MEMORANDUM FOR THE RECORD

Event: Interview with Eric Sirri, former head of the Trading and Markets Division at the SEC

Type of Event: Phone interview

Date of Event: Thursday, April 1, 2010

Team Leader: Tom Krebs

Location: 1717 Pennsylvania Avenue NW, Suite 800, Washington, DC

Participants - Non-Commission:

- Eric Sirri, former head of the Trading and Markets Division, SEC
- Sam Forstein, general counsel of the SEC
- Sarah Hanker, SEC

Participants - Commission:

- Donna Norman
- Troy Burrus
- Mina Simhai
- Jay Lerner
- Hilary Allen

Date of MFR: April 22, 2010

Summary of the Interview or Submission:

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

The purpose of this phone call was to discuss the SEC's Consolidated Supervised Entity program.

Background

Mr. Sirri was an academic until 1996, when he became the chief economist at the SEC. In 1999, he returned to academia, and in September 2006, he returned to the SEC as the director of the Division of Trading and Markets. He held this position until April 2009.

Division of Trading and Markets

The Division of Trading and Markets oversees stock exchanges, broker/dealers, over-the-counter transactions, transfer agents, clearing agents, options markets, and credit rating agencies.

For a year prior to Mr. Sirri starting with the division, Robert Colby was the acting director of the division. When Mr. Sirri arrived, Mr. Colby returned to his prior position of deputy director. Trading and Markets was responsible for the CSE program, which was up and running when Mr. Sirri started with the division. It supervised the five investment banks.

CSE Program

There were roughly 25 people on the CSE staff. Matt Eichner, an assistant director, supervised the CSE program, and he reported to associate director Mike Macchiaroli. This reporting structure was logical, given that Macchiaroli was responsible for broker/dealers, because the focus of the CSE program was on the activities of the consolidated entity to the extent that they impacted the broker/dealers.

The CSE program focused on the broker/dealers; the derivatives subsidiaries of investment banks were not examined. It allowed the SEC to better understand the activities of the investment banks, which—outside of the broker/dealers—had previously been opaque to the SEC. When the SEC evaluated the CSE entities, it paid specific attention to firms' risk and financial controls (including risk management and financial models) because of their impact on the broker/dealers.

The SEC had no statutory authority to regulate investment bank holding companies, so it had to cobble its authority together with rules. It did not gain authority for full supervision of the investment bank holding companies. Without this authority, the SEC did not have the same imprimatur that the Fed had in its supervision of financial holding companies.

Mr. Sirri would meet personally with senior management of the investment banks for relationship purposes. At Lehman Brothers, he met with Fuld, Russo, Callan, O'Meara, and Lowitt. At Bear Stearns, Mr. Sirri had more contact with their risk people and never met Warren Spector. Such meetings weren't focused on any particular issues.

The SEC staff maintained frequent contact with the investment banks (especially with their senior personnel, but more junior people were contacted if necessary). Prior to the summer of 2007, SEC supervisors would speak to the firms at least once a week. If there were issues (for example, if a bank was not going to meet its earnings projections), conversations would be more frequent.

Sometimes the staff identified issues (for example, the size of the liquidity pool) on which they would do horizontal reviews across all the investment banks. They would use the outcome of these reviews as the basis for establishing best practices that they would encourage the investment banks to use. There was an escalation procedure if an SEC staff member could not resolve an issue with his/her counterpart at the investment bank. Macchiaroli would first try to resolve it with his counterpart at the bank. If that didn't resolve the issue, then Mr. Sirri would try to resolve it with the CEO.

The operations of financial firms (like Bear) are somewhat opaque, and risk profiles can change radically in a short period of time (for this reason, financial firm bonds trade at a higher yield than other corporate bonds). Relationships with financial firms must be based on trust and confidence because it can be hard to get a handle on the complexity of the entity in the short period of time in which a risk profile can change.

Prior to the financial crisis, becoming a financial holding company (FHC) under Federal Reserve supervision was not attractive to the investment banks because the restrictions on the business operations of FHCs and their subsidiaries were designed to protect the depositors of commercial banks. However, after the failure of Bear Stearns, the Fed's role as the lender of last resort (and to some extent the guarantor of the financial system) became more important to the investment banks. They understood that the SEC couldn't help them in times of trouble and that the Fed (with its balance sheet) could.

After Bear, the nature of supervision of the investment banks changed, and the NY Fed and the SEC started meeting with the firms individually. The first round of meetings covered the quality of assets, funding, and capital. A later round of meetings covered the need to raise capital, and the firms were given target amounts. A further round of meetings covered the firms' plans to raise capital.

The SEC traditionally took the view that liquidity was paramount in large securities firms, but the Fed had more of an emphasis on capital raising. Because the Fed had become the *de facto* primary regulator because of its balance sheet, its view prevailed. The SEC wanted to be collaborative, and so came to accept the Fed's focus on capital. Sirri said that in hindsight, selling assets to increase liquidity should perhaps have been stressed more. Sirri's view is that selling assets adds transparency to asset values – when the assets are opaque, they may be overly discounted. Sirri thought that the Fed, however, was concerned that a rush to sell would lead to further technical declines in asset prices and that the Fed might not have wanted to see balance sheets contract.

The involvement of the Fed changed the focus of the investment banks, but it didn't undermine the SEC. The Fed and the SEC worked reasonably well together. There was tension between the Fed/OCC and the SEC with respect to Citi and JPMorgan, where the banking regulators were the primary regulators and the SEC operated as the functional regulator for the broker/dealer subsidiaries. In these cases, the SEC had to rely on the banking regulators (and not the firms themselves) for information.

During the financial crisis, the SEC had firms run scenarios for stress tests, but each firm ran different scenarios that matched their risk management type. These scenarios were developed jointly by a firm and the SEC – the SEC tried to maintain some similarities between different firms' tests.

Sirri's view is that it was not realistic to think that the SEC could have seen the risks associated with mortgage assets (the market generally missed this too). Sirri believes that even if the SEC had seen these risks, the sale of these assets would have had to have occurred by 2005/2006 to avoid the crisis – it is difficult to force banks to sell assets during their most profitable period. Neither the SEC nor anyone else saw the correlation risk in the market – to see this would have required recognition that AAA bonds are risky.

The SEC never thought that there would be a run on Bear or that there would be a situation where you couldn't enter into a repo transaction with Treasuries. Thus, none of these situations were run as stress test scenarios. As the financial crisis worsened, the SEC began to see liquidity and funding risk as the most important risks to be managed by the investment banks. The SEC encouraged a reduction in reliance on commercial paper and wanted the repo term extended from

28 to 40 days.

In trying to insure its risky assets, Merrill Lynch generated too much exposure to the monolines, so the SEC told ML to stop entering into agreements with the monolines.

Congress has kept the SEC thinly staffed when compared to the markets they are supervising: Sirri doesn't think that the CSE program was out of line.

Bear and Lehman

The Bear Stearns situation unfolded much more quickly than Lehman. In the beginning of March 2008, the SEC started having meetings with Bear on the subject of Bear's liquidity. Bear didn't have huge subprime exposure – rather, the problem here was a breakdown of the investment banking funding model, which had worked well for years. Bear started the week of March 10, 2008 with an $18 billion liquidity pool, but its counterparties walked away from it and it couldn't open for business by Thursday.

Bear's hedge funds didn't pose any risk to Bear initially, as it had no contractual obligation to stand behind them. However, for reputational reasons, Bear agreed to provide resources once they got in trouble. Sirri guesses that after this pledge was made, counterparties started to increase haircuts and reduce exposure to Bear.

The big problem with Lehman was illiquid assets (especially subprime mortgages and commercial real estate). Lehman didn't want to sell these assets because they are hard to value, and it would incur losses on these. The Fed was more concerned with Lehman raising capital than selling assets to raise liquidity. The SEC had involvement with Lehman with respect to accounting issues/relief for the proposed SpinCo (which never eventuated).

Mr. Sirri was not aware of Lehman's use of Repo 105, or of the liquidity issues reported by Merrill, or of any issues with respect to the valuation process at Lehman beyond those identified during the Commission's inspections. The issue of Lehman's comfort deposit with Citi did not rise to Mr. Sirri's attention.

Mr. Sirri doesn't consider that the liquidity number reported by Lehman needed to be the same as the liquidity number calculated by the SEC. His view is that it is ok for different entities to think about liquidity differently, although he acknowledges that this makes comparison difficult. (The SEC originally required that liquidity had to be at the holding company level, and be unencumbered. The SEC, however, found it reasonable that some firms wanted to keep some of their liquidity at the subsidiary level).

IG's Report

Mr. Sirri thought the IG's report was poorly done (for example, the IG never spoke to Mr. Sirri or any of his deputies, or anyone at the investment banks; the report said that certain documents were missing information and didn't note that that information was readily available in other documents).

Additional Comments

There was no permanent director of the SEC's division of Trading and Markets between the time when Ms. Nazareth left the Division in August of 2005 and the time Mr. Sirri started in September of 2006. During that time, it appears that the structure of the SEC staff focusing on CSE supervision changed. Under Ms. Nazareth's tenure, it appears that there was a dedicated staff of 10-12 people in the Trading and Markets division, and examinations (of risk and otherwise) were conducted by OCIE. During Mr. Sirri's tenure, there was a dedicated staff of about 25 people in Trading and Markets, and these performed all the risk-related examinations. OCIE continued to perform its more traditional role of examining broker/dealers.

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