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EMAIL to MARY SHAPIRO  
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Thank you for your response. My recommendation is a straightforward one. I would urge a "Special Study," under oath with subpoena power, similar to the one that was conducted in the early 1960s by the SEC. I would urge that the new study include the following:

- How financial institutions finance their activities
- Derivatives and how they are accounted for in determining capital requirements
- How risk books are prepared and how, when and on what form they are transmitted to senior management
- Structured finance
- Off Balance Sheet transactions
- Leverage
- Program trading
- Collateralized debt obligations
- Credit default swap market
- Short selling
- Accounting issues re "fair market value"
- Securitization

The study might take as long as 18 months or possibly even two years. I do not believe it is meaningful to talk of regulation unless there is an accurate body of knowledge about exactly what happens and precisely how different instruments are financed, traded, marketed, recorded and reported.

Let me quote my testimony before the U.S. Senate in 1994 – almost 15 years ago:

"First derivatives can be used to leverage risk -- interest rate, currency rate, share prices -- without putting up a lot of money. That simply means that during a period of volatility, losses or gains are magnified manyfold. And often the leverage is asymmetrical; that is, the potential gains are limited, while the losses may be multiples of the maximum gain.

Second, current accounting conventions mask error, risk and mistake. They are not designed as risk management tools. They have tax consequences, which may be one of the reasons why it has been so difficult to develop a comprehensive set of conventions which also can be used for risk management purposes.

The truth is we do not, generally, mark derivatives to market. Many derivatives are unmarkable. In certain transactions, mistakes can be hidden because accounting conventions do not record them, either because they are ad hoc or there is no market, or they are off balance sheet. There is, too often, little reality testing. We continue to pretend that a rolling loan gathers no loss. We pretend that if a triggering event occurs in a different time period, the loss can be delayed. And when losses can be ignored, greater risks are taken.

Third, senior managers are rarely as informed as traders, and legislation is not likely to make them so. Typically, senior management is usually unaware of the technical operations of financial engineering.

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Management is not trained in the intricacies of convexity or volatility. As a result, reports are inadequate, supervision thin. Risk management leaves a lot to be desired. Worse, most of us have great difficulty in admitting to those who report to us that we do not know nearly as much as they. That is a recipe for potential disaster.

Fourth, many products, particularly over-the-counter derivatives and aspects of the mortgaged-backed market are idiosyncratic, ad hoc, unpublicized, illiquid. That means they are difficult, if not impossible, to price or value. It means that if held as collateral, there may be no buyers in the event of a forced sale, or the spreads between buyers and sellers may be so wide that even hedges are ineffective.”

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In 1998 I testified before the House of Representatives as follows:

“This brings me to my final point and, to my own mind, the most important. We have enough essays, surveys, studies, green books, Basle guidelines, international studies about credit risk, basis risk, legal risk, event risk, operational risk. They are all fine and so will be future ones -- whether mandated by legislation or done voluntarily. But they all read like a cross between graduate school theses, at best, and a public policy consultant’s think-piece. We are writing essays without really knowing, in a systematic fashion, how the market works. We need far more precise day-to-day market information on who does what; how is it financed; how do bankers and dealers pass on their risks; how is leverage actually accomplished, etc.

The time is now, I suggest, for a “Special Study,” under oath, with subpoena power, conducted independently, reporting directly to Congress, with such commentary by the Federal Reserve, Treasury, Comptroller of the Currency, SEC, CFTC, and anyone else who would like to comment on the ultimate analyses and conclusions of the Study.

The Chairman of the SEC and Chairwoman-Designate of the CFTC should designate a Director of the Study and then let that Director staff the Study – with subpoena power. We will not find out how the market really works without such a Study. Why subpoena power? Let me remind this Committee that at the time of the Salomon Brothers affair almost three years ago, which had many of the elements of the subject now being looked at, no securities firm would voluntarily testify about their operations in the REPO and government securities market. Nor will they do so fully and frankly about derivatives in response to a letter from the Secretary of Treasury or the Chairman of the Federal Reserve.

They will under oath. And that is the way to develop a body of knowledge in this particular area. The alternative is to rely on Grand Juries, SEC investigations after the fact, class action lawsuits and surveys.

Three years ago, in Senate hearings on the operations of the government securities market in connection with the Salomon Brothers affair, I testified:

“Finally, I would urge a major inquiry -- not an adversarial investigation -- into the operations of the securities markets (including the government securities markets and those of derivative products and financing) similar to the Special Study of Securities Markets conducted in the early 1960s which reported directly to Congress.”

I can only repeat the same recommendation here, but this time note, merely by way of example, five matters, almost chosen at random, which have not yet really been publicized, and which are indicative of what we don't know about -- except in the most superficial and uncoordinated fashion.

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2. The effects of illiquid collateral, particularly in the mortgaged-backed market, and its effect on the U.S. government bond market when small changes in interest rates are magnified when the collateral can't be sold and, instead, the U.S. government bond market absorbs the selling pressure as financial intermediaries seek to protect themselves.”

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One final point – about five years ago I spoke to about 500 staff of SEC and made the same points as above. I say this not because I want to show prescience, but rather because the problems are longstanding and can only be addressed after a substantial body of knowledge has been developed. I am afraid that can only be done under oath with subpoena power. Later, as we did after the Special Study, the SEC might have public hearings which would go a long way to garner public support for major change. That is precisely what happened re unfixing commission rates, institutional membership on stock exchanges, etc.

Kindest regards,

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