

**Testimony of H. David Kotz  
Inspector General of the  
Securities and Exchange Commission**



**Before the Financial Crisis Inquiry Commission**

**Wednesday May 5, 2010**

## **Introduction**

Thank you for the opportunity to testify today before this Commission on the subject of the implementation of the Securities and Exchange Commission's (SEC's or Commission's) Consolidated Supervised Entities (CSE) program and the adequacy of the SEC's oversight of The Bear Stearns Companies, Inc. (Bear Stearns) and other CSE program participants. I appreciate the interest in the SEC and the Office of Inspector General (OIG). In my testimony today, I am representing the OIG, and the views that I express are those of my Office, and do not necessarily reflect the views of the Commission or any Commissioners.

The SEC OIG's mission is to promote the integrity, efficiency and effectiveness of the critical programs and operations of the SEC. This mission has become increasingly important in light of the current economic crisis facing our nation. The SEC OIG includes the positions of the Inspector General, Deputy Inspector General, Counsel to the Inspector General, and has staff in two major areas: Audits and Investigations.

Our audit unit conducts, coordinates and supervises independent audits and evaluations related to the Commission's internal programs and operations. The primary purpose of conducting an audit is to review past events with a view toward ensuring compliance with applicable laws, rules and regulations and improving future performance. Upon completion of an audit or evaluation, the OIG issues an independent report that identifies any deficiencies in Commission operations, programs, activities, or functions and makes recommendations for improvements in existing controls and procedures.

The Office's investigations unit responds to allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff and contractors. We carefully review and analyze the complaints we receive and, if warranted, conduct a preliminary inquiry or full investigation into a matter. The misconduct investigated ranges from fraud and other types of criminal conduct to violations of Commission rules and policies and the Government-wide conduct standards. The investigations unit conducts thorough and independent investigations into allegations received in accordance with the applicable Quality Standards for Investigations. Where allegations of criminal conduct are involved, we notify and work with the Department of Justice and the Federal Bureau of Investigation, as appropriate.

### **Investigative Reports**

Over the past 2½ years since I became the Inspector General of the SEC, my Office's investigative unit has conducted numerous comprehensive investigations into significant failures by the SEC in accomplishing its regulatory mission, as well as investigations of allegations of violations of statutes, rules and regulations, and other misconduct by Commission staff members and contractors. Several of these investigations involved senior-level Commission staff and represent matters of great concern to the Commission, Congressional officials and the general public. When appropriate, we have reported evidence of improper conduct and made recommendations for disciplinary actions, including removals from the Federal service, as well as recommendations for improvements in agency policies, procedures and practices.

Specifically, we have issued investigative reports regarding a myriad of allegations, including claims of Enforcement's failures to pursue investigations

vigorously or in a timely manner, improper securities trading by Commission employees, improper conflicts of interest by Commission staff members, unauthorized disclosure of non-public information, whistleblower allegations of contract fraud, preferential treatment given to prominent persons, retaliatory termination, perjury by supervisory Commission attorneys, falsification of federal documents, and the misuse of official position, government resources and official time. In August 2009, we issued a 457-page report of investigation analyzing the reasons that the SEC failed to uncover Bernard Madoff's \$50 billion Ponzi scheme. More recently, we issued a thorough and comprehensive report of investigation regarding the history of the SEC's examinations and investigations of Robert Allen Stanford's \$8 billion alleged Ponzi scheme.

### **Audit Reports**

Our audit unit has also issued numerous reports involving matters critical to SEC operations and the investing public. These have included audits of the Commission's CSE and broker-dealer risk assessment programs, an audit of the Division of Enforcement's (Enforcement's) practices related to naked short selling complaints and referrals, a review of Enforcement's process for recommending disgorgement waivers, and an analysis of the SEC's oversight of credit rating agencies. In addition, because our investigative report related to the Madoff Ponzi scheme identified systematic breakdowns in the manner in which the SEC conducted its examinations and investigations, we also performed three comprehensive reviews providing the SEC with 69 specific and concrete recommendations to improve the operations of both Enforcement and the Office of Compliance Inspections and Examinations (OCIE).

## **Bear Stearns-Related Audit Reports**

One of the most significant audit reports we have prepared to date was a comprehensive report issued in September 2008, analyzing the Commission's oversight of the SEC's CSE program, through which the Commission exercised direct oversight over Bear Stearns, the Goldman Sachs Group, Inc. (Goldman Sachs), Morgan Stanley, Merrill Lynch & Co (Merrill Lynch) and Lehman Brothers Holdings Inc. (Lehman Brothers).

The SEC initiated this audit based on a Congressional request received on April 2, 2008, from the Honorable Charles E. Grassley, the Ranking Member of the United States Senate Committee on Finance, asking that the OIG analyze the Commission's oversight of CSE firms and broker-dealers subject to the Commission's risk assessment program. Specifically, Senator Grassley's letter requested a review of the Division of Trading and Market's (TM's) oversight of the five CSE firms, with a special emphasis on Bear Stearns, and asked that the OIG analyze how the CSE program was run and the adequacy of the Commission's monitoring of Bear Stearns. In response to this Congressional request, we conducted two separate audits: an audit of the CSE program as it related to Bear Stearns and an audit of TM's broker-dealer risk assessment program.

### **Background of the CSE Program**

In 2004, the Commission adopted rule amendments under the Securities and Exchange Act of 1934, which created the voluntary CSE program. This program was established to allow the Commission to supervise certain broker-dealer holding companies on a consolidated basis. In this capacity, the Commission's supervision

extended beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself.

A broker-dealer became a CSE by applying to the Commission for an exemption from the Commission's standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision, if it did not already have a principal regulator. By obtaining an exemption from the standard net capital rule, the CSE firms' broker-dealers were permitted to compute net capital using an alternative method.

At the time of the OIG's audit fieldwork, which was subsequent to Bear Stearns' collapse in March 2008, the Commission exercised direct oversight of only four CSE firms: Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers. On September 15, 2008, Lehman Brothers announced that it would file for bankruptcy protection, and the Bank of America announced its agreement to acquire Merrill Lynch. Both Lehman Brothers and Merrill Lynch had experienced serious financial difficulties. On September 21, 2008, the Federal Reserve approved (pending a statutory five-day antitrust waiting period), applications from Goldman Sachs and Morgan Stanley to become bank holding companies with the Federal Reserve as their new principal regulator.

### **The Collapse of Bear Stearns**

Bear Stearns was a holding company that had two registered broker-dealers. Its main activities included investment banking, securities and derivatives sales and trading, clearance, brokerage and asset management. Bear Stearns was highly leveraged and had

a large exposure (*i.e.*, concentration of assets) in mortgage-backed securities. Bear Stearns also had less capital and was less diversified than several other CSE firms.

In June 2007, two hedge funds that Bear Stearns managed collapsed because of subprime mortgage losses. Nearly a year later, during the week of March 10, 2008, rumors began to spread about liquidity problems at Bear Stearns. Due to Bear Stearns' lenders not rolling over secured financing, Bear Stearns began to face severe liquidity problems. As a result, on March 14, 2008, JP Morgan Chase & Co. (JP Morgan) provided Bear Stearns with emergency funding. According to Congressional testimony provided by officials of Bear Stearns and the Federal Reserve Bank of New York (FRBNY), after the markets closed on March 14, 2008, it became apparent that the FRBNY's funding could not stop Bear Stearns' downward spiral. On March 16, 2008, it was announced that Bear Stearns would be sold to JP Morgan, with financing support coming from the FRBNY. In May 2008, the sale of Bear Stearns was completed.

### **Audit Objectives and Work**

The Congressional request the OIG received on April 2, 2008, noted that TM was responsible for regulating the largest broker-dealers and their associated holding companies and requested a review of TM's oversight of the five CSE firms it directly oversaw, with a special emphasis on Bear Stearns. The request further called for the OIG to analyze how the CSE program was run, to examine the adequacy of the Commission's monitoring of Bear Stearns, and to make recommendations to improve the Commission's CSE program. The audit's objectives were to evaluate the Commission's CSE program, emphasizing the Commission's oversight of Bear Stearns and determine whether

improvements were needed in the Commission's monitoring of CSE firms and its administration of the CSE program.

The audit was not intended to be a complete assessment of the multitude of events that led to Bear Stearns' collapse and, accordingly, did not purport to demonstrate any specific or direct connection between the failure of the CSE program's oversight of Bear Stearns and Bear Stearns' collapse.

Given the complexity of the subject matter, we retained an expert, Albert S. (Pete) Kyle, Ph.D., to provide assistance with the audit. Professor Kyle, a faculty member at the University of Maryland Robert H. Smith School of Business, is a renowned expert on many aspects of capital markets, and has conducted significant research on numerous finance-related matters. He served as a staff member of the Presidential Task Force on Market Mechanisms (the Brady Commission) after the stock market crash of 1987 and has worked as a consultant on financial topics for several government agencies.

#### **Audit Findings.**

The OIG's audit identified significant deficiencies in the CSE program that warranted improvement. The CSE program's mission, as it was described on the SEC's website, provided in pertinent part:

The regime is intended to allow the Commission to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including US and foreign-registered banks and broker-dealers, *or the broader financial system at risk.* [Emphasis added]

The audit found that the CSE program failed to carry out its mission in its oversight of Bear Stearns because, under the Commission and the CSE program's watch, Bear Stearns suffered significant financial weaknesses and the FRBNY needed to intervene during the week of March 10, 2008, to prevent significant harm to the broader financial system.

Overall, the audit found that there were significant questions about the adequacy of a number of the CSE program's requirements, given that Bear Stearns was compliant with several of these requirements, but nonetheless collapsed. In addition, the audit found that prior to Bear Stearns' collapse, TM became aware of numerous potential red flags regarding Bear Stearns' concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and the lack of compliance with the spirit of certain Basel II standards (*i.e.*, international standards for banking supervision), but did not take actions to limit these risk factors.

The audit further found that procedures and processes were not strictly followed. For example, the Commission issued an order that approved Bear Stearns to become a CSE prior to the completion of the inspection process. Further, the SEC's Division of Corporation Finance (Corporation Finance) did not review a Bear Stearns 10-K filing in a timely manner.

The audit also identified numerous specific concerns with the Commission's oversight of the CSE program. Some of the concerns the audit identified included:

(a) Bear Stearns was compliant with the CSE program's capital and liquidity requirements; however, its collapse raised questions about the adequacy of these requirements.

(b) Although TM was aware, prior to Bear Stearns becoming a CSE firm, that Bear Stearns' concentration of mortgage securities was increasing for several years and was beyond its internal limits, and that a portion of their mortgage securities (*e.g.*, adjustable rate mortgages) represented a significant concentration of market risk, TM did not make any efforts to limit Bear Stearns' mortgage securities concentration.

(c) Prior to the adoption of the rule amendments that created the CSE program, the broker-dealers affiliated with the CSE firms were required either to maintain a debt-to-net capital ratio of less than 15 to 1 after their first year of operation, or to have net capital not less than the greater of \$250,000 or two percent of aggregate debit items computed in accordance with the *Formula for Determination of Reserve Requirements for Broker-Dealers*. However, the program did not require CSE firms to have a leverage ratio limit. Further, despite TM being aware that Bear Stearns' leverage was high and some authoritative sources describing a linkage between leverage and liquidity risk, TM made no efforts to require Bear Stearns to reduce its leverage.

(d) TM was aware that the risk management of mortgages at Bear Stearns had numerous shortcomings, including the lack of expertise by risk managers in mortgage-backed securities at various times, the lack of timely formal review of mortgage models, persistent understaffing, a proximity of risk managers to traders suggesting a lack of independence, turnover of key personnel during times of crisis, and the inability or unwillingness to update models to reflect changing circumstances. Notwithstanding this knowledge, TM missed opportunities to push Bear Stearns aggressively to address these identified concerns.

(e) There was no documentation of discussions between TM and Bear Stearns concerning scenarios involving a meltdown of mortgage market liquidity, accompanied by a fundamental deterioration of the mortgages themselves. TM appeared to identify the types of risks associated with these mortgages that evolved into the sub-prime mortgage crisis, yet did not require Bear Stearns to reduce its exposure to sub-prime loans.

(f) Bear Stearns was not compliant with the spirit of certain Basel II standards and we did not find sufficient evidence that TM required Bear Stearns to comply with these standards.

(g) TM took no actions to assess the tolerance for risk on the part of Bear Stearns' Board of Directors and senior officials (*e.g.*, the Chief Executive Officer), although we found that this was a prudent and necessary oversight procedure.

(h) Without an appropriate delegation of authority, TM authorized the CSE firms' internal audit staff to perform critical audit work involving risk management systems, instead of this work being performed by the firms' external auditors, as the rule that created the CSE program required.

(i) In June 2007, two of Bear Stearns' managed hedge funds collapsed. Subsequent to this collapse, significant questions were raised about the lack of involvement in handling the crisis by some of Bear Stearns' senior management officials. However, TM did not reassess the communication strategy component of Bear Stearns' contingency funding plan after the collapse of the hedge funds, and significant questions were once again raised about the handling of the crisis by some of Bear Stearns' management officials during the week of March 10, 2008.

(j) The Commission issued four of the five orders approving firms (including Bear Stearns) to use the alternative capital method, and thus become CSEs, before the inspection process was completed.

(k) Corporation Finance did not review Bear Stearns' most recent 10-K filing in a timely manner. The effect of this untimely review was that Corporation Finance deprived investors of material information that they could have used to make well-informed investment decisions (*i.e.*, whether to buy/sell Bear Stearns' securities). In addition, the information obtained through the review process (*e.g.*, Bear Stearns' exposure to subprime mortgages) could have been potentially beneficial to dispel the rumors that led to Bear Stearns' collapse.

#### **Audit Recommendations.**

The audit identified 26 recommendations intended to improve the Commission's oversight of the CSE firms.

The recommendations included, among others:

(a) A reassessment of guidelines and rules regarding the CSE firms' capital and liquidity levels;

(b) Taking appropriate measures to ensure that TM adequately incorporates a firm's concentration of securities into the CSE program's assessment of a firm's risk management systems and more aggressively prompts CSE firms to take appropriate actions to mitigate such risks;

(c) A reassessment of the CSE program's policy regarding leverage ratio limits;

(d) Ensuring that: (1) the CSE firms have specific criteria for reviewing and approving models used for pricing and risk management, (2) the review and approval process conducted by the CSE firms is performed in an independent manner by the CSE's risk management staff, (3) each CSE firm's model review and approval process takes place in a thorough and timely manner, and (4) limits are imposed on risk taking by firms in areas where TM determines that risk management is not adequate;

(e) Being more skeptical of CSE firms' risk models and working with regulated firms to help them develop additional stress scenarios that have not already been contemplated as part of the prudential regulation process;

(f) Greater involvement on the part of TM in formulating action plans for a variety of stress or disaster scenarios, even if the plans are informal;

(g) Taking steps to ensure that mark disputes do not provide an occasion for CSE firms to inflate the combined capital of two firms by using inconsistent marks;

(h) Encouraging the CSE firms to present risk management data in a useful manner, which is consistent with how the CSE firms use the information internally and allows risk factors to be applied consistently;

(i) Ensuring (in accordance with Basel II) that the CSEs take appropriate capital deductions for illiquid assets and stressed repos, especially stressed repos where illiquid securities are posted as collateral;

(j) Greater discussion of risk tolerance with the Boards of Directors and senior management of CSE firms to better understand whether the actions of CSE firms' staff are consistent with the desires of the Boards of Directors and senior management;

(k) Requiring compliance with the existing rule that requires external auditors to review the CSE firms' risk management control systems, or seek Commission approval in accordance with the Administrative Procedures Act for this deviation from the current rule's requirement;

(l) Ensuring that the review of a firm's contingency funding plan includes an assessment of a CSE firm's internal and external communication strategies;

(m) Developing a formal automated process to track material issues identified by the monitoring staff to ensure they are adequately resolved;

(n) Ensuring that all phases of a firm's inspection process are completed before recommending that the Commission allow any additional CSE firms the authority to use the alternative capital method;

(o) Improving collaboration efforts among TM, Corporation Finance, OCIE, and the Office of Risk Assessment (ORA);

(p) The development by Corporation Finance of internal guidelines for reviewing filings timely and tracking and monitoring compliance with its internal guidelines; and

(q) The creation of a Task Force led by ORA with staff from TM, the Division of Investment Management, and OCIE to perform an analysis of large firms with customer accounts that hold significant amounts of customer funds and have unregulated entities, to determine the costs and benefits of supervising these firms on a consolidated basis.

## **The Agency's Response**

On September 26, 2008, a day after the OIG issued its final audit report on the SEC's Oversight of Bear Stearns and Related Entities, former SEC Chairman Christopher Cox announced that TM would end the CSE program. Notwithstanding the closure of the program, the SEC has made efforts to implement the recommendations contained in our report and to improve its operations accordingly. Specifically, with respect to recommendations that pertained directly to the terminated CSE program, TM has, where appropriate, considered the applicability of the OIG's recommendations to its oversight of broker-dealers and has consulted with the Federal Reserve, which assumed responsibility for overseeing the activities of several firms at the holding company level. As of March 31, 2010, management had completed implementation of 23 of the 26 recommendations contained in the OIG's audit report.

## **Concluding Remarks**

In conclusion, we appreciate this Commission's interest in the SEC and our Office and, in particular, in our audit report pertaining to the CSE program and Bear Stearns. I believe that this Commission's analysis of these matters as part of its overall evaluation of the causes of the current financial and economic crisis in the United States is beneficial to strengthening the accountability and effectiveness of the SEC. Thank you.