this  
23 document?

24 A I probably did because I see my name as listed  
25 here.

1 Q But you are pretty sure that you did not do any  
2 analysis of the spreadsheet?

3 A I am pretty sure that I did not attempt to  
4 compute -- do any more than maybe a cursory analysis. I do  
5 not believe there would be any new insights that I would be  
6 able to gain from doing an analysis of this spreadsheet.

7 Q Do you know if there were any further requests made  
8 of your office from enforcement related to the Madoff matter?

9 A I am not aware of any other requests.

10 Q You provided some information to Mr. Dale and you  
11 followed up giving him some insight about Mr. Madoff's other  
12 operations. Did you have any further communications with Mr.  
13 Dale about that?

14 A I believe I had one follow up conversation in the  
15 hallway asking what happened. He said that he met with them  
16 and provided feedback to them. He did not tell me much  
17 detail beyond that.

18 Q When Mr. Dale said to you that he provided  
19 feedback, he was referring to your analysis of the fact that  
20 the split strike forward conversion strategy as described in  
21 attachment to Simona Suh's May 4, 2006 email could not have  
22 generated those returns?

23 A I assume that he passed on that opinion.

24 Q But he did not indicate to you what happened  
25 subsequently?

1           A     No.

2           Q     Could you go back to Exhibit 3? Can you tell us  
3 what was it exactly in your review of these documents, the  
4 description of split strike conversion forward, as attached  
5 to the May 4, 2006 email from Simona Suh -- what was it that  
6 made you come to that conclusion?

7           A     This is a very easy strategy to implement. Anybody  
8 could implement it. There are certain principals that we  
9 strongly believe as trained financial economists that it is  
10 not easy to beat the market. It is not easy to generate high  
11 returns. In order for a person to generate returns that  
12 consistently beat the market, they need to have some access  
13 to superior information.

14                     Simply following a mechanistic trading strategy  
15 involving securities that anybody could trade, just as a  
16 matter of principal, it cannot be used to consistently beat  
17 the market.

18           Q     And the specific strategy that was described in  
19 this document as the split strike forward conversion strategy  
20 was not a strategy you determined --

21           A     The document here provides only a limited  
22 description of the split strike forward conversion strategy.  
23 It does not provide a complete description of the strategy.  
24 I use the name of the strategy to infer what the strategy was  
25 because it is fairly obvious for someone in option pricing

1 what it would be. Forward conversion strategy is basically  
2 buying a stock or an index, writing a covered call, and  
3 buying a protected put at the same time.

4 Generally, that would be done with call option and  
5 the put option having the same strike price. The effect of  
6 writing a call option and buying a put option is equivalent  
7 to taking the short side of a forward contract. If you are  
8 long on a forward or a stock and short at the same time, the  
9 risk completely cancels out and that is a strategy that has  
10 no risk.

11 If the call and put option prices are incorrect or  
12 not efficient, then you, relative to the stock price, could  
13 do this strategy and lock in an arbitrage profit. There are  
14 so many people out there trying to do this that the prices of  
15 these contracts adjust very quickly and eliminate any profits  
16 from doing that strategy, beyond the transaction costs of  
17 implementing the strategy.

18 Q Is it fair to say that after you reviewed the  
19 documents attached to Simona Suh's May 4, 2006 email you  
20 determined that there had to be another explanation as to how  
21 one could achieve the returns that were described, other than  
22 this strategy?

23 A The answer to that is a little bit complicated.  
24 There are certain strategies that have the characteristic  
25 that I would describe as extreme negative skewness. These

1 are strategies that can go for a long time generating  
2 apparent excess returns, but every period running the risk of  
3 a catastrophe. This type of strategy is one that sometimes  
4 hedge funds follow. When they follow a strategy that has  
5 this type of return pattern they can go for a fairly long  
6 time appearing to beat the market.

7 From an economic perspective, it is similar to a  
8 strategy of writing insurance policies. You can go year  
9 after year writing insurance policies and keeping the  
10 premiums and making a profit, but every period you run the  
11 risk that there will be an earthquake and you will have huge  
12 claims and you will have a big loss.

13 Hedge funds and other investors can follow this  
14 type of strategy that will appear to beat the market.  
15 Exposed after the fact it does beat the market for a certain  
16 amount of time, but then it crashes. An example of this  
17 might be some of the strategies followed by long term capital  
18 management, which were able to beat the market for a long  
19 time, but then when there was a national financial crisis  
20 they lost everything.

21 To get back to answering your question. First of  
22 all, I did not see any data on Madoff's returns so I did not  
23 know for sure that there were excess returns. Having been  
24 told there were excess returns, I would conclude that there  
25 are one of two possibilities. Either the excess returns were

1 not generated by this strategy and must have been generated  
2 by some other strategy, or perhaps that they were not true  
3 excess returns.

4 There could have been what appeared to be excess  
5 returns, but were actually just analogous to collecting  
6 insurance premiums. Earning excess returns every period, but  
7 taking on huge risk. If you lever up then you can generate  
8 substantial returns that way.

9 BY MR. FIELDER:

10 Q Do you recall characteristics of the excess returns  
11 where Madoff was reportedly cheating as they were represented  
12 to you? Do you recall if they told you the duration, how  
13 many years, he had been achieving excess returns?

14 A No one told me any details about the magnitude of  
15 the excess returns or the duration.

16 BY MR. KOTZ:

17 Q Anything about the consistency of the returns?

18 A I do not recall. It is possible that Bill could  
19 have mentioned to me that the returns were highly consistent.  
20 This is a common attribute of this type of strategy that I  
21 was describing a moment ago. You can generate high,  
22 consistent returns if you bear this extreme crash risk every  
23 period.

24 Q Let's say there was a market correction during that  
25 time period. When the tech bubble burst how would that

1 affect that strategy?

2 A There are many different strategies out there that  
3 potentially could have this extreme negative skewness. Some  
4 of those strategies are not dependent on the direction of the  
5 market. For example, long term capital management. Many of  
6 their bets were not on the direction of the market, but bets  
7 on the credit spread. That is the difference between the  
8 yield of high credit quality bond and a low credit quality  
9 bond.

10 They were betting that those yields would converge.  
11 For a long time they were basically right, but then the  
12 yields suddenly diverged dramatically and they lost a lot of  
13 money. It is not simply a question of the direction of the  
14 market. I do not recall today the extent to which I had  
15 these thoughts three years ago, but this is my general way of  
16 thinking about these types of problems.

17 Q You said that you did have a chance to read Harry  
18 Markopolos's complaint.

19 A Recently, yes.

20 Q What were your observations on that?

21 A I do not have any formal analysis of his complaint.  
22 I do think some of the language in the report was  
23 exaggerated. I think that for the most part the red flags  
24 that he raises in there were ones that would justify  
25 investigation.

1 BY MS. STEIBER:

2 Q Would it have been helpful for you in your analysis  
3 to understand more about some of the issues related to  
4 Madoff?

5 A Yes.

6 (SEC Exhibit No. 5 was marked for  
7 identification.)

8 BY MR. KOTZ:

9 Q Let me show you a copy of the complaint. We are  
10 going to mark it as Exhibit 5. It says, "The world's largest  
11 hedge fund is a fraud. November 7, 2005 submission to the  
12 SEC. Madoff Investment Securities, LLC." If you turn to  
13 page 9 of this complaint you will see the first paragraph.  
14 "Some time ago during different market conditions I ran a  
15 study using the Black-Scholes market option pricing model to  
16 analyze the value of front running with the goal of putting a  
17 monetary value on front running where the insider knew the  
18 customer's order and traded ahead of it."

19 He talks a little bit about that study. He says at  
20 the end of that paragraph, "The SEC should be able to  
21 duplicate these results." Could the SEC have duplicated  
22 these results? Could this kind of study have been done?

23 A Yes. In fact, Personal Privacy, when he was chief  
24 economist, ran a similar type of study in his preparation for  
25 commenting on Regulation MNS. It was not in enforcement

1 context at all. It was not specifically in the context of  
2 front running. The technical aspect of this analysis is not  
3 easy, but it is something that I could do, or several other  
4 people in OEA could do.

5 BY MS. STEIBER:

6 Q Did anyone ever ask you to duplicate these results  
7 or run the analysis?

8 A No.

9 Q Do you know of anyone else in OEA ever trying to  
10 duplicate these results or run this analysis discussed in  
11 that red flag?

12 A I do not believe anyone has. This is a comment  
13 that he is making about a hypothetical front running strategy  
14 that he imagines Madoff might have been doing. This is an  
15 analysis of how profitable it could be to do some other type  
16 of abuse, which turned out he was not doing.

17 Q But you were capable of --

18 A I would have been capable of replicating this type  
19 of study. It seems very simple, in fact. It looks like he  
20 is just using the Black-Scholes pricing model to compute what  
21 is the value of an option with one minute to expiration.

22 BY MR. KOTZ:

23 Q In reviewing Harry Markopolos's complaint, you see  
24 that he alleges that Bernard Madoff is running a Ponzi  
25 scheme.

1           A     Yes.

2           Q     Is there anything you could have done with this  
3 complaint to determine whether the allegation is correct?

4           A     I do not think I could have definitively determined  
5 that this allegation is correct. That would have required  
6 inspection. As an economist I am not involved in  
7 inspections. If I had been given this at the time, I suspect  
8 I would have commented on it for enforcement. The most  
9 important fact, I think, is I did not know how big his  
10 operation was. I did not know that he was managing so many  
11 assets.

12                   BY MS. STEIBER:

13           Q     Why would that have made a difference?

14           A     If I had known that then I would not have believed  
15 it possible to generate high returns on such a large asset  
16 base by pilfering assets away from the brokerage customers.  
17 I had presumed that it was a relatively small portfolio. If  
18 you have a really large broker-dealer operation and you abuse  
19 your customers and pilfer money away from them to benefit  
20 your asset clients, you could enhance your returns.

21                   If you are doing it with a huge base of billions  
22 and billions of dollars that would have an insignificant  
23 impact on your returns so you could not generate real returns  
24 that way. I would have also simply recommended to  
25 enforcement or OC or whoever asked me, that they should

1 investigate this carefully because this type of strategy  
2 would not be capable of earning extreme returns.

3 I think that I was turned off a little bit by some  
4 of the tone and self-grandizing language in the report. Many  
5 of the basic red flags are ones that I think would be of  
6 concern. I do not think there is a lot of analysis that I  
7 could do that would ultimately prove that it is a Ponzi  
8 scheme.

9 BY MR. KOTZ:

10 Q But there are things that OC and enforcement could  
11 do?

12 A Yes.

13 Q So you did not hear anything further about this  
14 investigation or about Madoff until December 2008; is that  
15 right?

16 A That is right, to the best of my recollection.

17 Q Bill Dale said to you that he had relayed the  
18 information. Did he give any indication that he was  
19 frustrated or unhappy that he was not going to be more  
20 involved in the matter?

21 A No. I do not think so. There are so many hundreds  
22 of investigations going on and so few economists to support  
23 that, that our general approach in OEA is to provide support  
24 when we are asked to and seek out opportunities to provide  
25 support. But to leave the main decisions about which cases

1 100 index and options on those equities, there would be some  
2 strategy that legitimately was generating returns that were  
3 such a correlation with the S&P 100?

4 A Yes. There are strategies that one could follow  
5 that would be uncorrelated with the S&P 500. If somebody  
6 were doing insider trading and had advance information about  
7 mergers and hedged all the market risk, they could have  
8 strategies that are uncorrelated with the market and earn  
9 these kinds of returns. If you are including illegal  
10 strategies in the mix, then I think there are possible ways  
11 that somebody could achieve this.

12 Q So one strategy would be insider trading that you  
13 identified. Would front running be a strategy that you think  
14 could generate these types of returns? I want to remind you  
15 of what you already pointed out in this document about the  
16 size of assets that he was managing.

17 A I do not think that front running or other types of  
18 abuse of broker-dealer information could generate returns on  
19 an asset base this large.

20 MR. KOTZ: The only thing else I wanted to ask you  
21 is if you could please, for the purpose of protecting the  
22 integrity of the investigation, not discuss what we discussed  
23 today with anybody.

24 THE WITNESS: Okay.

25 MR. KOTZ: Thank you very much.

1 (SEC Exhibit No. 6 was marked for  
2 identification.)

3 BY MS. STEIBER:

4 Q I want to show you a November 21, 2003 email from

5 Investment Adviser #1 Risk Manager to Investment Adviser #1 Portfolio Manager of Investment Adviser #1

6 analyzing Madoff's options trading. Can you just tell us  
7 what your impression of the analysis is?

8 MR. KOTZ: We are going to mark that as Exhibit 6.

9 THE WITNESS: This email describes trading volume  
10 and the S&P 100 options. It says OEX options transactions.  
11 That refers to S&P 100 options, which are traded on the CBOE.  
12 This document is indicating that the trading volume in that  
13 market is not high enough to be consistent with a claim that  
14 a market participant is following a split strike conversion  
15 strategy using S&P 100 options on a huge scale. That is the  
16 gist of this email.

17 BY MS. STEIBER:

18 Q Were you provided this email?

19 A No.

20 BY MR. KOTZ:

21 Q Do you agree with the analysis in there?

22 A I have no way right now of double checking the  
23 numbers. I do not know if the numbers are right, but I do  
24 agree it is something that makes sense to look at. If  
25 somebody is saying they are doing a certain strategy it would

1 make sense to go out and look at the trading volume.

2 If the scale of the strategy they are claiming to  
3 follow is significantly larger than the available liquidity  
4 or volume in that market, then that would be a red flag that  
5 they were not telling the truth.

6 BY MS. STEIBER:

7 Q Were you capable of doing this analysis? Was this  
8 an especially difficult analysis to run?

9 A No. It looks to me like all they are doing is  
10 looking at trading volumes on certain days. If I had  
11 specific information about what Madoff's purported strategy  
12 was, then I could have easily looked up the volume data to do  
13 this similar type of analysis.

14 Q If someone had claimed to be trading over the  
15 counter, would you expect documentation to exist?

16 A Documentation?

17 Q Of options trading over the counter.

18 A Most over the counter volume is done with large  
19 broker-dealers who provide the other side. I would certainly  
20 expect documentation to exist at the counter-party. I would  
21 expect any reputable investment advisor should keep  
22 documentation on their side too.

23 Q Even if the broker-dealer happened to be in Europe  
24 would you expect they would keep documentation?

25 A Yes, I would expect them to keep documentation.

1 This is not my area of expertise.

2 BY MR. FIELDER:

3 Q Do you have an opinion as to whether or not, if  
4 there had been over the counter options trades placed by  
5 Madoff with counter parties and had a volume that this email  
6 discussed would have been placed, would those counter parties  
7 continue to trade with Madoff if he had consistently placed  
8 bets with them?

9 A That is kind of a strange question. It presupposes  
10 the fact pattern that I do not think is likely to be  
11 possible. I do not think the strategy that he said he was  
12 following actually would make money. If somehow Madoff or  
13 some other trader was able to stumble upon some really  
14 extremely profitable strategy and execute over the counter,  
15 then one of two things would happen as a result. Either the  
16 counter-party would lose money or the counter-party would  
17 have to be hedging.

18 If the counter-party was not hedging, then I would  
19 suspect that they would be losing money and they would not  
20 want to continue doing those types of trades. I do not know  
21 enough about the specific business of these to know how much  
22 risk they are willing to bear. My intuition is they would  
23 probably prefer to hedge if possible and not bear the risk  
24 themselves.

25 MR. KOTZ: Thank you.