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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

April 16, 2008

The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Grassley:

Thank you for your letter dated April 2, 2008. In your correspondence, you requested information concerning the recent Bear Stearns-JPMorgan Chase transaction and the oversight of Bear Stearns, among other things, prior to and following its sudden collapse the week of March 10, 2008. Attached are answers prepared by the SEC staff to the questions you pose.

I hope this information is helpful to you. Please be assured that the SEC's staff will continue to be in close contact with the industry and federal banking regulators to monitor the situation. Feel free to call me at (202) 551-2126 or to have your staff call Jonathan Burks, Director of our Office of Legislative and Intergovernmental Affairs, at (202) 551-2016 if you would like to discuss the matter further.

Sincerely,

Christopher Cox
Chairman

Similar Letter Sent to Senator Max Baucus, Chairman
Committee on Finance

Senator Christopher Dodd, Chairman
Committee on Banking, Housing, and Urban Affairs

Senator Richard Shelby, Ranking Member
Committee on Banking, Housing, and Urban Affairs

Responses to Questions Posed in April 2, 2008 Letter

1. What steps is the SEC taking to re-assess the liquidity standards imposed on CSEs?

The CSE firms have an obligation to maintain substantial liquidity relative to their unsecured funding, and SEC staff is taking steps to improve the secured funding plans of each CSE, such as increasing term and diversification across lenders. Program staff has modified its approach to analyzing funding at the CSEs, particularly examining the term of secured and unsecured funding arrangements. Staff also is discussing with CSEs extra secured funding capacity for less liquid positions. Also, senior SEC staff is discussing with CSE senior management their funding plans, including plans for raising new capital by accessing the equity and long-term debt markets. A likely outcome of this process will be the articulation of additional supervisory expectations related to liquidity and, in particular, requirements that will increase resiliency in the event of disruption in secured funding markets.

2. What enforcement mechanisms exist to ensure compliance with the standards and do those mechanisms need to be strengthened to avoid similar problems with other CSEs?

The SEC has an array of mechanisms for ensuring compliance with capital, liquidity, and other requirements applicable to investment bank holding companies supervised under the CSE regime. The SEC can require that a CSE firm take corrective action and ultimately may revoke the CSE's conditional exemption from the broker-dealer net capital rule. This would force the firm to meet the standard net capital requirements, trigger disclosure requirements, and compel the firm to meet the requirements imposed by the European Union or face restrictions on its ability to operate in Europe.

More specifically, paragraph (e) of Appendix E to Rule 15c3-1 provides that the SEC may impose additional conditions on the broker-dealer which may include, but are not limited to, restricting the broker-dealer's business on a product-specific, category-specific, or general basis; submitting to the SEC a plan to increase the broker-dealer's net capital or tentative net capital; filing more frequent reports with the SEC; modifying the broker-dealer's internal risk management control procedures; or computing the broker-dealer's deductions for market and credit risk. This section also provides that the SEC may require, as a condition of continuation of the exemption, that the CSE file more frequent reports or modify its group-wide internal risk management control procedures. Further, if the SEC finds it necessary or appropriate in the public interest or for the protection of investors, the SEC may impose additional conditions on either the broker-dealer or holding company should certain events occur, such as the broker's tentative net capital falling below a minimum, a material deficiency in the risk management controls, or the CSE failing to comply with the undertakings. In addition, the SEC may impose additional conditions if it finds the conditions are necessary or appropriate in the public interest and for the protection of investors.

The entire CSE regime is at present voluntary because although federal law provides for supervision of commercial banking by bank regulatory agencies, no such scheme exists for the largest investment banks. Without this voluntary program there would not have been any consolidated information available to regulators, including the Federal Reserve Bank of New

York, when Bear Stearns precipitously lost liquidity in mid-March 2008. I support legislation that would close this statutory gap.

3. To what extent was the collapse in investor confidence in Bear Stearns a reflection of uncertainty created by investments and liabilities maintained off the balance sheets and thus not transparent to the public markets?

Bear Stearns was not a sponsor of structured investment vehicles and similar off balance sheet structures. Rather, the concern in the markets appeared to center on Bear Stearns' exposure to mortgage-related securities and other credit products, which was the subject of extensive commentary and analysis by a variety of outside observers including equity analysts and rating agencies.

4. According to press reports, JPMorgan Chase has already promised some senior Bear Stearns officials retention packages. When will the SEC receive disclosures regarding any special executive compensation arrangements associated with the transaction and what is the SEC doing to ensure that those disclosures are complete and accurate?

Please see the response to the next question.

5. Will the SEC be examining executive compensation provisions for Bear Stearns upper-management in light of the company's collapse, including any special arrangements as part of the deal between Bear Stearns and JPMorgan Chase?

On Friday, April 11, 2008, JPMorgan Chase filed a Form S-4 registration statement to register the share exchange with Bear Stearns's shareholders. The registration statement includes disclosure about financial interests of Bear Stearns's senior executives that differ from those of the other Bear Stearns shareholders. When the Division of Corporation Finance staff fully reviews a registration statement, its review covers all aspects of a company's disclosure about the transaction and the parties to it. In a filing review, the staff will raise comments in which it recommends that a company provide enhanced disclosure where the current disclosure does not appear adequate or lacks clarity.

6. When was the SEC informed of the deal and what role, if any, did it play in its negotiation?

The SEC did not participate in negotiations between JPMorgan Chase and Bear Stearns regarding the acquisition. SEC staff communicated daily with staff of the Federal Reserve Bank of New York during the week of March 10 regarding Bear Stearns's financial condition. The SEC participated in calls with the Treasury, Federal Reserve, and Federal Reserve Bank of New York, beginning Thursday, March 13 and through the weekend, regarding Bear Stearns' condition. Some of these phone calls described the ongoing negotiations between JPMorgan and Bear Stearns, but calls on which the SEC participated did not include JPMorgan and Bear Stearns. Ultimately, the SEC was informed of the conclusion of the deal Sunday night shortly before public announcement of the deal and the Federal Reserve's Primary Dealer Credit Facility.

On Sunday afternoon, March 16, JPMorgan Chase contacted SEC staff about relief and securities law guidance that they sought in furtherance of a possible deal. To assist in advancing a possible transaction, the SEC staff was able to provide several letters clarifying the staff's position on certain matters connected with the merger. Specifically, the Division of Trading and Markets wrote a letter addressing the timing of JPMorgan's filing of a Form BD with the SEC. The Division of Investment Management wrote two letters concerning issues under the Investment Company Act and Investment Advisers Act arising out of the change in control of investment advisers affiliated with Bear Stearns. The Division of Corporation Finance wrote a letter addressing sales by client accounts managed by JPMorgan and Bear Stearns of the other firm's securities, in view of the control relationship created by the merger agreement. The Division of Enforcement wrote a letter concerning investigations and potential future inquiries into conduct and statements by Bear Stearns before the public announcement of the transaction with JPMorgan. The staff declined to provide assurances about possible future enforcement actions.

7. **According to New York Stock Exchange (NYSE) Rule 312.03(c)(1), shareholder approval is required for the issuance of stock with voting power 20% or greater than outstanding shares. Yet JPMorgan purchased 39.5% of Bear Stearns through the issuance of new shares without shareholder approval. As part of its responsibility to provide oversight of Self-Regulatory Organizations (SROs), such as the NYSE, please describe the extent to which the SEC reviewed or approved this portion of the transaction in light of that rule.**

The NYSE provided an exception to the shareholder approval requirement under the NYSE Listed Company Manual (Section 312.05), which allows an exception to the shareholder approval policy when (1) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and (2) reliance by the company on this exception is expressly approved by the Audit Committee of the Board of the company. A company relying on this exception must mail to all shareholders not later than 10 days before issuance of the securities a letter alerting them to its omission to seek the shareholder approval that would otherwise be required under the rules of the NYSE and indicating that the Audit Committee of the Board of the company has expressly approved the exception. The NYSE staff consulted with the SEC staff before providing this exception. The negotiated agreement and plan of merger between Bear Stearns and JPMorgan Chase is conditioned on stockholder approval, among other things.

8. **To what extent is the SEC investigating any anomalous trading or potential manipulation surrounding this extraordinary event? Is the SEC examining, for example, those with the 10 or 15 largest short positions in Bear Stearns just before the collapse?**

The SEC takes very seriously the potential for market manipulation and will continue to investigate instances of highly suspicious trading. However, it is the SEC's longstanding policy to conduct its inquiries on a confidential basis. The SEC conducts its investigations in this manner to preserve the integrity of its investigative process as well as to protect persons against whom unfounded charges may be made where the SEC determines that enforcement action is not necessary or appropriate. The existence or non-existence of an investigation as well as

information which may be gathered during an investigation is not disclosed unless made a matter of public record in proceedings brought before the SEC or the courts.

9. Has the SEC received any referrals or other notifications from SROs related to suspicious trading or potential manipulation surrounding the transaction? If so, please describe in detail the size, scope, and suspicious nature of the transactions or manipulative activities.

To encourage referrals from the SROs and to protect the integrity of their supervisory responsibilities and the Commission's enforcement process, the SEC policy of conducting inquiries on a confidential basis applies to enforcement-related communications with the SROs.

10. Has the SEC taken any special measures to ensure that suspicious trades or potential manipulation surrounding the transaction are identified and investigated as quickly as possible? If so, please explain.

The SEC takes the potential for market manipulation very seriously and investigates instances of highly suspicious trading. However, as noted above it is the SEC's policy to conduct its investigations on a confidential basis,

11. Has the SEC sought to obtain from the parties timelines, documents, the names of those who represented the parties to the transaction, or other materials? If not, please indicate whether, under what circumstances, and in what timeframe the SEC intends to do so.

As noted above, it is the SEC's policy to conduct any investigations on a confidential basis. The SEC would seek such information if required in the course of its enforcement of the securities laws. In addition, since the announcement of the proposed acquisition, the SEC staff has been in contact with in-house counsel at both Bear Stearns and JPMorgan Chase to discuss aspects of the deal and to obtain relevant documents.

12. Just days before the transaction was announced, you publicly expressed confidence in the "capital cushion" of Bear Stearns and other CSEs. On what did you base your conclusion and why did it prove to be apparently inaccurate in light of later events?

The conclusion was accurate then and now, based on all information currently available to us. At the beginning of the week of March 10th, and at all times through the date of its agreement to be acquired by JPMorgan Chase during the weekend of March 15th and 16th, Bear Stearns had a capital cushion well above what is required to meet supervisory standards calculated using the Basel II standard. Specifically, even at the time of its sale on Sunday, Bear Stearns' consolidated capital, and the net capital of its broker-dealer subsidiaries, exceeded the relevant supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity – not inadequate capital – caused Bear Stearns' demise.

It is should also be noted that the net capital rules that applied to the U.S. broker-dealer subsidiary, as distinct from the holding company, are designed to preserve investors' funds and securities in times of market stress, and they served that purpose in this case. This investor protection objective was amply satisfied by the current net capital regime, which – together with the protection provided by the Securities Investor Protection Corporation (SIPC) and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm – worked in this case to fully protect Bear Stearns' broker-dealer customers.

What happened to Bear Stearns during the week of March 10th was unprecedented. For the first time, a major investment bank that was well-capitalized and apparently fully liquid experienced a crisis of confidence that denied it not only unsecured financing, but short-term secured financing, even when the collateral consisted of agency securities with a market value in excess of the funds to be borrowed. Counterparties would not provide securities lending services and clearing services. Prime brokerage clients moved their cash balances elsewhere. These decisions by counterparties, clients, and lenders to no longer transact with Bear Stearns in turn influenced other counterparties, clients, and lenders to also reduce their exposure to Bear Stearns. Over the weekend, Bear Stearns faced a choice between filing for bankruptcy on Monday morning, or concluding an acquisition agreement with a larger partner.

Even prior to the experience with Bear Stearns, the SEC's supervision of investment bank holding companies has always recognized that capital is not synonymous with liquidity – and that more is required to determine a firm's financial health. A firm can be highly capitalized – that is, it can have far more assets than liabilities – while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets – cash and high-quality instruments such as U.S. Treasury securities that can be used as collateral – to meet its financial obligations as they arise.

For this reason, CSEs are required to maintain funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding is not available for a period of one year. But what neither the CSE regulatory approach nor any existing commercial bank or investment bank regulatory model had taken into account is the possibility that secured funding, even that backed by high-quality collateral such as agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectancy that secured funding, albeit perhaps on less favorable terms than normal, would be available in any market environment. For this reason, the inability of Bear Stearns to borrow against even high-quality collateral on March 13th and March 14th – an unprecedented occurrence – had prompted the Federal Reserve's action to open the discount window to investment banks. The Bear Stearns experience has challenged the measurement of liquidity in every regulatory approach, not only here in the United States but around the world. For these reasons, the SEC will formally participate in work by the Basel Committee to strengthen the standards applicable to liquidity risk.

13. According to a December 10, 2007, *Wall Street Journal* article, as well as regulatory filings, the SEC had an investigation underway of Bear Stearns for improperly valuing mortgage securities. Please provide the Committee with information about this issue.

As previously mentioned, it is the Commission's policy to conduct its inquiries on a confidential basis. The Commission does not disclose the existence or non-existence of an investigation or information generated in any investigation unless made a matter of public record in proceedings brought before the Commission or the courts. In addition, it is our understanding that the Inspector General is conducting an investigation into the events reported in the December 10, 2007 Wall Street Journal article at the request of Senator Grassley and will report its findings as appropriate. However, it should be noted that the events reported in the Wall Street Journal article do not in fact relate to mortgage-backed securities.