

Harvey Pitt

ELIAS
Leducat
Pitt

9/17/10

> Philosophy of Residual Regulation

> Bob Hinkley
> Donna Noma

PUP AB degree '65 Brooklyn College

St Johns Univ Law - JD 1968

> SEC - from school - 1968-1978 -
last 3 - comm. gen'l counsel

1978 - Sept. partner - Freed, Frank →
→ Until 2001

Bush - apptd. 26th Chmn SEC

2003 - founded Kalamazoo Partners

Strategic Consulting

② Kalamazoo Legal Services - law firm entity -
didn't want to go back to law in
adversarial -

help cos. that want to do better -

Variety of advice -

Law firms - unidimensional -

Econ, Acctg, PR, Corp. Relat. -

Some clients more comfortable -
w/ adv/ client privilege

2 separate firms -

Contract separately w/ clients

① Cause of Fin. Crisis - ?

Multiple - imp to limit # of causes hurt

Chances for solutions -

" Reg. system was badly broken "

Dodd-Frank - very worried - didn't do

What we needed to do

"Responsibility on our Regulatory system"

Conhary is not less a man rule - Better Regulation -

Our system grew up after Great Dep.

System based on legal. - "what you were
born as + what you were called"

By 1970s - didn't make sense - Money Market Mutual
Fund invention -

Siphoned savings into those accounts - + avail. for
Use.

After that occurred - perhaps regulators became
flexible abt allowing banks to allow biz (other)

GLB - Congress elimin. barriers of Glass Steagall -

No quarrel w/ removing these barriers -

If you're going to allow everyone to be in everyone
else's biz - no revision of the structure -

Modified Rules -

No adjustment to modifying Regul. Structure

① Free market cannot achieve it all -

Role of govt - Bush ple -

Don't believe - imp. discipl. rule - engage fin. services

Major problem in my view

2) Related problem - New products -

"govt ill suited to comprehend what

was going on + had no mandate to do so"

Derivatives - per said no regul. -

Tended to be an oblig. for someone to
be collecting data

7 Problem - Transparency - Stanley O'Neal -
Merrill Lynch -

Markets moving faster than you can predict
Everyone saw this. It wasn't hidden.
No one stepped up + paid wait a minute.

① Sarbanes-Oxley violation Sect. 404 - ?

Hard to say -

Could well have been a problem.

Markets were deteriorating rapidly.

< If Sarbanes Oxley had done - should have
prevented the Fin. Crisis we experienced >

- ① Regulation Outmoded
- ② Lack of Transparency

What this crisis proved - one word - "Nimbleless"

- ③ WAS NOT a clear ability on gov't part to deal in
national way as issues were evolving

Subprime crisis - I had been retained by

Paulson + Co. they shocked the subprime - clever

They got a phone call from major brokerage firm
solidity market manip. - thought they were long + they were short

2006-2007 -

Ny Fed FDIC Treasury
CFIC SEC Fed

“No authority”

Obama
Rep. + Auer
on part of govt

People didn't know what they did do

Not
Nimble

CFMod. Act - prohibited SEC from
regulating derivatives

Dodd-Frank - (too command + control?)

Tension - we overregulate everything + we don't regulate any
"Unfort. I think both of those pos. are wrong"

Obama admin - If it had approached this in a diff
manner - did have approached this in a way that
should have gotten bip. support

Ability of anyone - impact on Capital markets -

- 1) Report on what's going on
- 2) Clear resps. for govt to analyze that data +
disseminate it to the markets

SEC - upset me back then - collects data
+ don't do anything w/ it

Mutual Funds

was not able to get this done
Economically focused biz.

- Fed does a better job of it -

"They lost sight of that - what risks you're
Creating"

Q Surprised - risk mgmt.

"I was staggered by it"

Merrill - fixed - not for the rt. reason

~~the~~ ^{so it}
Trip wires >

Credit easy + then pulled back

Housing philosophy - own their own homes -

"for me these aren't the causes"

Troublesome - loans for the sake of securing loans

Securitization - was a brilliant idea -

banks law off loans - but not if

what it produces is more loans to worse candidates

Not the focus -

Two classes of ppl - + too many who want
to take adv. of it -

Banks + securitiz - no excuse for maintaining
high standards for loans

"The Fin. Crisis is still ongoing -"

In my view - we're in the middle of this -

Impact obvious : Employment
BLS understates unemployment

"I think we're in for a lot more
suffering" - & not address those causes of
the crisis

Q → Securitization - Home loans moved into
Securitization - unregulated - Not fixed?

Dodd-Frank - 5% skin in the game -
(100% → 105% model -) - not work

Pt. want to be - continuing resp. for making
the loans -

"The ppl who took the loans shld have known."

There's more than enough blame to go around.

Big Short - 5 ppl or so - who are lkg @ the details
of the subprime loans + saying "this
makes no sense"

Clarks + No comprehension - unreadable -

2001 - See return ^{of} disclosure had long ceased
to be informing ppl + all abt creating
defenses to liability"

Still hasn't been fixed

I wanted to fix it.

Speech - 1936 annual report - Co.
6 pp. (w/ Financials 2pp.)

" People don't have any comprehension
of it - "

5 ppl who looked -

" That is the way it worked "

Paulson " I had to explain to them how
the markets work

How you could manipulate the markets. "

Paulson - " Cop on the beat. "

They gave specific info -

calls - there was follow up w/ some

Gov agencies -

+ publicity - spotlight - shut down - the
manipulation activity -

The manipulat. did not occur -

" No one prosecuted "

" Name - language - this was a gift -

No cases were brought. "

If they had clear auth.
Maybe they didn't →

Bob K
Paulson - a regulatory function -
proactive -
Govt was equipped to deal w/ securitiz. ?

"No, not really."

When I was chairman - top to bottom mgmt.
Review done. It was finished w/ recomm.
from SEC -

I left it to Bill Donaldson, successor -
He did not put out -

never had
"SEC did not have risk mgmt capability"

Eron hit - Monday stuff mgmt.
prediction "Next crisis is going to be in the mutual fund
industry"

Soc. Sec. - proposals to privatize
Opponents - argue most ppl are not
capable of mgr acct & market risk
→ Problem - will blow up -

This is what got me interested in trade negot.

Madoff said to staff - Feb 2003 rule proposal -
When I got there SEC office of inspect.
"OICE" - 5yr. cycle to look at money mngs.

> Proposed outsourcing - require of every investment
adviser exam every yr. or every other yr. -
Regul. by SEC -

OICE
SEC - can't do inspections from - They can't
do inspections - "It's a joke"

No way SEC - no talent; can't pay what's req'd
and system he came up w/ for a compliance
audit -

No institutional system - "That is there throughout
govt" -

"Govt will always be reactive, but my
goal was to make them much more proactive"

Q Tension too much - Not every regul -
Financial Conglomerates - passed in Europe
2001 - SEC - find an equivalent regulator -

"No. That was just developing (when he left)"

Q - Prior to that program existing -
"Finnis approached SEC to get into the prudential
regulation business" - on his watch?

"I don't know that we had gotten imperturbed, at least when I was there"

Perriss - Prudential Regulation is salutary, not sufficient.
We proved that in response to 9/11

- Let's set up a hotline for the people who are regulated.

Goal is to tell them how they should handle it, versus after the fact enforcement

• SEC - worried that they would advise + shield bad actors they don't see

Cox - dis-banded the system, which was voluntary.

Farni + Fudde - ^{Congress asked} - claims they
they should be subject to
they registered w/ SEC

CSC system could have worked,
or even if it was initially voluntary. "

Regulation was not very effective

Q 2001-2003 - Any disc. even if we don't have jurisd. over derivatives
→ holding co. → broker-dealer -

Ex. ^{history of} NASDAQ merger w/ London Stock Exchange
(he used to rep. Lloyd's of London)

There was auth. but I heard no disc.

Derivatives - Greenspan was worried about regulating derivatives

Q - SEC - AAA - relies on ratings
Broker-Dealers - "The SEC's blood source"

2:20 pm

What did the SEC see internally abt whether that reliance was OK?

I do recall some discussions.

SEC had no jurisd over ratings agencies.

Ratings agencies got courts to say opinions prot. by First Amendment.

Because of 9/11 - ple worried abt risks.

Investment - that mutual funds could make:

"Wanted us to lower the standards +

I wouldn't do that"

Ratings
Agencies

Report issued during that time from SEC -

SEC had @ ratings agencies on equities
Not derivatives

"It was unfortunate"

I work up a lot of hedge funds -

FASB - "not one iota of credence -

Fair market value problem is that Govt
SEC, never helped to insure a consistent
way that ppl wd value assets"

**FAIR
MARKET
VALUE**

Here are indep economists to check valuation
of assets

If gov't wd have done that, "fair market
value" wd not have been cited

People were just making it up -

Buffett : "They were making to myth"

They never did this -

"The Rating Agencies were completely snowed by this"

Rating Agencies - it concerned me -

No one was raising the issue

"They must have been sitting there
Thinking they missed the money"

"It's like this little dirty secret"

SEC - don't think focused on this issue -
Regul. jurisd - focus on parts -
not functions -

"I think the problems were known"

"The regul. system we had did not
function - The lack of auth
is never really an excuse."

ENRON - he wanted CEOs to
certify their finances -

"We had auth - we had to use it."

let a court tell you

Merill - Lehman - bonuses -

Retention bonuses - Lawyers said yes -

"Represent a corp. Not just calling balls + strikes"

Pl don't step up -

"Agencies could have done things"

Emergency -

"No doubt in my mind - could + shld have done more"

Q

Self-report. - Rule 144A - took away the
speed bumps that were in the
securities market -

> Rational basis for concern.

if Company needs capital - ought to be able to
get it instantly -

Not contributors 144A + self-reports

SEC - Regulation - don't keep up w/ the times - if markets are changing automatically, you have to innovate

> Doubtful that is happening.

> Comfortable w/-

Proactive dynamics of markets -

After 9/11 - up to NYC - press conf.
crisis mgmt - done all my life -
we had to be out front -

Lacking in front when fin. crisis started to hit - started to hit before 2007

> Bear Stearns - Where was SEC when it started to go down.
Why weren't they front + center.

Lacked transparency -

(The Panic) his clients asked him what was going on

JP Morgan - "The govt \$ to Bear was the bailout"

"Lehman had good solid assets"
What happened to Lehman - was almost critical
in my book -

"That blood was on the govt's hand"

"Prior to Lehman (on the street) it was
assumed govt wld bail out"

"I think they panicked - just that on their
watch the US wld have another
Great Depression"

Fed now weaker

Treasury in charge of FSOC -
too much auth

> Deregulation - gets distorted ?

Too big a release that free markets -
Can do it all

Ex. Vignette - my medec. Levitt -

he wanted the options exchanges
to have a common interface -
pricing -

Trade Through Rule - if you trade there
best nat'l price -

got SEC to pass; didn't put it in effect -
Treat of that rule as club to get options
to go.

Ex - Overregul + unrec. regul. + ineffective regul.

Got all 5 options in a room -

Repealed the trade thru rule - illegal
2003 - Uniform interface

"From my view it was deregulation"

Analysts reports - mkt in Nov.

if you do it - got it done by May Big name -

"Deregulation - didn't need a gov't
regul. to get what I wanted"

" I'm sure there were people who
bel. in the regime like it was
a religion -
I didn't "

" All I ever took from dengue. "

" Fiat is a service business "

Come in + tell us what's going on
You can't regulate if you don't want to
Know what people are thinking abt.

" A less hospitable environment to
exploring cooperation "

I think it ceased functioning in a way -
lack of trust resulted

> Don't like prescriptive rules -

✓ Yes - clients
✓ Lehman & Goldman

