

MEMORANDUM FOR THE RECORD

Event: Meeting with Members of the SEC Regarding the CSE Program

Type of Event: Meeting at the Office of the General Counsel at SEC

Date of Event: April 13, 2010

Participants - Non-Commission:

Mike Macchiaroli, Director of Trading and Markets, Sam Forstein, Assistant General Counsel, Sarah Hancus, Office of the General Counsel

Participants - Commission:

Tom Krebs, Troy Burrus, Jay Lerner, Greg Feldberg, Desi Duncker and Mina Simhai

MFR Prepared by: Mina Simhai

Date of MFR: April 13, 2010

Summary of the Interview or Submission:

This is not a transcript of the meeting and should not be quoted as such

On Thursday, March 18, 2010 Tom Krebs, Troy Burrus, Jay Lerner, Greg Feldberg, Desi Duncker and I met with Mike Macchiaroli, Director of Trading and Markets; Sam Forstein, Assistant General Counsel; and Sarah Hancus, Office of the General Counsel, at the SEC to discuss the CSE Program and oversight over Bear Stearns and Lehman Brothers under the CSE Program.

Background Leading up to the CSE Program

According to the SEC:

- In the 1990s, the SEC began working on holding company issues. Drexel was an example of a holding company that failed.
- In 1995, the Derivatives Policy Group was set up. Through this program, the SEC collected information voluntarily outside of the broker/dealers. The SEC collected information on derivatives and it had built in stress tests. Goldman Sachs agreed to give the SEC information for the whole firm. The five firms that later became CSE program participants (Bear Stearns, Lehman Brothers,

- Goldman Sachs, Morgan Stanley and Merrill Lynch) participated in the Derivatives Policy Group.
- The SEC had seen the pattern of the holding company failing, and then the broker dealer collapsed many times.
 - The EU issued a directive that said broker-dealers who had a presence in the E.U. must have a consolidated regulator. The U.S. investment banks did not want to be regulated by the Fed, and OTS did not have the authority to regulate them. That left the SEC. The SEC did not have authority to regulate the holding companies, so the holding companies had to agree to give the SEC consolidated oversight. This permitted the SEC to examine the entities and get reports on them. The SEC did not examine entities that were already regulated.
 - The SEC granted firms who consented to SEC consolidated regulation an exemption from the Net Capital Rule, allowing an exemption for position taking and allowed participants to do VAR for liquid assets. To be in the program, firms had to have a minimum of \$5 billion in liquid capital. Bear Stearns, the smallest member of the CSE Program, gave the SEC a hard time about the \$5 billion minimum, but eventually agreed to it.

CSE Program Generally

According to the SEC:

- The SEC evaluated the holding companies on a liquidation basis, not as a going concern.
- Under the prior net capital rule there were precise haircuts that firms had to take for certain assets. Under the CSE Program, the SEC would approve internal models submitted by the firms, and these internal models would be used to calculate capital requirements.
- Broker dealer assets included repo, borrowed stocks, margin debits and commodities. They were not allowed to have derivatives because derivatives had credit risk. Derivatives were done out of the firms' UK broker/dealers.
- Through the CSE Program, the SEC received, pursuant to Rule 15(c)(3)(4) examinations and monthly reports on value at risk and market and credit risk (approximately 25-35 pages per month), and the SEC had monthly meetings with the 5 CSEs. The CSE Program used Basel II capital requirements. It was all done on a consolidated basis at the holding company level.
- The CSE Program focused on soundness of a firm. If a firm was not sound, CSE staff would look at what steps should be taken.
- Mike Macchiaroli stated the CSE Program should have looked at more than Basel Standards – it should have looked at valuations and liquidity.
- Mike Macchiaroli thought the CSE Program was a good program.

CSE Program Staff

According to the SEC:

- The CSE program had 10-12 people, broken into teams of 3 (with some overlap) that monitored risk at the 5 CSEs, Citibank and Chase. The main focus was on the holding companies.
- The CSE Program had several PhD economists, including Matt Eichner and David Lynch, a group of accountants, and an examination staff.
- Citibank and Chase wanted the exemption from the net capital rules that other CSE entities received, but they did not receive it and the SEC relied on the Fed to regulate Citibank and Chase.
- The CSE staff would take reports received from the CSEs at face value and work from there. The CSE program did not perform audits or in depth examinations. Instead, they verified the Basel II calculations (*e.g.* the capital at the holding companies), verified controls, analyzed reports received from the CSEs and asked them questions.
- Associate Director Matt Eichner reported to Mike Macchiaroli (who was an Assistant Director).

Basel II

- Mike Macchiaroli stated he did not trust Basel II for 3 reasons:
 - 1) it allowed many correlations that do not hold up in a real crisis,
 - 2) no liquidity in the model, and
 - 3) no concentration limits.

Examinations

According to the SEC:

- Examinations were done out of OCIE. At one point it seemed that OCIE was more concerned with finding violations than checking controls.
- OCIE conducted complete examinations of the CSEs before they were allowed into the CSE Program.
- Mike Macchiaroli advised there were some tensions with the examination staff.
- Around 2007 the Division of Trading and Marketing (“T&M”) (where the CSE Program was located), rather than OCIE, was given the authority to conduct examinations, so T&M hired additional staff.

Coordination with the Fed

According to the SEC:

- Before the MOU was in place there was no formal agreement with the Fed, but they cooperated with the SEC.
- Mr. Macchiaroli stated that the Fed hid some documents from the SEC because the Fed was worried that the SEC would turn the documents over to OCIE, but he also stated that there was full cooperation between Lehman and SEC.

Failure of the CSE Program

According to the SEC:

- By April/May of 2007 it was too late; it was clear to Mike Macchiaroli that something was wrong with the CSE Program.
- In June of 2007 Mike Macchiaroli knew the CSE Program was done. He also knew that mortgages were going bad.
- Mike Macchiaroli stated he does not think holding company regulation works. There are too many legal entities and too much leverage.

Bear Stearns

According to the SEC:

- By July 2007, there was nothing the SEC could do to help the Bear Stearns situation. They just kept monitoring the situation at Bear Stearns. Bear Stearns was continually optimistic.
- In August of 2007 Mike Macchiaroli was worried that Bear Stearns would fail.
- Sunday Meeting.
 - On a Sunday in August of 2007, Mike Macchiaroli, Matt Eichner and others from the CSE Program went to NYC to meet with Bear Stearns' CFO (Sam Molinaro), Treasurer (Bob Upton), and Chief Risk Officer (Mike Alix), and 2 other executives from Bear Stearns.
 - At the meeting, Bear Stearns executives went through their numbers with the CSE Program staff. The SEC couldn't detect anything wrong and couldn't point to anything specific, but they were still worried about Bear Stearns.
 - After the meeting, the CSE Program staff called Annette Nazareth to brief her on the situations.
 - The result of this meeting was the SEC wanted more reports from Bear Stearns to ascertain the liquidity and capital at Bear Stearns.
- Bear Stearns was a relatively small firm (approximately \$400 billion) that was very heavily into the mortgage business and securitizations. Bear Stearns separated its businesses by brokers (customers) and dealers (positions).
- After the Sunday meeting Bear Stearns and the CSE Program continued talking and meeting.

- Once the mortgage and securitization markets dried up, Bear Stearns could not sell its positions and could not raise capital. The falling market brought Bear down with it.
- Mike Macchiaroli saw no evidence that Bear's marks were bad. However, the SEC did find Bear's leverage of 8:1 very troubling.
- January 2008.
 - The mortgage market was imploding.
 - CSE Program staff went back to Bear Stearns and asked how they thought they would make it through the next year. Sam Molinaro responded that he thought Bear Stearns would make it through 2008.
- Documents
 - The CSE program received monthly reports for market and credit risk.
 - Reports were sent to the director of T&M by the staff.
- The SEC believed Bear's problem was liquidity.
- Repo.
 - In the last 2 weeks all of Bear Stearns' liquidity drained away. The CSE Program had thought that Bear Stearns would be able to get repo, but the liquidity model did not work. People thought a 5% haircut would be enough, but the market demanded 20-40%, and Bear Stearns could not meet these haircuts.
 - Fidelity and Federated pulled repo from Bear Stearns.
- Sale to JPM.
 - On Friday morning around 6:30 Hank Paulson, Tim Geithner and Jamie Dimon decided that JP Morgan Chase would buy Bear Stearns.
 - Mike Macchiaroli did not expect \$2 a share to go through; he expected shareholders would reject this price.
- Mike Alix, Chief Risk Officer, was very good. He was on top of things, but Mr. Macchiaroli was not sure how much pull Mike Alix had within Bear Stearns. He speculated that Bear Stearns became too aggressive and probably did not listen to Mike Alix.
- Not sure if Jimmy Cayne understood mortgages.
- Bear Stearns was too heavily concentrated in mortgages.
- Does not believe the broker-dealer failed, it was very liquid. There were massive losses at the holding company level.
- People at Bear Stearns that Mike Macchiaroli dealt with:
 - Sam Molinaro
 - Robert Upton
 - Jeff Farber
 - Paul Friedman
 - Mike Alix

Managing Balance Sheet at Quarter End.

According to the SEC:

- The CSE program staff was aware that the CSEs managed their balance sheets at quarter end. It showed how liquid things were, was common practice, and did not add to the risk profiles. SEC was ok with it, so long as it was disclosed.
- If a firm put assets on its balance sheet, it had to have capital to back those assets.
- CSE Program spoke with Don Walker in the SEC's Corporate Finance division about disclosure issues and they worked out what needed to be disclosed.

Lehman Brothers

According to the SEC:

- Repo 105.
 - When Matt Eicher was quoted as saying “we didn’t care about Repo 105” he meant that he didn’t care from a risk perspective, as it had no impact on the overall risk of the firm.
 - If the SEC had known about Repo 105, it would have required Lehman to disclose it.
 - Leverage was already coming down, Lehman didn’t need Repo 105.
 - Repo 105 was legal under UK law.
 - The SEC found out about Repo 105 in January 2010 when it saw the Valukus report.
 - The SEC stated one other firm admitted it was doing Repo 105 transactions, and it will have to disclose it.
- After Bear Stearns, Lehman clearly was the next firm in line to fail because it was also heavy on mortgages and didn’t have other big businesses. Lehman had high real estate risk and less capital. JPM and money market funds also had a role in bringing Lehman down.
- Lehman was better capitalized than Bear Stearns had been but also had a bigger balance sheet. Lehman had \$27 billion in capital and \$80 billion in long term debt. Lehman was highly leveraged and had a small customer base.
- Lehman was still able to get capital in June of 2008 (approx. \$7 or \$8 billion).
- Lehman failed because it had too many illiquid assets on its books. Poor communications and a disbelief in what was happening contributed too. **Lehman had \$55 billion in illiquid assets.**
- Lehman tried to salvage the firm with the Spinco deal, which it told the SEC about.
- Erin Callan and Richard Fuld thought Lehman’s only hope was selling Lehman. They were hoping that the Fed would save them.
- In June/July of 2008 Lehman asked the Treasury Department for \$100 million to provide liquidity to Lehman.
- In August Lehman was still optimistic.
- Mike Macchiaroli does not believe the broker-dealer failed, it was very liquid. There were massive losses at the holding company level.

- Barclays got a great deal on Lehman – they paid \$250 million and received billions of dollars worth of assets.
- In August of 2008 Mike Macchiaroli knew Lehman was going down.
- People at Lehman that Mike Macchiaroli dealt with:
 - O'Mara
 - Ed Greeb
 - Martin Kelly
 - Dave Goldfarb
 - Tom Russo