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THE RECKONING

Agency's '04 Rule Let Banks Pile Up New Debt

By STEPHEN LABATON

“We have a good deal of comfort about the capital cushions at these firms at the moment.” — Christopher Cox, chairman of the Securities and Exchange Commission, March 11, 2008.

As rumors swirled that Bear Stearns faced imminent collapse in early March, Christopher Cox was told by his staff that Bear Stearns had \$17 billion in cash and other assets — more than enough to weather the storm.

Drained of most of its cash three days later, Bear Stearns was forced into a hastily arranged marriage with JPMorgan Chase — backed by a \$29 billion taxpayer dowry.

Within six months, other lions of Wall Street would also either disappear or transform themselves to survive the financial maelstrom — Merrill Lynch sold itself to Bank of America, Lehman Brothers filed for bankruptcy protection, and Goldman Sachs and Morgan Stanley converted to commercial banks.

How could Mr. Cox have been so wrong?

Many events in Washington, on Wall Street and elsewhere around the country have led to what has been called the most serious financial crisis since the 1930s. But decisions made at a brief meeting on April 28, 2004, explain why the problems could spin out of control. The agency's failure to follow through on those decisions also explains why Washington regulators did not see what was coming.

On that bright spring afternoon, the five members of the Securities and Exchange Commission met in a basement hearing room to consider an urgent plea by the big investment banks.

They wanted an exemption for their brokerage units from an old regulation that limited the amount of debt they could take on. The exemption would unshackle billions of dollars held in reserve as a cushion against losses on their investments. Those funds could then flow up to the parent company, enabling it to invest in the fast-growing but opaque world of mortgage-backed securities; credit derivatives, a form of insurance for bond holders; and other exotic instruments.

The five investment banks led the charge, including Goldman Sachs, which was headed by Henry M. Paulson Jr. Two years later, he left to become Treasury secretary.

A lone dissenter — a software consultant and expert on risk management — weighed in from Indiana with a two-page letter to warn the commission that the move was a grave mistake. He never heard back from Washington.

One commissioner, Harvey J. Goldschmid, questioned the staff about the consequences of the proposed exemption. It would only be available for the largest firms, he was reassuringly told — those with assets greater than \$5 billion.

“We’ve said these are the big guys,” Mr. Goldschmid said, provoking nervous laughter, “but that means if anything goes wrong, it’s going to be an awfully big mess.”

Mr. Goldschmid, an authority on securities law from Columbia, was a behind-the-scenes adviser in 2002 to Senator Paul S. Sarbanes when he rewrote the nation’s corporate laws after a wave of accounting scandals. “Do we feel secure if there are these drops in capital we really will have investor protection?” Mr. Goldschmid asked. A senior staff member said the commission would hire the best minds, including people with strong quantitative skills to parse the banks’ balance sheets.

Annette L. Nazareth, the head of market regulation, reassured the commission that under the new rules, the companies for the first time could be restricted by the commission from excessively risky activity. She was later appointed a commissioner and served until January 2008.

“I’m very happy to support it,” said Commissioner Roel C. Campos, a former federal prosecutor and owner of a small radio broadcasting company from Houston, who then deadpanned: “And I keep my fingers crossed for the future.”

The proceeding was sparsely attended. None of the major media outlets, including The New York Times, covered it.

After 55 minutes of discussion, which can now be heard on the Web sites of the agency and The Times, the chairman, William H. Donaldson, a veteran Wall Street executive, called for a vote. It was unanimous. The decision, changing what was known as the net capital rule, was completed and published in The Federal Register a few months later.

With that, the five big independent investment firms were unleashed.

In loosening the capital rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms’ own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves.

Over the following months and years, each of the firms would take advantage of the looser rules. At Bear Stearns, the leverage ratio — a measurement of how much the firm was borrowing compared to its total assets — rose sharply, to 33 to 1. In other words, for every dollar in equity, it had \$33 of debt. The ratios at the other firms also rose significantly.

The 2004 decision for the first time gave the S.E.C. a window on the banks’ increasingly risky investments in mortgage-related securities.

But the agency never took true advantage of that part of the bargain. The supervisory program under Mr. Cox, who arrived at the agency a year later, was a low priority.

The commission assigned seven people to examine the parent companies — which last year controlled

financial empires with combined assets of more than \$4 trillion. Since March 2007, the office has not had a director. And as of last month, the office had not completed a single inspection since it was reshuffled by Mr. Cox more than a year and a half ago.

The few problems the examiners preliminarily uncovered about the riskiness of the firms' investments and their increased reliance on debt — clear signs of trouble — were all but ignored.

The commission's division of trading and markets "became aware of numerous potential red flags prior to Bear Stearns's collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain" capital standards, said an inspector general's report issued last Friday. But the division "did not take actions to limit these risk factors."

Drive to Deregulate

The commission's decision effectively to outsource its oversight to the firms themselves fit squarely in the broader Washington culture of the last eight years under President Bush.

A similar closeness to industry and laissez-faire philosophy has driven a push for deregulation throughout the government, from the Consumer Product Safety Commission and the Environmental Protection Agency to worker safety and transportation agencies.

"It's a fair criticism of the Bush administration that regulators have relied on many voluntary regulatory programs," said Roderick M. Hills, a Republican who was chairman of the S.E.C. under President Gerald R. Ford. "The problem with such voluntary programs is that, as we've seen throughout history, they often don't work."

As was the case with other agencies, the commission's decision was motivated by industry complaints of excessive regulation at a time of growing competition from overseas. The 2004 decision was aimed at easing regulatory burdens that the European Union was about to impose on the foreign operations of United States investment banks.

The Europeans said they would agree not to regulate the foreign subsidiaries of the investment banks on one condition — that the commission regulate the parent companies, along with the brokerage units that the S.E.C. already oversaw.

A 1999 law, however, had left a gap that did not give the commission explicit oversight of the parent companies. To get around that problem, and in exchange for the relaxed capital rules, the banks volunteered to let the commission examine the books of their parent companies and subsidiaries.

The 2004 decision also reflected a faith that Wall Street's financial interests coincided with Washington's regulatory interests.

"We foolishly believed that the firms had a strong culture of self-preservation and responsibility and would have the discipline not to be excessively borrowing," said Professor James D. Cox, an expert on securities law and accounting at Duke School of Law (and no relationship to Christopher Cox).

“Letting the firms police themselves made sense to me because I didn’t think the S.E.C. had the staff and wherewithal to impose its own standards and I foolishly thought the market would impose its own self-discipline. We’ve all learned a terrible lesson,” he added.

In letters to the commissioners, senior executives at the five investment banks complained about what they called unnecessary regulation and oversight by both American and European authorities. A lone voice of dissent in the 2004 proceeding came from a software consultant from Valparaiso, Ind., who said the computer models run by the firms — which the regulators would be relying on — could not anticipate moments of severe market turbulence.

“With the stroke of a pen, capital requirements are removed!” the consultant, Leonard D. Bole, wrote to the commission on Jan. 22, 2004. “Has the trading environment changed sufficiently since 1997, when the current requirements were enacted, that the commission is confident that current requirements in examples such as these can be disregarded?”

He said that similar computer standards had failed to protect Long-Term Capital Management, the hedge fund that collapsed in 1998, and could not protect companies from the market plunge of October 1987.

Mr. Bole, who earned a master’s degree in business administration at the [University of Chicago](#), helps write computer programs that financial institutions use to meet capital requirements.

He said in a recent interview that he was never called by anyone from the commission.

“I’m a little guy in the land of giants,” he said. “I thought that the reduction in capital was rather dramatic.”

Policing Wall Street

A once-proud agency with a rich history at the intersection of Washington and Wall Street, the Securities and Exchange Commission was created during [the Great Depression](#) as part of the broader effort to restore confidence to battered investors. It was led in its formative years by heavyweight New Dealers, including James Landis and William O. Douglas. When President [Franklin D. Roosevelt](#) was asked in 1934 why he appointed Joseph P. Kennedy, a spectacularly successful stock speculator, as the agency’s first chairman, Roosevelt replied: “Set a thief to catch a thief.”

The commission’s most public role in policing Wall Street is its enforcement efforts. But critics say that in recent years it has failed to deter market problems. “It seems to me the enforcement effort in recent years has fallen short of what one [Supreme Court](#) justice once called the fear of the shotgun behind the door,” said [Arthur Levitt Jr.](#), who was S.E.C. chairman in the Clinton administration. “With this commission, the shotgun too rarely came out from behind the door.”

Christopher Cox had been a close ally of business groups in his 17 years as a House member from one of the most conservative districts in Southern California. Mr. Cox had led the effort to rewrite securities laws to make investor lawsuits harder to file. He also fought against accounting rules that would give less favorable treatment to executive stock options.

Under Mr. Cox, the commission responded to complaints by some businesses by making it more difficult for the enforcement staff to investigate and bring cases against companies. The commission has repeatedly

reversed or reduced proposed settlements that companies had tentatively agreed upon. While the number of enforcement cases has risen, the number of cases involving significant players or large amounts of money has declined.

Mr. Cox dismantled a risk management office created by Mr. Donaldson that was assigned to watch for future problems. While other financial regulatory agencies criticized a blueprint by Mr. Paulson, the Treasury secretary, that proposed to reduce their stature — and that of the S.E.C. — Mr. Cox did not challenge the plan, leaving it to three former Democratic and Republican commission chairmen to complain that the blueprint would neuter the agency.

In the process, Mr. Cox has surrounded himself with conservative lawyers, economists and accountants who, before the market turmoil of recent months, had embraced a far more limited vision for the commission than many of his predecessors.

'Stakes in the Ground'

Last Friday, the commission formally ended the 2004 program, acknowledging that it had failed to anticipate the problems at Bear Stearns and the four other major investment banks.

"The last six months have made it abundantly clear that voluntary regulation does not work," Mr. Cox said.

The decision to shutter the program came after Mr. Cox was blamed by Senator John McCain, the Republican presidential candidate, for the crisis. Mr. McCain has demanded Mr. Cox's resignation.

Mr. Cox has said that the 2004 program was flawed from its inception. But former officials as well as the inspector general's report have suggested that a major reason for its failure was Mr. Cox's use of it.

"In retrospect, the tragedy is that the 2004 rule making gave us the ability to get information that would have been critical to sensible monitoring, and yet the S.E.C. didn't oversee well enough," Mr. Goldschmid said in an interview. He and Mr. Donaldson left the commission in 2005.

Mr. Cox declined requests for an interview. In response to written questions, including whether he or the commission had made any mistakes over the last three years that contributed to the current crisis, he said, "There will be no shortage of retrospective analyses about what happened and what should have happened." He said that by last March he had concluded that the monitoring program's "metrics were inadequate."

He said that because the commission did not have the authority to curtail the heavy borrowing at Bear Stearns and the other firms, he and the commission were powerless to stop it.

"Implementing a purely voluntary program was very difficult because the commission's regulations shouldn't be suggestions," he said. "The fact these companies could withdraw from voluntary supervision at their discretion diminished the mandate of the program and weakened its effectiveness. Experience has shown that the S.E.C. could not bootstrap itself into authority it didn't have."

But critics say that the commission could have done more, and that the agency's effectiveness comes from the tone set at the top by the chairman, or what Mr. Levitt, the longest-serving S.E.C. chairman in history,

calls “stakes in the ground.”

“If you go back to the chairmen in recent years, you will see that each spoke about a variety of issues that were important to them,” Mr. Levitt said. “This commission placed very few stakes in the ground.”

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