Credit Crisis: Where Was The SEC?

Liz Moyer, 02.06.08, 6:00 AM ET

Six years after the lessons of Enron and a decade after Long-Term Capital collapsed, regulators still can't seem to blunt the damage complex securities can have on financial markets. Why?

It's a fair question. Investment banks, mortgage brokers and ratings agencies are all being blamed for the subprime mortgage bubble and its sudden and stunning demise. But little has been said about the watchdogs at the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority, the regulators who oversee the activities of the banks. They have the power to stop fraud in the business of selling the complex credit derivatives, and they have jurisdiction over whether the complex securities sold by the banks met suitability requirements for the investors who bought them. Yet time and again, they've failed to do so.

Most notably, the SEC has the power to monitor whether the investment banks had adequate capital relative to their trading positions and balance sheets and the proper risk management systems to prevent catastrophic losses. More than $100 billion in write-downs later, several banks are scrounging for capital, and it's clear those risk management procedures weren't functioning very well, if at all.

One of the problems is the lack of clear information, outside the banks and trading floors, about the credit derivatives market. Collateralized debt obligations (CDO) and other structured finance products trade over-the-counter rather than on an exchange, at least in the United States. Many of them trade infrequently, meaning price information is limited.

Washington and Wall Street have been hesitant to clamp down on the over-the-counter market, the source of much profit-making. Last year, as the subprime market began its collapse, the President's Working Group, which includes the Treasury Department, the Federal Reserve, the SEC and the Commodities Futures Trading Commission, recommended against tighter oversight of the over-the-counter market, in the context of vetoing tighter regulation of hedge funds, saying the industry can self-police.

A counterparty risk group led by former New York Fed President Gerald Corrigan has also recommended industry "best practices" in lieu of tighter regulation of the derivatives trading market.

Leaving it up to Wall Street hasn't proven very effective, however. "The decision by the President's Working Group to recommend no detailed regulation of the over-the-counter market was wrong," says David Ruder, a former SEC chairman and now law professor at Northwestern University.

Regulators are taking a hard look at how banks structured, priced and sold mortgage-laden securities, but by the estimate of some it's too little and too late. "I don't think all the king's horses and all the king's men will put this together again," says Gary Aguirre, a former SEC lawyer.

There were warning signs.

In the summer of 2006, Jeff Kronthal, a senior executive in Merrill Lynch's structured products group, was fired after reportedly balking at then-Chief Executive Stanley O'Neal's demands that the firm get more aggressive in its risk-taking with mortgage securities. Kronthal was hired back by new Chief Executive John Thain in December to advise on the firm's risk management.

He wasn't the only one to sound alarms about the housing bubble and the explosion of the credit derivatives market. "Many credible people were public about their dissatisfaction with the mortgage loan market," says Janet Tavakoli, a structured finance expert with her own Chicago consulting firm.

She blames the ratings agencies for flawed ratings methodologies. The Fed and the SEC, among other regulators, are just packs of economists and lawyers. "I do not expect lawyers to be rigorous in their analysis."

Regulators saw warning signs as early as 2005, but failed to pursue them. Bear Stearns, in its first quarter 2005 financial disclosure, said it faced the threat of a civil enforcement action in connection with its pricing, valuation and analysis of $63 billion worth of CDOs. In the same filing, Bear Stearns said it was contacted by the New York State attorney general, then Eliot Spitzer, about $16 billion worth of CDOs it sold to an unnamed client.

The inquiries were brought up again in the August quarterly regulatory report and in the year-end 2005 filing, when Bear Stearns said it was "continuing to respond to subpoenas and other requests for information from regulatory and law enforcement officials."

But that's the last time Bear Stearns brought it up, suggesting the matter had been sidelined or dropped. Aguirre says it sounds fishy. "I find it troubling," he says.

Aguirre has his own beef with the SEC. He was fired in 2005 after aggressively pursuing an insider trading case against Pequot Capital, the powerful New York hedge fund. Aguirre, who says he was fired after trying to interview current Morgan Stanley Chief Executive John Mack in the matter, says the agency is too close to the industry it covers to be effective as a watch dog. A spokesman for the SEC wouldn't comment for this story.

Others say it's just a matter of things spiraling out of control more quickly than anyone could imagine. "It's very late in the game to be pointing fingers," said Howard Pitkin, Commissioner of Banking in Connecticut. "We all need to sharpen our pencils as far as spotting these problems."

On Friday, Massachusetts securities regulators filed a civil fraud suit against Merrill Lynch over $14 million worth of collateralized debt obligations it sold to the town of Springfield. The state claims the CDOs were unsuitable and sold without the town's consent. (Merrill has acknowledged the latter and paid the town back in full for the investment, which is now practically worthless.)

Earlier last week, the Federal Bureau of Investigation disclosed it had opened criminal fraud probes into 14 companies over their mortgage securitization activities, which includes everything from originating loans to buying them, packaging them and selling them to investors. The FBI didn't identify the companies.

Connecticut and New York attorneys general have also opened investigations into how Wall Street structured and sold mortgage-laden securities.

Goldman Sachs, Morgan Stanley and Bear Stearns have disclosed in their recent regulatory filings that they have been questioned by multiple regulators about their activities involving subprime mortgage securities. In November, Merrill Lynch said the SEC had initiated an inquiry into its subprime mortgage portfolio. All the banks have said they are cooperating. Maybe they should shore up their risk management while they're at it.