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October 1, 2008

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Cox:

I am writing you as the principal House author of H.R. 3657, the Market Reform Act of 1990, a bill which President George H.W. Bush signed into law on October 16, 1990 (see Public Law 101-432).

This legislation was enacted by Congress to address many of the concerns that had been raised regarding the stability of our nation's securities markets in the aftermath of the October 1987 Crash, the October 1989 "mini Crash," and the failure of Drexel Burnham following the collapse of the junk bond market. At the time this bill was signed into law, then-SEC Chairman Richard Breeden noted that the risk assessment language "creates a system of information and oversight over the parents and other affiliates of broker-dealers, thereby giving the Commission 'early warning' of potential danger signs."

I am writing you to express my strong concern at the Commission's appalling failure to implement this provision of the Market Reform Act. I am also dismayed to learn that instead of vigorously administering and enforcing this law, the SEC instead created a largely toothless and ineffectual voluntary "Consolidated Supervised Entity Program." This program turned out to be completely inadequate and inconsistent with the intent of Congress in passing the Market Reform Act.

I believe the SEC's inexcusable regulatory failure in this entire area has contributed to the current problems roiling our nation's financial markets. The Commission's failure has now necessitated a massive federal

government intervention into the financial services industry. I request that the Commission explain, in specific terms, what actions it now intends to take in response to this situation.

Background and Purpose of the Risk Assessment Provision

As you know, in Section 4 of the Market Reform Act, Congress amended Section 17 of the Securities Exchange Act to require all broker-dealers to report to the SEC information regarding the financial condition of its associated persons (e.g., any affiliates, subsidies, etc.) which are reasonably likely to have a material impact on the financial condition of such broker-dealers. Under the provision, the SEC was empowered to get access to both summary and call reports from any broker-dealer regarding the financial state of its associated persons.

The House Energy and Commerce Committee report accompanying the bill (House Report 101-524) explained the purpose of this section:

> "The Committee believes that, on the basis of historical experience and recent events, information regarding the overall financial exposure of broker-dealer holding company systems is critical to the ability of regulators to monitor risks to the stability and integrity of the nation's securities markets. Without access to routinely available information concerning the financial and securities activities of unregulated affiliates, which activities have the potential to impinge on the availability of capital to large broker-dealers, regulators lack the necessary early warning of potential capital problems."

The Committee report further noted:

> "Over the past decade, an increasing number of broker-dealers have formed holding company systems and have moved many potentially risky activities (such as bridge loan financing, interest rate swaps, and foreign currency transactions) outside of the broker-dealer and into affiliates or holding companies that are not under direct regulatory oversight. Many of these activities may involve significant potential exposure to the broker-dealer entity. In periods of adverse market conditions, it is particularly important for the Commission to have access to information regarding the extent of such activities in order to assess the stability of the broker-dealer participants in the marketplace."

SEC Inspector General Reports

Two reports issued by the SEC's Office of Inspector General on September 25, 2008 (see SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, Office of Inspector General, Securities and Exchange Commission (Report No. 446-A, http://www.sec.gov/about/oig/audit/2008/446-a.pdf); and SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program, Office of Inspector General, Securities and Exchange Commission, (Report No. 446-B, http://www.sec.gov/about/oig/audit/2008/446-b.pdf)), paint a disturbing picture of lax regulation, shoddy oversight, and outright incompetence on the part of the SEC and its staff.

The report issued by the SEC's Inspector General regarding the SEC's existing risk assessment program includes the following findings:

- 18 years after enactment of the Market Reform Act, the SEC still has not finalized the "temporary" rules it issued back in 1992 to implement the risk assessment provision – despite the significant changes that have taken place in broker-dealer operations and in our nation's financial markets;
- The SEC doesn't even bother to review most of the risk assessment filings submitted by the 146 firms that are subject to these rules;
- Following the purchase of Bear Stearns in May 2008 by JP Morgan Chase, the SEC still has not determined whether Bear Stearns broker-dealer operations are subject to risk assessment filing requirements with the Commission.
- The SEC apparently doesn't bother to enforce compliance with its risk assessment rules, or with its own policies and procedures relating to these rules;
- The SEC's list of firms that are "exempt" from filing risk assessment reports is both incomplete and erroneous;
- The SEC has not forced firms to file risk assessment reports electronically, so that only 20 of the 146 firms filing actually do so in the more convenient and useful electronic form;
- The SEC's system for electronic filing of risk assessment reports doesn't even allow the SEC staff to fully access the information contained in these filings so that they can do their jobs effectively;

With respect to the Consolidated Supervised Entity (CSE) Program, the SEC's IG found that:

- Bear Stearns was compliant with the CSE capital ratio and liquidity requirements, but the collapse of the firm raised very serious questions about the adequacy of these requirements;
- The SEC did not adequately address several significant risks that impact the overall effectiveness of the CSE program (including concentration of assets, use of leverage, risk management processes, risk scenarios);
- The SEC staff, apparently without proper authority, allowed the CSE firms' internal auditors to perform critical work – when such work should only have been done by an outside auditor;
- The SEC did not require the communication strategy component of Bear Stearns contingency funding plan after the collapse of two of the firms' managed hedge funds;
- The SEC's monitoring staff did not adequately track material issues;
- The SEC's orders allowing firms such as Bear Stearns to use the alternative capital method were generally approved before the inspection process was completed;
- The SEC office responsible for overseeing the CSE program did not collaborate with other SEC offices or divisions that should have been consulted about aspects of the program;
- The SEC's review Bear Stearns' 2006 10-K filing was not done in a timely fashion;
- Certain firms may pose a systemic risk to the financial markets because they are not supervised on a consolidated basis; and,
- The SEC should address organizational issues involving the future of the CSE program in light of the collapse of Bear Stearns, the bankruptcy of Lehman Brothers, the purchase of Merrill Lynch by Bank of America, and the transformation of Goldman Sachs and Morgan Stanley from investment to commercial banks.

I note that in a press release issued on Friday, you announced the cancellation of the Consolidated Supervised Entity Program -- an obviously long-overdue step in dealing with what was clearly a failed program. I would respectfully request that you report on what specific steps the SEC now intends to take to fully utilize the authorities conferred upon it by the risk assessment provisions of the Market Reform Act, in conjunction with the SEC's other existing authorities over broker-dealers and our nation's securities markets. Clearly, more aggressive and effective use of the SEC's

risk assessment legal authorities is warranted, and the SEC needs to devote sufficient staffing and resources to making this program effective.

In addition, the press release the SEC issued Friday notes that with respect to those broker-dealers that have – either voluntarily or not – become bank holding companies, the SEC has worked out a Memorandum of Understanding with the Federal Reserve to ensure proper supervision of such entities' financial and operating conditions. That is useful. But what is the SEC going to do with respect to the firms that remain subject to its oversight?

The IG report raises some very serious concerns about the competence of the Securities and Exchange Commission in carrying out its responsibilities. In response to these reports, what if any changes – if any -- does the Commission intend to make in this area beyond simply eliminating the failed Consolidated Supervised Entities Program?

Finally, I request that you inform me what specific steps the SEC will take in response to each of the findings and recommendations made by the Inspector General in the two aforementioned reports.

Thank you for your cooperation in providing responses to these requests. Should you have any questions about these requests, please have your staff contact Mr. Jeff Duncan of my staff at 202-225-2836.

Sincerely,

Edward J. Markey