GARY J. AGUIRRE

By Facsimile or Electronic Mail

February 13, 2008

Senator Christopher Dodd
Chairman
United States Senate Committee on
Banking, Housing and urban Affairs
728 Hart Senate Office Building
Washington, D.C. 20510

Senator Richard C. Shelby
Ranking Member
United States Senate Committee on
Banking, Housing and urban Affairs
110 Hart Senate Office Building
Washington, DC 20510

Re: Hearing on the of State of the United States Economy and Financial Markets

Dear Chairman Dodd and Ranking Member Shelby:

As the current credit crisis unfolds, investors and the public must rely upon your Committee to uncover its causes and scope. Your hearing on Thursday, The State of the United States Economy and Financial Markets, offers an opportunity to question those regulators who are responsible for protecting the capital markets from this evolving crisis. I respectfully submit there are two key questions that penetrate to the core of this crisis:

1) Why did counterparty discipline fail?

2) Why did the SEC stop an investigation three years ago that could have averted the subprime crisis?[1]

I will try to put these questions into sharper focus with the context below.

The myth of counterparty discipline

In essence, the nation has two capital markets: one market is semi-transparent and semi-regulated; the other market is opaque and unregulated. The semi transparent market appears on balance sheets. It is subject to SEC regulations requiring disclosure. It includes investment banks and public companies that regularly file SEC forms disclosing their financial operations.

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The opaque market has its own players and its own playing field. The players are hedge funds—also unregulated and opaque—and the proprietary desks of investments banks. As investment banks own more and more hedge funds, their players also become unregulated and opaque. The playing field is the over-the-counter derivatives and instruments, such as subprime debt, which are off the balance sheets.

The opaque market is experiencing geometric growth. The notional value of the derivative market has increased fivefold since 2003, from around $100 trillion to over $500 trillion. Likewise, hedge funds are having the same geometric growth in assets under management and in sheer numbers. The SEC predicts the assets under managements by hedge funds will grow from $2 trillion to $6 trillion by 2015. Hedge funds currently dominate the trading markets around the world—with only $2 trillion in assets. It is hard to envision the extent to which they will control the markets when their assets grow to $6 trillion, all operating in the shadows.

Hedge funds love to play with the most dangerous forms of derivatives—credit default swaps (CDS). There are now $42 trillion in CDS. These guarantees differ little from gambling. The potential rewards for insider trading are nearly unlimited, as is the negative impact on the capital markets.

After the Great Crash, Congress enacted legislation designed to make our markets transparent. The same legislation created the Securities and Exchange Commission. As money flows from the regulated market to the unregulated market, we are now recreating the conditions that existed immediately before the Great Crash.

The investment banks and hedge funds have come up with a new principle for protecting the capital markets. It is called counterparty discipline. Translated, it means: "Trust us." The term is tossed around as if it were natural law in the financial markets, much like gravity in the physical world. In reality, counterparty discipline is a slogan, a myth, which has been sold to regulators by investment banks and hedge funds so they can operate in the shadows without regulation.

We hear about counterparty discipline during Congressional hearings from those who wish the opaque, unregulated markets to grow. During financial crises, the same folks talk less about "counterparty discipline." Indeed, we are only told that it "eroded" without explanation why.

In fact, the theory of counterparty discipline reverses reality. When the markets are moving upward, optimism is high. It is a cliché, but nevertheless true, that upward trading markets are driven by greed. All of our major investment banks, with the possible exception of Goldman Sachs, failed to detect that subprime debt was a time bomb. Why did counterparty discipline fail the investment banks in their moment of need? I respectfully submit this question should be posed to the three regulators who are testifying on Thursday.

Where is the SEC?

Over the past two months, the Wall Street journal, the New York Times, Reuters, CNBC and Forbes have all asked a single question: where was the SEC on subprime debt?[2] Significantly, three years ago, the SEC was conducting an investigation that could have averted the subprime crisis.[3] The investigation focused on Bear Stearns' evaluation of subprime debt, the core issue in the current crisis. The investigation reached a point where Bear Stearns was told it would be charged. Then, for no known reason, the investigation was switched off. A recent Wall Street Journal article suggests that the effective prosecution of the Bear Stearns case might have averted the subprime crises.[4]

The Bear Stearns investigation is stunningly similar to the SEC investigation of Pequot Capital Management which I headed. Like Bear Stearns, the Pequot investigation appeared to be advancing towards a filing. Like Bear Stearns, senior SEC management decided to halt the investigation. Like Bear Stearns, the SEC was later forced to focus on the underlying abuse, but only after that abuse grabbed media attention. In Bear Stearns, the underlying abuse was overvalued subprime debt. In Pequot, the underlying abuse was widespread insider trading by hedge funds.

We know why the Pequot investigation was stopped. According to a joint report by the Senate Judiciary and Finance Committees,[5] a major investment bank, Morgan Stanley, retained an influential attorney who intervened at the highest level of the Division of Enforcement to stop the investigation. The two Senate committees concluded that senior SEC officials gave preferential treatment to a member of Wall Street's elite and then fired the lead investigator (me) when he questioned that decision. None of the senior SEC officials who derailed the Pequot investigation were ever disciplined. Was the Bear Stearns investigation stopped in a similar way? Did another influential attorney, hired by Bear Stearns, place a call to a high-level official at the SEC?

Your Committee has oversight jurisdiction of the SEC. The SEC's mission is to protect the capital markets and investors. It had a chance to protect the capital markets from the current subprime crisis three years ago, when it was investigating whether Bear Stearns overvalued subprime debt. Why did the SEC call a halt to the Bear Stearns investigation? Who made that decision?

Sincerely,

Gary J. Aguirre

CC: Members of the U.S. Senate Committee on Banking, Housing and urban Affairs.

[1] Michael Siconolfi, *Did Authorities Miss a Chance To Ease Crunch?—SEC, Spitzer Probed Bear CDO Pricing in '05, Before Backing Away,* Wall St. J., Dec. 10, 2007, at C1.

[2] *Id.*; Gretchen Morgenson, *O Wise Bank, What Do We Do? (No Fibbing Now),* N. Y. times, January 27, 2008, at 1; Karey Wutkowski, *SEC Chief Awaits Final Senate Report on Pequot,* Reuters News, February 9, 2007; http://www.cnbc.com/id/22706231/site/14081545/; and Liz Moyer, *Credit Crisis: Where Was The SEC?* Forbes.com, Feb. 6, 2008. Available at http://www.forbes.com/2008/02/05/sec-cmos-banking-biz-wall-cx_lm_0206sec.html.

[3] Michael Siconolfi, *Did Authorities Miss a Chance To Ease Crunch?—SEC, Spitzer Probed Bear CDO Pricing in '05, Before Backing Away,* Wall St. J., Dec. 10, 2007, at C1.

[4] *Id.*

[5] Senate Report No. 110-28 (2007), at 684 Available at http://finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20080307%20SEC.pdf.