# Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions

Testimony
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

September 23, 2008

By
Christopher Cox
Chairman
U.S. Securities and Exchange Commission

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me here to today to discuss the turmoil in the U.S. credit markets and the efforts of the Securities and Exchange Commission, in concert with the Department of the Treasury, the Federal Reserve, and other regulators to protect investors and our markets. I should say at the outset that my testimony is on my own behalf as Chairman of the SEC, and does not necessarily represent the views of the Commission or individual Commissioners.

Last week, by unanimous decision of the Commission and with the support of the Secretary of the Treasury and the Federal Reserve, the SEC took temporary emergency action to ban short selling in financial securities. We took this action in close coordination with regulators around the world. At the same time, the Commission unanimously approved two additional measures to ease the crisis of confidence in the markets that threatened the viability of all financial firms, and which potentially threatened the ability of our markets to function in a fair and orderly manner. The first makes it easier for issuers to repurchase their own shares on the open market, which provides an important source of liquidity in times of market volatility. The second requires weekly reporting to the SEC by hedge funds and other large investment managers of their daily short positions -- just as long positions are currently reported quarterly on Form 13F.

All of these actions relying upon the Commission's Emergency Authority under Section 12(k) of the Securities Exchange Act remain in effect until October 2, and are intended to stabilize the markets until the legislation you are crafting becomes law and takes effect.

The Commission's recent actions followed on the heels of new market-wide SEC rules that more strictly enforce the ban on abusive naked short selling contained in Regulation SHO. These new rules require a hard T+3 close-out; they eliminate the options market maker exception in Regulation SHO; and they have put in place a new anti-fraud rule expressly targeting fraudulent activity in short-selling transactions.

First and foremost, the SEC is a law enforcement agency, and we have devoted an extraordinary level of enforcement resources to hold accountable those whose violations of the law have contributed to the subprime crisis and the loss of confidence in our markets. We have over 50 pending law enforcement investigations in the subprime area. Our Office of Compliance Inspections and Examinations has initiated examinations of the effectiveness of broker-dealers' controls to prevent the spread of false information intended to manipulate securities prices. The Division of Enforcement has undertaken a sweeping investigation into market manipulation of financial institutions, focused on broker-dealers and institutional investors with significant trading activity in financial issuers and with positions in credit default swaps. The reason for this aggressive enforcement investigation is the significant opportunities that exist for manipulation in the $58 trillion CDS market, which is completely lacking in transparency and completely unregulated.

Our subprime enforcement efforts fall primarily into three broad categories: first, subprime lenders; second, investment banks, credit rating agencies, insurers and others involved in the securitization process; and third, banks and broker-dealers who sold mortgage-backed investments to the public.

We are investigating whether mortgage lenders properly accounted for the loans in their portfolios, and whether they established appropriate loan loss reserves. In connection with the sale of mortgage-backed securities and collateralized debt obligations, we are investigating the role of the various parties involved in the securitization process. Among other things, we are focused on whether lenders adequately disclosed the risk profiles of underlying loans, whether they valued their portfolios appropriately, and whether they made adequate risk disclosures to investors. We are also investigating whether investment banks and broker-dealers defrauded retail customers by making false representations, or by putting investors into unsuitable mortgage-backed investments.

Last month, the Enforcement Division, working with state regulators from around the country, entered into agreements that when finalized will be the largest settlements in the history of the SEC, in behalf of investors who bought auction rate securities from Merrill Lynch, Wachovia, UBS and Citigroup. The terms of these agreements would provide complete recovery for individual investors. Our Enforcement Division is continuing to investigate other firms.

Recently the Commission brought enforcement actions against two portfolio managers of Bear Stearns Asset Management, whose hedge funds collapsed in June of last year. We allege that they deceived their investors and institutional counterparties about the financial state of the hedge funds, and in particular the hedge funds' over-exposure to subprime mortgage-backed securities. The collapse of the funds caused investor losses of over $1.8 billion.

The Commission is likewise using our regulatory authority to ensure that the market continues to function in a fair and orderly manner. Last week, the Commission’s Office of Chief Accountant provided guidance to clarify the accounting treatment of banks' efforts to support their money market mutual funds. The guidance clarified how banks should treat, for purposes of their balance sheets, the financial support they provide to money market funds within the same financial services complex. This will help assure banks that assistance to money market funds does not automatically trigger adverse accounting results. Clarity on this subject is important to protect investors in money market funds.

In the past week, the SEC, working with the Federal Reserve, oversaw the sale of substantially all of the assets of Lehman Brothers, Inc., to Barclays Capital. This quick result, following the Lehman bankruptcy, has brought immediate and significant benefits to Lehman's brokerage customers and the capital markets. The hundreds of thousands of Lehman's customer accounts can now be transferred, instead of going through a lengthy brokerage liquidation process that could take weeks and impair customer access to cash and securities. The transfer of most retail accounts, which hold over one hundred billion dollars in assets, is expected to be completed within days.

The problems that each of these actions has addressed have their roots in the subprime mortgage crisis -- which itself was caused by a failure of lending standards. The most recent dislocations have included the taxpayer rescues of Fannie Mae, Freddie Mac, and AIG, as well as the failure of Lehman Brothers and IndyMac. Financial institutions in every regulated sector have been damaged, and every one of those investment banks, traditional banks, and thrifts has been vulnerable to the effects of this toxic mortgage contagion.

The SEC's own program of voluntary supervision for investment bank holding companies, the Consolidated Supervised Entity program, was put in place by the Commission in 2004. It borrowed capital and liquidity measurement approaches from the commercial banking world -- with unfortunate results similar to those experienced in the commercial bank sector. Within this framework, prior to the spring of 2008, neither commercial bank nor investment bank risk models contemplated the scenario of total mortgage market meltdown that gave rise to, for example, the failure of Fannie Mae and Freddie Mac, as well as IndyMac and 11 other banks and thrifts this year.

The creators of the Consolidated Supervised Entity program in 2004 had designed it to operate on the well-established bank holding company model used by regulators not only in the United States but around the globe. They decided that the CSE rules would permit the parent holding company to calculate its capital adequacy using an approach consistent with either of the Basel standards, adopted by the Basel Committee on Banking Supervision. But the market-wide failure to appreciate and measure the risk of mortgage-related assets, including structured credit products, has shown that neither the Basel I nor Basel II standards as then in force were adequate. Each had serious need of improvement.

As a result, since March 2008, the SEC and other groups in which we participate have focused on improving standards for capital, liquidity, and risk management in both commercial and investment banking. Following the sale of Bear Stearns, groups such as the Senior Supervisors Group, the Financial Stability Forum, the International Organization of Securities Commissions, and the Basel Committee all pointed to the need to strengthen and improve these standards.

In the meantime, beginning immediately in the wake of the Bear Stearns sale to JPMorgan Chase, the Division of Trading and Markets, working with the Federal Reserve, implemented substantially more rigorous approaches to supervision of liquidity levels and liquidity risk management. They have developed scenarios that are of much shorter duration and that are much more severe, including denial of access to secured as well as unsecured funding. Those more stringent scenarios assume no access to the Fed's discount window or other liquidity facilities, although in fact such facilities are now available to the major investment banks. As a matter of prudence, investment banks are urged to maintain capital and liquidity at levels far above what would be required under the standards themselves.

But beyond highlighting the inadequacy of the pre-Bear Stearns CSE program capital and liquidity requirements, the last six months -- during which the SEC and the Federal Reserve have worked collaboratively with each of the CSE firms pursuant to our Memorandum of Understanding -- have made abundantly clear that voluntary regulation doesn't work. There is simply no provision in the law that authorizes the CSE program, or requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis, or to submit to SEC requirements regarding leverage. This is a fundamental flaw in the statutory scheme that must be addressed, as I have reported to the Congress on prior occasions.

Because the SEC’s direct statutory authority did not extend beyond the registered broker dealer to the rest of the enterprise, the CSE program was purely voluntary -- something an investment banking conglomerate could choose to do, or not, as it saw fit. With each of the remaining major investment banks now constituted within a bank holding company, it remains for the Congress to codify or amend as you see fit the Memorandum of Understanding between the SEC and the Federal Reserve, so that functional regulation can work.

The failure of the Gramm-Leach-Bliley Act to give regulatory authority over investment bank holding companies to any agency of government was, based on the experience of the last several months, a costly mistake. There is another similar regulatory hole that must be immediately addressed to avoid similar consequences. The $58 trillion notional market in credit default swaps -- double the amount outstanding in 2006 -- is regulated by no one. Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market. This is an area that our Enforcement Division is focused on using our antifraud authority, even though swaps are not defined as securities, because of concerns that CDS offer outsized incentives to market participants to see an issuer referenced in a CDS default or experience another credit event.

Economically, a CDS buyer is tantamount to a short seller of the bond underlying the CDS. Whereas a person who owns a bond profits when its issuer is in a position to repay the bond, a short seller profits when, among other things, the bond goes into default. Importantly, CDS buyers do not have to own the bond or other debt instrument upon which a CDS contract is based. This means CDS buyers can "naked short" the debt of companies without restriction. This potential for unfettered naked shorting and the lack of regulation in this market are cause for great concern. As the Congress considers fundamental reform of the financial system, I urge you to provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and orderly markets.

Mr. Chairman, I appreciate this opportunity to discuss the current market turmoil, the policy choices that Congress now faces, and the SEC's actions to maintain orderly markets and protect investors in this crisis.