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FCIC memo of staff interview with Annette Nazareth, Securities and Exchange Commission

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MEMORANDUM FOR THE RECORD

Event: Telephone Call with Annette Nazareth (former SEC Commissioner) and Scott Muller of Davis Polk

Type of Event: Conference Call

Date of Event: April 1, 2010

Participants - Non-Commission:

Annette Nazareth (former SEC Commissioner) and Scott Muller of Davis Polk

Participants - Commission:

Mina Simhai, Troy Burrus, Donna Norman, Jay Lerner, and Hilary Allen

Date of MFR: April 1, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

On Thursday, April 1, 2010, FCIC staff participated in a phone call with former SEC Commissioner Annette Nazareth and Scott Muller of Davis Polk. The purpose of the phone call was to discuss the SEC's Consolidated Supervised Entity program.

Background: Annette Nazareth

- Ms. Nazareth started with the SEC in September 1998 as senior counsel to Chairman Arthur Levitt.
- Ms. Nazareth became the interim director of the Investment Management division for a few months of 1999, then became the director of Market Regulation in March 1999. She held that position until August 2005.
- Ms. Nazareth was a Commissioner of the SEC from August 2005 until January 2008.

Regulation of investment banks prior to the CSE program

- Since the failure of Long Term Capital Management, the SEC had been cognizant that there were regulatory gaps in the financial system. Incrementally, the SEC took a progression of steps to get a better view of the investment banks.
- In 1999, Congress chose not to mandate regulation of investment banks in Gramm Leach Bliley. Ms. Nazareth's view is that Congress did not want to expand the mandate of the SEC. Also, her view is that there was an assumption that the investment banks would register as Financial Holding Companies, and thus be subject to regulation by the Federal Reserve. Investment banks were not required to register as Financial Holding Companies, however, and they did not do so.
- Until 2004, there was no regulatory supervision of investment holding companies – there was only supervision of their broker/dealer affiliates. Lots of activities, including derivatives trading, are done outside of the broker/dealer affiliates.
- In 1998, a Derivatives Policy Group was formed to get reports on derivatives.
- Later (around 1998 or 1999), there was a voluntary reporting regime for the derivatives activities of broker/dealers.
- These activities gave the SEC a broader experience with regulating investment banks (particularly with respect to taking a holistic or prudential approach to regulation) which experience was drawn upon in carrying out the CSE program.
- The existing net capital rule needed to be revised, as it didn't recognize all the hedging that was used to reduce risk. As a result, firms would do a capital hedge, then a further hedge for regulatory purposes, which distorted the market and created systemic risk. Investment banks asked the SEC to revise the net capital rule to recognize the actual risks of trading practices.
- The SEC revised the net capital rule. Ms. Nazareth's view is that the changes were conservative and only gave partial relief to the investment banks.
- To use the new net capital rule, an entity had to be subject to the consolidated supervision of the SEC. This was the inducement to sign up for the new CSE program. Subsequently, the SEC permitted entities that were already subject to the consolidated supervision of the Federal Reserve (e.g. Smith Barney) to rely on the new capital rule without subjecting them to consolidated SEC supervision.

<u>CSE Program</u>

- The Consolidated Supervised Entity program was instituted in 2004. It was a response to an EU directive (which Ms. Nazareth views as driven by the UK FSA) which required that any financial institution operating in the UK had to be subject to home country consolidated supervision, otherwise the institution would be subject to EU consolidated supervision at an intermediate level. (This would require the establishment of an intermediate holding company with separate capitalization – a very inefficient structure).
- The investment banks requested consolidated supervision from the SEC, and did not opt into the Federal Reserve's Financial Holding Company regime (even though the investment banks could have done this, and this would have satisfied the requirements of the EU directive).
- Ms. Nazareth's view is that the investment banks didn't want bank-type supervision from the Fed. They wanted to be regulated by the SEC, which had been their functional regulator for 70 years.

- Ms. Nazareth's view is that the investment banks didn't think that the Fed understood investment banking, and didn't want to have each of their products subject to review. Her view was that there was a cultural difference between the investment banks and the Fed.
- The SEC saw regulation of investment bank holding companies as an important regulatory gap that they wanted to fill responsibly and without ruffling the feathers of other agencies. The SEC knew that it would need to build up to administer the CSE program.
- The mandate of the CSE program was to monitor risk management at a consolidated level.
- The SEC modeled its CSE program on international standards – including Basel – for consolidated supervision (especially the Fed's supervision program). The SEC interacted with the Fed to see if its regulation was comparable. Ms. Nazareth considers that the investment banks were required to hold high levels of capital, and that the SEC's standards were conservative.
- Unlike the Fed, the SEC did not plan to have examiners onsite at the investment banks. Instead, there were monthly visits/telephone calls with the investment banks.
- No Memorandum of Understanding (MOU) was required for the Fed and the SEC to share information. However, an MOU was put in place to address the Fed's concerns that the information it provided to the SEC might be used for enforcement purposes.
- Only five entities were supervised as part of the CSE program.
- There were 10-12 people in the Trading and Markets area who were dedicated to the CSE program. These people were not just lawyers – the SEC had sought out staff with more economics and finance backgrounds. When pressed, Ms. Nazareth stated that although more resources would have been nice, the staff was sufficient.
- The 10-12 dedicated staff were supported by the examination staff in OCIE. These examination staff were more experienced in broker/dealer examinations. The examinations undertaken as part of the CSE program were of a different kind – the intention was that the SEC would continuously review and look at a wide variety of activities in routine examinations that were not centered on potential violations.
- Over time, the view was that the CSE program would be better if the examination staff were in the same unit as the dedicated CSE staff.
- The SEC was constantly assessing whether the resources it had for the CSE program were sufficient. The view was that CSE supervision was an evolving process – new but important business for the SEC. Ms. Nazareth's view was that the CSE program was progressing well, while acknowledging that it was a start-up.
- To join the CSE program, investment banks had to document 100% of their procedures for the SEC. According to Ms. Nazareth, reports that said that firms joined the CSE program before their documentation was complete are factually inaccurate.
- The SEC Commissioners received reports of meetings between SEC staff and the investment banks. Prior to Bear, the Commissioners did talk broadly about the originate-to-distribute model and securitization, but didn't have any broad concerns about investment banks.
- The SEC did see trends among the investment banks, including how lending had changed (from 3% of lending being subprime to 20% of lending being subprime), but it didn't understand that the quality of the underlying assets had changed.

- The originate-to-distribute model was not seen as posing a threat, because the SEC (and the other regulators) didn't see the problems with the underlying assets. The SEC never drilled down to the level of the actual mortgages being packaged.
- The SEC wasn't relying on the leverage numbers provided to it by the investment banks (the SEC realized that this could be manipulated legally). The SEC was more concerned with the liquidity of the banks.
- No one ever raised any concerns about the CSE program to Ms. Nazareth.

Responses to Criticism of the CSE Program

- There are inaccurate financial findings in the Inspector General's report criticizing the CSE program, which the SEC staff was given no opportunity to rebut.
- Ms. Nazareth's view is that it is wrong to assume that just because there were problems with investment banks, there were problems with the CSE program. The financial system generally had problems.
- Ms. Nazareth's view is that just because a firm fails, that doesn't mean that the regulator failed.
- Notwithstanding that more resources are always better, Ms. Nazareth does not consider what happened to be the result of a lack of resources.
- The SEC and the Fed did all they could do with the available tools. There are things that the SEC and the Fed achieved that they haven't received credit for – for example, they forced up liquidity provisions (Bear Stearns had $19 billion in liquidity a week before it collapsed).
- Ms. Nazareth's position is that the real problem was the absence of a systemic risk regulator with oversight over the financial system as a whole Her view is that you don't go from being awash with capital to being in trouble unless the risk associated with the assets comprising that capital aren't properly comprehended.
- Everyone (not just the SEC) got the risk-weighting models for capital calculation wrong.
- Ms. Nazareth doesn't consider that the change in SEC Commissioner and the lack of a director of the Division of Trading and Markets in 2005-2006 were material to the failure of Bear and Lehman.