

NATIONAL CENTER FOR REGULATORY REFORM

# Report on the Derivative Market Crash of 2008

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U.S. President and Congress Must Lead a Worldwide  
Reform of Financial, Securities and Banking Systems

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The Derivative Market Crash of 2008 caused a world banking financial crisis. The U.S. President and Congress must act to restore the banking and financial system by reforming it to serve the public interest.

## TABLE OF CONTENTS

I.	SUMMARY OF REPORT .....	1
A.	Results of Credit Derivative Market Speculation .....	2
B.	Struggling Financial Markets and Government Support .....	5
C.	Lessons from The 1933 Banking Crisis.....	6
II.	BACKGROUND .....	9
III.	THE WORLDWIDE DERIVATIVE BANKING SYSTEM .....	13
A.	Credit Default Swaps .....	16
B.	Collateralized Debt Obligation .....	17
C.	Synthetic Collateralized Debt Obligation .....	18
D.	Total Return Swap .....	18
E.	Explosion in Growth.....	19
F.	Major Banks And Worldwide Companies Hold And Promote Derivatives .....	20
IV.	DERIVATIVE MARKET COLLAPSE OF 2008 .....	22
A.	Bear Stearns Collapse Triggers Bank Crisis .....	23
B.	Bear Stearns And Washington Mutual Disappear Into JP Morgan Chase.....	38
C.	Countrywide and Merrill Lynch Disappear Into Bank of America .....	41
D.	Lehman Brothers Collapses .....	43
E.	Bank Failures Wreak Havoc on Financial Markets World-Wide .....	44
F.	The Collapse of AIG.....	47
V.	FUNDAMENTAL PRINCIPLES ABANDONED IN BANK AND INSURANCE COMPANY BAILOUT .....	47
VI.	REFORMS NEEDED.....	53
VII.	CONCLUSION.....	58

## TABLE OF EXHIBITS

- Exhibit 1 9 March 1933 Franklin D. Roosevelt Message to Congress on Resumption of Banking. <http://www.presidency.ucsb.edu/ws/index.php?pid=14474>
- Exhibit 2 19 April 1933 Excerpts from President Franklin Roosevelt’s press conference. <http://www.presidency.ucsb.edu/ws/index.php?pid=14620>
- Exhibit 3 23 October 2008 Former Federal Reserve Chairman Alan Greenspan testimony before the House Committee on Government Oversight and Reform. <http://oversight.house.gov/documents/20081023100438.pdf>
- Exhibit 4 19 May 1933 Report from the Committee on Banking and Currency US House of Representatives p. 1
- Exhibit 5 8 October 2008 SEC Chairman Christopher Cox Speech Opening Remarks at SEC Roundtable on Modernizing the SEC’s Disclosure System Washington, D.C. <http://www.sec.gov/news/speech/2008/spch100808cc.htm>
- Exhibit 6 8 May 2003 Remarks by Chairman Alan Greenspan *Corporate governance* at the 2003 Conference on Bank Structure and Competition, Chicago, Illinois (via satellite), see <http://books.google.com/books?id=mBGE9JycgrEC&pg=PA371&lpg=PA371&dq>  
<http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm>
- Exhibit 7 27 April 2001 Remarks by Chairman Alan Greenspan *The paydown of federal debt* Before the Bond Market Association, White Sulphur Springs, West Virginia (via videoconference) April 27, 2001. <http://www.federalreserve.gov/BoardDocs/Speeches/2001/20010427/default.htm>
- Exhibit 8 November 2008 Depository Trust & Clearing Corporation (“DTCC”) Trade Information Warehouse Data. <http://www.dtcc.com/news/newsletters/dtcc/2008/nov/index.php>
- Exhibit 9 Vinod Kothari, Introduction to Credit Derivatives
- Exhibit 10 June 2006, PIMCO Bond Basics

- Exhibit 11 27 September 2006 University of Chicago Law School Faculty Blog, Moral hazard and credit derivatives. [http://uchicagolaw.typepad.com/faculty/2006/09/moral\\_hazard\\_an.html](http://uchicagolaw.typepad.com/faculty/2006/09/moral_hazard_an.html)
- Exhibit 12 30 January 2007 Seeking Alpha: *Credit Derivatives, Moral Hazard and System Risk*. <http://seekingalpha.com/article/24443-credit-derivatives-moral-hazard-and-systemic-risk>
- Exhibit 13 3 November 2008 (Bloomberg) US TO Borrow Record This Quarter to Finance Deficit. <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aLxufXAnIqE>
- Exhibit 14 3 November 2008 U.S. Treasury press release Treasury Announces Marketable Borrowing Estimates. <http://www.treasury.gov/press/releases/hp1236.htm>
- Exhibit 15 Board of Governors of the Federal Reserve System, Press Releases (Sept – Dec 2008) regarding Federal Reserve auctions of credit through its Term Auction Facility. <http://www.treasury.gov/press/>
- Exhibit 16 4 March 1933 Inaugural Address by President Franklin D. Roosevelt. <http://www.presidency.ucsb.edu/ws/index.php?pid=14473>
- Exhibit 17 12 November 2008 Speech by SEC Chairman: Building on Strengths in Designing the New Regulatory Structure, by Chairman Christopher Cox *U.S. Securities and Exchange Commission* PLI 40th Annual Securities Regulation Institute New York, New York. <http://www.sec.gov/news/speech/2008/spch111208cc.htm>
- Exhibit 18 Office of Management and Budget (OMB) North American Industry Classification System (NAICS) Update Process Fact Sheet <http://www.census.gov/eos/www/naics/faqs/faqs.html#q1>
- Exhibit 19 Adolf A. Berle *Navigating the Rapids* 1918-1971 p. 90
- Exhibit 20 5 March 1933 Franklin D. Roosevelt Proclamation No. 2038 Calling Congress Into Extraordinary Session. <http://www.presidency.ucsb.edu/ws/index.php?pid=14584>
- Exhibit 21 6 March 1933 Franklin D. Roosevelt Proclamation No. 2039 Declaring Bank Holiday. <http://www.presidency.ucsb.edu/ws/index.php?pid=14661>

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- Exhibit 23(a) 9 March 1933 Franklin D. Roosevelt Message to Congress on Resumption of Banking
- Exhibit 23(b) 10 March 1933 Franklin D. Roosevelt Executive Order 6073 on Reopening Banks. <http://www.presidency.ucsb.edu/ws/index.php?pid=14507>
- Exhibit 24 12 March 1933 Franklin D. Roosevelt Fireside Chat on Banking. <http://www.presidency.ucsb.edu/ws/index.php?pid=14540>
- Exhibit 25 FDIC Legal Opinion The Legality of Discount Brokerage Services When Offered By Insured Nonmember banks General Counsel’s Opinion No. 6, 48 *Fed. Reg.* 22989, May 23, 1983]
- Exhibit 26 29 June 1987 Congressional Research Service: Glass-Steagall Act: Commercial vs. Investment Banking Jackson William D.
- Exhibit 29 FASB Statement of Financial Accounting Standard No. 133.6
- Exhibit 30 Stulz, Rene M. Demystifying Financial Derivatives, p. 20
- Exhibit 31 The William Margrabe Group, Inc., Consulting, Derivatives Dictionary. <http://www.margrabe.com/Dictionary.html>
- Exhibit 32 *Eternity Global Master Fund Ltd. V. Morgan Guar. Trust Co. of N.Y.* 375 F. 3d 168, 171-172 (2<sup>nd</sup> Cir. 2004)
- Exhibit 33 Mengle, David, Head of Research International Swaps and Derivatives Association, Credit Derivatives: An Overview, p. 3. [http://www.frbatlanta.org/news/conferen/07fmc/07FMC\\_mengle.pdf](http://www.frbatlanta.org/news/conferen/07fmc/07FMC_mengle.pdf)
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- Exhibit 36 17 March 2008 BBC Report Rescue for troubled Wall St bank

- Exhibit 37 ISDA Brief of Amicus Curiae in Support of the Brief of Defendant-Appellant in the US Court of Appeals Second Circuit in *Aon Financial Products, vs. Societe Generale*
- Exhibit 38 Second Quarter 1998 OCC Reports on Bank Trading and Derivatives Activities
- Exhibit 39 Second Quarter 2008 OCC Reports on Bank Trading and Derivatives Activities
- Exhibit 40 16 April 2008 ISDA News Release ISDA Publishes Year-End 2007 Market Survey
- Exhibit 41 DTCC News and Information for DTCC customers DTCC Addresses Misconception About Credit Default Swaps
- Exhibit 42 14 November 2008 DTCC Trade Information Warehouse Data Top 1000 Reference Entities, Gross and Net National amounts
- Exhibit 43 *AON Financial Products v. Societe Generale*, 476 F. 3d 90 (Second Circuit 2007)
- Exhibit 44 2008 Schedule 14A Bear Stearns Information Required in a Proxy Statement, p.27
- Exhibit 45 IndyMac Bancorp 2002 SEC 10K Report p. 9
- Exhibit 46 11 July 2008 Dow Jones Newswires US Regulators Close IndyMac Bankcorp, Blame Schumer
- Exhibit 47 2007 IndyMac Bancorp SEC 10-K Report p. 66
- Exhibit 48 24 July 2008 AP story Grand Jury investigating lenders
- Exhibit 49 18 June 2008, U.S. Grand Jury Indictment in US v. Ralph Cioffi and Matthew Tannin CR 08 415 US District Court Eastern District of New York
- Exhibit 50 19 December 2007 Civil Complaint Barclays Bank PLC, v. Bear Stearns Asset Management Inc., Ralph Cioffi, Matthew Tannin, Bear, Stearns & Co. Inc., and the Bear Stearns Companies Inc.
- Exhibit 51 30 August 2007 Opinion p. 4 US Bankruptcy Court Southern District of New York, In re: *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* (In Provisional Liquidation)

- Exhibit 52 14 November 2007 State of Massachusetts Administrative Complaint *In the Matter of Bear Stearns Asset Management* (Docket No. E-2007-0064)
- Exhibit 53 Dufey, Gunter; and Rehm, Florian; “An Introduction to Credit Derivatives”
- Exhibit 54 29 October 2008 Bank of America Complaint filed against Bear Stearns Asset Management, Ralph Cioffi, Matthew Tannin, and Raymond McGarrigal
- Exhibit 55 10 March 2008 Moody’s Investors Service Press Release: Moody’s Downgrades Bear Stearns Alt-A Deals
- Exhibit 56 14 March 2008 Moody’s Investors Service Press Release: Moody’s downgrades Bear Stearns to Baa1; continues to review down
- Exhibit 57 24 March 2008 JPMorgan Chase and Bear Stearns Announce Amended Merger Agreement
- Exhibit 58 11 January 2008 Bank of America Press Release: Bank of America Agrees to Purchase Countrywide Financial Corp.
- Exhibit 59 14 May 2008 Order In Re Countrywide Financial Corp. Derivative Litigation
- Exhibit 60 16 September 2008 Credit Default Swaps Complicate Lehman Bankruptcy
- Exhibit 61 2006 10K Report Lehman Brothers p 41
- Exhibit 62 Insurance Information Institute Largest U.S. Financial Services Firms by Revenues
- Exhibit 63 13 November 2008 County of San Mateo press release announcing suit against Lehman Brothers Executives and CPA
- Exhibit 64 Complaint *San Mateo County v. Lehman Brothers*
- Exhibit 65 14 October 2008 Treasury Leadership Roundtable Financial Counterparty Credit Default Swaps Analysis
- Exhibit 66 OCC’s Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2008
- Exhibit 68 Depository Trust & Clearing Corporation 14 November 2008 report
- Exhibit 69 FDIC Quarterly Report for Second Quarter 2008, Table VIA Derivatives and Page 1 - [http://www.fdic.gov/bank/analytical/quarterly/2008\\_vol2\\_3/FDIC135\\_Quarterl](http://www.fdic.gov/bank/analytical/quarterly/2008_vol2_3/FDIC135_Quarterl)

- Exhibit 70 25 November 2008 Capital Purchase Program Transaction Report
- Exhibit 71 FDIC Institution lists ranking banks by total assets as of 30 June 2007 and 30 September 2008
- Exhibit 72 FDIC Failed Bank List as of 21 November 2008, attached as Exhibit 72.
- Exhibit 73 FDIC All Institutions Performance Third Quarter Report - <http://www2.fdic.gov/qbp/2008sep/qbpall.html>
- Exhibit 74 AIG 10 K Report 2007
- Exhibit 75 1 December 2008, Prepared Remarks of Assistant Secretary Patrick O'Brien on Treasury's Approach Toward Combating Kleptocracy
- Exhibit 76 11 March 2008 Federal Reserve Bank of New York Press Release, Statement Regarding System Open Market Account Activity
- Exhibit 77 16 March 2008 Federal Reserve Bank of New York Press Release, Federal Reserve Announces Establishment of Primary Dealer Credit Facility
- Exhibit 78 PDC Facility: Program Terms and Conditions
- Exhibit 79 PDCF: Frequently Asked Questions
- Exhibit 80 24 March 2008 Federal Reserve Bank of New York Press Release - Statement on Financing Arrangement of JP Morgan Chase's Acquisition of Bear Stearns
- Exhibit 81 24 March 2008 Federal Reserve Bank of New York Press Release - Summary of Terms and Conditions Regarding the JPMorgan Chase Facility
- Exhibit 82 11 July 2008 FDIC Press Release FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank
- Exhibit 83 13 July 2008 US Department of Treasury Press Release, Paulson Announces GSE Initiatives
- Exhibit 84 19 September 2008 Federal Reserve Bank of New York Press Release, Statement Regarding Planned Purchase of Agency Debt
- Exhibit 85 7 October 2008 Federal Reserve Press Release
- Exhibit 86 14 October 2008 CPFF Program Terms and Conditions
- Exhibit 87 17 October 2008 CPFF Frequently Asked Questions



Exhibit 88	3 October 2008 The White House Press Release: President Bush Signs H.R. 1424 Into Law
Exhibit 89	Emergency Economic Stabilization Act of 2008
Exhibit 90	14 October 2008 US Department of Treasury Press Release - Treasury Announces TARP Capital Purchase Program Description
Exhibit 91	TARP AIG SSFI Investment - Summary of Senior Preferred Terms
Exhibit 92	Process-Related FAQs for Capital Purchase Program
Exhibit 93	10 November 2008 US Department of Treasury Press Release announcing restructuring of AIG transaction
Exhibit 94	Treasury Department Tranche Report to Congress (Including Systemically Significant Failing Institution Program) (“SSFI”)
Exhibit 95	14 November 2008 Testimony of Interim Assistant Secretary for Financial Stability Neel Kashkarl before the House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy
Exhibit 96	21 October 2008 Federal Reserve Press Release announcing the creation of the Money Market Investor Funding Facility (MMIFF)
Exhibit 97	MMIFF Frequently Asked Questions
Exhibit 98	MMIFF Program Terms and Conditions
Exhibit 99	23 November 2008 Treasury Department Press Release Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup
Exhibit 100	Summary of Terms of Citigroup
Exhibit 101	25 November 2008 US Treasury Press Release Treasury Provides TARP Funds to Federal Reserve Consumer ABS Lending Facility
Exhibit 102	25 November 2008 US Treasury Press Release Secretary Paulson Remarks on Consumer ABS Lending Facility
Exhibit 103	2008 Form 8-K for AIG
Exhibit 104	10 November 2008 AIG Capital Structure and 3Q 2008 Earnings Investor Presentation
Exhibit 105	10 November 2008 US Treasury Press Release Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act

- Exhibit 106 2 August 2001 letter from Nancy Millar, President, National Organization for Women-NYC to Johnathan G. Katz, Secretary, Securities and Exchange Commission
- Exhibit 107 16 December 1999 CRS Report for Congress Major Financial Services Legislation, The Gramm-Leach-Bliley Act (P.L. 106-102): An Overview p. 2 (F. Jean Wells Specialist in Economic Policy Government and Finance Division William D. Jackson) <http://epic.org/privacy/glba/RL30375.pdf>
- Exhibit 108 Phillips, Ronnie J., *The Chicago Plan & New Deal Banking Reform* Page 60
- Exhibit 109 CRS Report Major Financial Services Legislation, the Gramm, Leach, Bliley Act
- Exhibit 110 Major Senate Investigations, A Selected List  
[www.senate.gov/artandhistory/history/resources/pdf/Investigations.pdf](http://www.senate.gov/artandhistory/history/resources/pdf/Investigations.pdf)
- Exhibit 111 9 December 2008 Statement of Edward J. Pinto before the Committee on Oversight and Government Reform United States House of Representatives

# I. SUMMARY OF REPORT<sup>1</sup>

“We are in the midst of a once-in-a century credit tsunami.” Alan Greenspan<sup>2</sup> 2008

This legislation [1933 Banking Act] will “mark the beginning of a new relationship between the banks and the people of this country.” FDR 1933<sup>3</sup>

“What we had to do last March [1933] was to clear away the dead wood. We had been heading for a bank smash-up for a long time and what we did was a drastic thing, which was to clear away the dead wood and start afresh.” FDR 1933<sup>4</sup>

Faced with the closing of the nation’s banks, the U.S. Congress in 1933 enacted fundamental banking reform legislation. In adopting the 1933 Banking Act Congress placed “general restrictions upon the operating policy of Federal Reserve banks with the intent to limit the extensions of credit for ordinary business purposes and to make plain that their resources are not to be used to support speculation.”<sup>5</sup> These credit restrictions were designed to stop bankers from speculating with depositor funds, a practice believed to be largely responsible for the massive bank failures beginning in the late 1920’s.

In 1999 the Congress repealed the 1933 Banking Act, essentially unwinding regulations enacted to curb the rampant speculation that caused the Great Crash of 1929.

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<sup>1</sup> The NATIONAL CENTER FOR REGULATORY REFORM (NCRR) is a Citizens Group organized in San Diego, California. <http://www.centerforregulatoryreform.org/> In 2006 the Securities & Exchange Commission (“SEC”) found the City of San Diego engaged in securities fraud, the largest municipal securities fraud in American history. The failure of the regulatory system to restrain or to hold those responsible for the unlawful behavior has served to undermine public confidence in the federal regulatory system. The Wall Street Journal has noted how the people of San Diego have paid the price for such unlawful conduct with the loss of the City’s credit rating and the curtailment of city services. The NCRR’s mission is to provide reports and research to citizens who want to reform our banking, securities, and business systems.

<sup>2</sup> 23 October 2008 Former Federal Reserve Chairman Alan Greenspan testimony before the House Committee on Government Oversight and Reform, attached as Exhibit 3.

<sup>3</sup> 9 March 1933 Message to Congress on Resumption of Banking, attached as Exhibit 1. The exhibits are posted on the Center for Regulatory Reform website. For copyright protected documents we suggest you retrieve the exhibit from the relevant websites.

<sup>4</sup> 19 April 1933 Excerpts from President Franklin Roosevelt’s press conference, attached as Exhibit 2.

<sup>5</sup> 19 May 1933 Report from the Committee on Banking and Currency US House of Representatives p. 1, attached as Exhibit 4 (also included is the 22 April 1932 Senate Report on the Operation of the National and Federal Reserve Banking Systems).

Sophisticated methods of speculation arose from the relaxing of the banking rules established in the 1933 Banking Act. Eventually, these new models for speculation morphed into a whole new system of investment vehicles sold over-the-counter to spread, reduce and hedge risks. These new vehicles were named credit derivative products. The markets that spawned these new credit derivative products were “completely lacking in transparency, and virtually unregulated.”<sup>6</sup> The new financial system they created crashed on its own accord in 2008.

#### A. RESULTS OF CREDIT DERIVATIVE MARKET SPECULATION

The failure to properly price these risky investments caused the collapse of the credit derivative market and precipitated a world banking crisis. Former Federal Reserve (Fed) Chair Alan Greenspan explains this in his 23 October 2008 testimony before the U.S. House of Representatives Government Oversight Committee:

It was the failure to properly price such risky assets that precipitated the crisis. In recent decades, a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the pricing model that underpins much of the advance in derivatives markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year (2007) because the data imputed into the risk management models generally covered only the past two decades, a period of euphoria.<sup>7</sup>

Just a few years earlier, credit derivatives had been trumpeted by Mr. Greenspan and other financial leaders. In May 2003, Mr. Greenspan said credit derivatives are “critical for economic stability.”<sup>8</sup> The promise of the credit derivative pioneers seemed unlimited: “you or your colleagues could produce a nearly riskless security.”<sup>9</sup> Five years later, the entire market collapsed under the financial burden of these credit derivatives.

The world’s major financial institutions, the International Swaps and Derivatives Association (“ISDA”), and hedge funds were successful beyond their wildest dreams when the credit derivative market climbed to \$58 trillion.<sup>10</sup> Unregulated and fueled by the imagination of

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<sup>6</sup> 8 October 2008 SEC Chairman Christopher Cox Speech Opening Remarks at SEC Roundtable on Modernizing the SEC’s Disclosure System Washington, D.C, attached as Exhibit 5.

<sup>7</sup> Ibid 4.

<sup>8</sup> Greenspan, Alan *The Age of Turbulence* p. 371; 8 May 2003 Remarks by Chairman Alan Greenspan *Corporate governance* at the 2003 Conference on Bank Structure and Competition, Chicago, Illinois (via satellite), attached as Exhibit 6.

<sup>9</sup> 27 April 2001 Remarks by Chairman Alan Greenspan *The paydown of federal debt* Before the Bond Market Association, White Sulphur Springs, West Virginia (via videoconference) April 27, 2001, attached as Exhibit 7.

<sup>10</sup> Ibid 6. In November 2008 the Deposit Trust & Clearing Corporation (“DTCC”) put the credit derivatives at \$32 trillion, attached as Exhibit 8.

those controlling the world's wealth, the credit derivative market became a "tangled web of interconnections" where "the failure of any one institution might jeopardize the entire financial system."<sup>11</sup>

The regulation-free, opaque world of credit derivatives and hedge funds created a zone of moral hazard.<sup>12</sup> Derivatives were "coupled with the device of securitization" and led to the "commoditization of credit risk." High risk mortgages known as subprime loans were sold to home buyers or home owners in the form of refinanced loans. These loans were taken by the originating banks grouped together in a bundle (securitized), and sold as a separate investment vehicle. The buyers of these new securitized loans sought to reduce the risks of the investment. As a result, the owners of the bundled loan securities entered into credit derivatives, known as credit default swaps. This was a principle driving force propelling the credit derivative into the stratosphere of becoming a \$58 trillion market.

A somber Alan Greenspan admitted in his October 2008 testimony before the Congress that moral hazard was the core reason for the Derivative Market Crash of 2008:

The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by the unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to create and sell mortgage backed securities so quickly that they never put their shareholder' capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling. Pressures on lenders to supply more 'paper' collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses.

As time passed, it became clear that home buyers and home owners that took the mortgages and loans would never be able to pay back these loans. In turn, it became clear that the securitized mortgages were bad debt. The SEC Chairman made this point in a November 2008 speech and stated that "billions in worthless mortgage paper" had been issued:

Above all, in the current turmoil, the markets and investors need transparency. From the moment that the collapse of lending standards created billions in worthless mortgage paper — and billions more in hidden risk — market participants have had enormous difficulty discovering and pricing that risk.

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<sup>11</sup> Ibid 6.

<sup>12</sup> The general concept of moral hazard is the tendency for insurance against loss to reduce incentives to minimize loss. Alan Greenspan explains that insurance causes people to be less careful about the adverse consequences of their actions because they are insured, Greenspan, Alan The Age of Turbulence p. 374; also see On the Genealogy of Moral Hazard, 75 Texas L. Rev. 237 (1996) (Tom Baker).

Illiquid instruments that were not long ago rated AAA for credit quality were hidden in off-balance sheet vehicles and elaborately structured securities.<sup>13</sup>

The promise that credit derivatives would hedge risks created a moral hazard zone.<sup>14</sup> Promoters of mortgage-backed-securities grew careless. Greed took hold and credit derivatives ballooned into a \$58 trillion market.

The derivative business grew “between the gaps and seams of the current regulatory system.”<sup>15</sup> It took the credit derivative market only 10 years to reach \$58 trillion.<sup>16</sup> It was “more than the gross domestic product of every country on earth, combined.”<sup>17</sup> Under the weight of \$58 trillion in credit derivatives, the market collapsed.<sup>18</sup>

Credit derivatives allowed banks to circumvent government-imposed capital adequacy requirements for risky loans. Credit derivatives allowed banks to offload risk through a credit derivative transaction.<sup>19</sup> In other words, the creation of credit derivatives allowed banks to keep the risk associated with loaned funds off their balance sheets. This allowed the banks to issue more loans.

Credit derivatives have vastly expanded credit for speculation purposes. In a sense, the credit derivative is only the most recent device used by bankers to expand credit for speculative purposes. The credit derivatives of the 1920’s that helped to dangerously expand credit until the Market Crash of 1929 were “bankers’ acceptances:”

The general ease and accessibility of credit under the regime which existed prior to 1929 was accentuated by the issue of instruments known as the bankers’ acceptance. In its original purpose this form of lending was intended to include only unquestionably liquid obligations, growing out of the actual sale of goods in

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<sup>13</sup> 8 October 2008 SEC Chairman Christopher Cox Speech Opening Remarks at SEC Roundtable on Modernizing the SEC’s Disclosure System Washington, D.C, attached as Exhibit 5.

<sup>14</sup> The general concept of moral hazard is the tendency for insurance against loss to reduce incentives to minimize loss. Alan Greenspan explains that insurance causes people to be less careful about the adverse consequences of their actions because they are insured, Greenspan, Alan *The Age of Turbulence* p. 374; also see *On the Genealogy of Moral Hazard*, 75 *Texas L. Rev.* 237 (1996) (Tom Baker).

<sup>15</sup> *Ibid* 6.

<sup>16</sup> *Ibid* 6.

<sup>17</sup> *Ibid* 6.

<sup>18</sup> *Ibid* 6.

<sup>19</sup> 27 September 2006 University of Chicago Law School Faculty Blog, *Moral hazard and credit derivatives*, attached as Exhibit 11; see also *The Promise and Perils of Credit Derivatives*, Partnoy, Frank, Skeeo David A. Jr., University of Pennsylvania Law School (2006), <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1129&context=upenn/wps>.

foreign trade, so that the acceptance became a short-term claim payable in international funds, usually gold. \*\*

Later amendments to the reserve act, adopted during the World War, broadened the use of the acceptance and opened the door to the application of a conception of its use which was principally that of a finance bill—a bill without reference to the immediately liquid character of a given transaction, and primarily based upon the general power of the parties to it to see that it was liquidated from some source. The use of the acceptance to supply what was called dollar exchange, although doubtless of advantage under proper restrictions, undoubtedly opened a door to grave abuses.\*\*<sup>20</sup>

By early 2007 voices were warning that credit derivatives were being abused because their economic risk was going undisclosed. Christopher Whalen, a financial analyst, warned on 30 January 2007 that the “OTC derivatives and kindred structures like collateralized debt obligations (CDO)” were driving “a process whereby assets are being packaged and sold at prices that understate the true economic risk” which is lowering “credit quality for the financial system as a whole.”<sup>21</sup>

## **B. STRUGGLING FINANCIAL MARKETS AND GOVERNMENT SUPPORT**

The failing financial institutions have sought protection in a rolling-in-place shelter cobbled together by the major market players, with help from the federal government. The shelters consist of four oversized banks into which the financial institutions suffering some of the greatest derivative losses have been folded.

These banks, albeit standing on shaky legs, are:

- 1) Bank of America (with Countrywide and Merrill Lynch);
- 2) Wells Fargo Bank (with World Savings and Wachovia);
- 3) JP Morgan Chase (Bear Stearns and Washington Mutual); and
- 4) Citibank.

These and a handful of other smaller financial institutions infected by the credit derivative disease are being kept alive by a multi-trillion dollar life support system from the U.S. Treasury and Federal Reserve System (the “Fed”). The U.S. government is struggling to borrow enough money to prop up the ailing financial system. The federal government has been attempting to borrow \$150 billion every few weeks.

Goldman Sachs estimates the U.S. government will have to borrow \$1 trillion in 2009 to cover its losses – largely tied to bad investments in the credit derivative market. According to Bloomberg news service, the U.S. Treasury “more than tripled its planned debt sales for this

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<sup>20</sup> Ibid 5.

<sup>21</sup> 30 January 2007 Seeking Alpha: *Credit Derivatives, Moral Hazard and System Risk*, attached as Exhibit 12.

quarter (October to December) to help finance a 2009 budget deficit that bond dealers advising the department estimate may swell to almost \$1 trillion.”<sup>22</sup> On 3 November 2008, the U.S. Treasury Department announced it would borrow \$550 billion from October to December 2008 to pay for the bailout.<sup>23</sup>

The Treasury Department appears to have had difficulty borrowing enough in some auctions, which highlights the delicate status of the financial industry. Table 1 compares the auction targets with actual amounts raised in the last 8 auctions:

**Table 1: Fed Credit Auctions (September through December 2008)**

Date 2008	Auction Amount	Propositions Submitted	Propositions Accepted	Bidders
10 September	\$25 B	\$46.2	\$25 B	53
23 September	\$75 B	\$133.5B	\$75 B	85
7 October	\$150 B	\$138 B	\$138 B	71
21 October	\$150 B	\$113.2 B	\$113.2 B	74
12 November	\$150 B	\$12.6 B	\$12.6 B	16
25 November	\$150 B	\$31B	\$31B	16
2 December	\$150 B	\$66.4 B	\$66.4 B	80 <sup>24</sup>

The widespread collapse of the banking system has been averted only because central banks and governments are taking “unprecedented measures” in transferring billions of dollars of federal funds to the troubled banks and insurance firms.<sup>25</sup> The government has committed to as much as \$8 trillion in assistance to the troubled financial service companies.<sup>26</sup>

### C. LESSONS FROM THE 1933 BANKING CRISIS

This Report documents the lessons learned and embodied in banking reform legislation passed after the 1933 bank crisis. Those lessons were aptly stated by President Franklin Roosevelt in 1933:

Finally, in our progress toward a resumption of work we require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with

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<sup>22</sup> 3 November 2008 (Bloomberg) US TO Borrow Record This Quarter to Finance Deficit, attached as Exhibit 13.

<sup>23</sup> 3 November 2008 press release U.S. Treasury Announces Marketable Borrowing Estimates, Exhibit 14.

<sup>24</sup> US Treasury press releases for 10 September, 23 September, 7 October, 21 October, 12 November, 25 November, 2 December 2008, Board of Governors of the Federal Reserve System, Press Releases (Sept – Dec 2008) regarding Federal Reserve auctions of credit through its Term Auction Facility, attached as Exhibit 15.

<sup>25</sup> Ibid 4.

<sup>26</sup> Pro Publica, <http://www.propublica.org/article/a-bailout-that-works>.



other people's money, and there must be provision for an adequate but sound currency.<sup>27</sup>

This Report proposes the United States President and the United States Congress lead a worldwide effort to reform and restore the banking and securities markets to their original purpose “to raise money for productive enterprise and for the support of millions of jobs throughout our economy.”<sup>28</sup>

This Report proposes bank insolvency reorganization for failed banks, regulation of credit derivatives and hedge funds, and prohibition of credit derivative speculation. This Report proposes a more strategic use of federal funds and opposes the wholesale transfer of trillions of dollars to the failed banks. The report is built in part on the fundamental principle that it is immoral for the federal government to transfer trillions of dollars of innocent taxpayer funds to relieve sophisticated market players from the market outcomes they created.

The Report urges the President and Congress to adopt legislation that will separate banking into commercial, investment and insurance divisions. It also recommends the idea that further division of the banking industry be considered.

The report recommends that the banks be kept as profit seeking ventures but that they be further divided and restrained within specific sectors.<sup>29</sup> Bank regulations would affirmatively establish separate banking sectors, e.g. natural resources and energy banks, communication industry banks, and transportation banks. The banking industry would be organized based on the principle of what division would best serve the public interest, within a profit seeking system.

The proposed reforms outlined in this report seek to:

- Repeal the 1999 repeal of the 1933 Glass- Steagall Act;
- Require collateralized derivatives to be registered as securities offerings under the 1933 Securities Act;
- Require hedge funds and hedge fund managers to be registered under the Investment Company and Investment Advisers Act;
- Define credit default swaps as insurance, subject to state insurance regulations;

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<sup>27</sup> 4 March 1933 Inaugural Address by President Franklin D. Roosevelt attached as Exhibit 16.

<sup>28</sup> 12 November 2008 Speech by SEC Chairman: Building on Strengths in Designing the New Regulatory Structure, by Chairman Christopher Cox U.S. *Securities and Exchange Commission* PLI 40<sup>th</sup> Annual Securities Regulation Institute New York, New York, attached as Exhibit 17.

<sup>29</sup> The North American Industry Classification System (NAICS) provides a useful catalogue of business sectors that should be consulted in thinking through the appropriate division of banks. The North American Industry Classification System (NAICS, pronounced Nakes) was developed under the direction and guidance of the Office of Management and Budget (OMB) as the standard for use by Federal statistical agencies in classifying business establishments. It also addresses services; see NAIC frequently asked questions sheet and NAICS Update Process Fact Sheet, attached as Exhibit 18.

- Prohibit credit default swap speculation; and
- Strengthen the Bank Holding Company Act, by among other things, extending it to investment banks.

The Report also recommends the creation of a Select Committee in the United States Senate that would work to establish a permanent factual record to support needed legislative reforms.<sup>30</sup> It is further recommended that Congressional Policy Committees with jurisdiction over banking and finance hold extensive hearings examining the extent of debt held by financial institutions regarding credit derivatives and how to best reorganize the banking system to serve the public interest.

In reforming the financial services industry, the President and Congress can shift the world's wealth from wasteful speculation to productive uses that benefit the public interest, such as building systems for renewable energy, reliable water supplies, efficient transportation, modern communication as well as schools, universities, hospitals, libraries, bridges and roads.

This Report concludes that the President and Congress can lead the world's banking system out of crisis by adopting fundamental reforms that will stop the harmful practices that caused the present banking emergency.

President Roosevelt and the 73<sup>rd</sup> Congress led the nation out of the crisis of their day. They addressed the nation with “a candor and a decision which the present situation of our people impels.” They did not “shrink from honestly facing conditions in our country today.”<sup>31</sup>

This Report urges the President and Congress take the same effective action to lead this nation and the world out of the financial crisis caused by the Derivative Market Crash of 2008. It urges that we have “the courage to grapple with the cardinal economic problem of modern life.”<sup>32</sup>

We must adopt the right regulations and put in place the right enforcement. Even former Fed Chair Alan Greenspan has admitted there has been a “breakdown of the central pillar of competitive markets” which requires “additional regulator changes.”<sup>33</sup>

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<sup>30</sup> Ibid 28.

<sup>31</sup> Ibid 27.

<sup>32</sup> Berle Adolf A. *Navigating the Rapids* 1918-1971 p. 90, attached as Exhibit 19.

<sup>33</sup> Ibid 4.

## II. BACKGROUND

“Confidence... thrives on honesty, on honor, on the sacredness of obligations, on faithful protection and on unselfish performance. Without them it cannot live.” FDR

“Repetition does not transform a lie into a truth.”  
FDR

On 3 March 1933, banking operations in the United States ceased after a period of heightened public fear resulting from the Great Stock Market Crash of 1929.<sup>34</sup> On 4 March 1933, Franklin Roosevelt was sworn in as the 32<sup>nd</sup> President of the United States. His inaugural address prepared the people of the United States for the effective action he planned to take to solve the national banking and financial crisis.<sup>35</sup>

On 5 March 1933, President Roosevelt called Congress into “extra session” to deal with the national banking crisis.<sup>36</sup> The next day, on 6 March 1933, the President proclaimed a four day national bank holiday.<sup>37</sup> Two days later, on 8 March 1933, he held his first press conference where he told the national press that “we must not put the Government any further in debt because of failed banks.”<sup>38</sup> He drew a line in the sand against the government funding the failed speculation strategies that ran rampant throughout the banking system. President Roosevelt told the public the federal government was not going to pay “its bills by starting printing presses.”<sup>39</sup>

On 9 March 1933 Roosevelt sent banking legislation to Congress because “the Government has been compelled to step in for the protection of depositors and the business of the Nation.”<sup>40</sup> He asked for “control over banks for the protection of depositors; authority forthwith to open such banks as have already been ascertained to be in sound condition and other such banks as rapidly as possible; and authority to reorganize and reopen such banks as may be found to require reorganization to put them on a sound basis.”<sup>41</sup>

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<sup>34</sup> 9 March 1933 Message to Congress on Resumption of Banking, attached as Exhibit 23(a).

<sup>35</sup> Ibid 27.

<sup>36</sup> 5 March 1933 Proclamation No. 2038 Calling Congress Into Extraordinary Session, attached as Exhibit 20.

<sup>37</sup> 6 March 1933 Proclamation No. 2039 Declaring Bank Holiday, attached as Exhibit 21.

<sup>38</sup> 8 March 1933 Transcript of President Franklin Roosevelt’s Press Conference, attached as Exhibit 22.

<sup>39</sup> Ibid 38.

<sup>40</sup> Ibid 34.

<sup>41</sup> Ibid 34.

Congress passed the emergency banking legislation on 9 March 1933 and President Roosevelt issued an order reopening the banks on 10 March 1933.<sup>42</sup> On 11 March 1933, Roosevelt delivered his first Fireside Chat to discuss the banking crisis. In plain words, he explained the steps he had taken to get the banks open. He told the citizens listening on home radios: “The success of our whole great national program depends, of course, upon the cooperation of the public-on its intelligent support and use of a reliable system.”<sup>43</sup> He assured the public:

We had a bad banking situation. Some of our bankers had shown themselves either incompetent or dishonest in their handling of the people's funds. They had used the money entrusted to them in speculations and unwise loans.

This was, of course, not true in the vast majority of our banks, but it was true in enough of them to shock the people for a time into a sense of insecurity and to put them into a frame of mind where they did not differentiate, but seemed to assume that the acts of a comparative few had tainted them all.

It was the Government's job to straighten out this situation and do it as quickly as possible. And the job is being performed.<sup>44</sup>

President Roosevelt told the people, if the problem was to be solved, everyone had to become personally involved in the solution:

We have provided the machinery to restore our financial system; it is up to you to support and make it work. It is your problem no less than it is mine. Together we cannot fail.<sup>45</sup>

On 16 June 1933, Congress passed the 1933 Banking Act, also known as the Glass-Steagall Act. The 1933 Banking Act erected a wall between commercial banking and investment banking.<sup>46</sup> The law was based upon and sought to end the record of bankers’ misusing depositor funds to speculate in stocks and other securities.

The Senate Banking Committee in 1933, under the direction of attorney Ferdinand Pecora, demonstrated in Committee hearings that banks had been abused by bank officers who sought personal wealth by using other people’s money. The banks, in other words, were taking depositors’ money to their rigged casinos, betting, losing and replacing those losses with other

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<sup>42</sup> 10 March 1933 Executive Order 6073 on Reopening Banks, attached also as Exhibit 23(b).

<sup>43</sup> 12 March 1933 Fireside Chat on Banking, attached as Exhibit 24.

<sup>44</sup> Ibid 43.

<sup>45</sup> Ibid 38.

<sup>46</sup> *Investment Company Institute v. Camp*, 401 U.S. 617, 630-634 (1971); see former Section 21 of the Glass-Steagall Act (12 U.S.C. 378).

people's money. Pecora's work illustrated the rampant speculation in the case against Charles E. Mitchell, president of National City Bank. Mitchell was shown to have received bonuses of \$3.5 million from National City Bank, a large portion of which came from speculation with National City Company, the bank's investment company affiliate. One of scores of examples involved National City Bank's dealings with a Cuban sugar company:

Early in the 1920's, for example, the bank had made several large loans to the Cuban sugar industry. In 1927, when these loans were in default, National City Bank issued \$50,000,000 in new bank stocks. Without informing the stock purchasers, the bank then transferred this additional capital to the National City Company, which purchased controlling interest in the sugar industry, recently consolidated into the General Sugar Corporation. With this windfall the sugar industry promptly repaid its debt to the National City Bank. Unweaving the story, Pecora asked: 'Is this what is known in the vernacular as "bailing out" of the bank of a bad loan?' Mitchell protested this implication, but did admit that the stockholders had no idea their money had enabled the investment company to assume the bank's 'slow and doubtful' sugar loans.<sup>47</sup>

The investigation became the landmark example of the types of risky investment strategies used by banks that had to be controlled by federal regulation:

[T]he legislative history of the Glass-Steagall Act demonstrated that banks were harmed by its direct or indirect dealings with investments securities. Banks were shown to have made unsound loans to affiliated investment companies. The American public lost confidence in banks connected to investments that resulted in customer losses. Banks made unsound "purpose loans" which were used to acquire questionable securities. Bank affiliates dumped bad investments in bank trust departments. And the interests of banks in promoting securities were shown to be in conflict with the obligation to render impartial investment advice.<sup>48</sup>

The wall built by the 1933 Banking Act to separate commercial and investment banking was based upon that hard experience learned in the late 1920s and early 1930s.

In the late 1980s the banking industry formed a movement to repeal the regulations which separated commercial banking from investment banks. Borrowing upon painful lessons learned in the late 1920s, government regulatory authorities prevented the repeal of the 1933 Banking Act. The case for preserving the Glass-Steagall Act includes the following arguments:

1. Allowing the same entity to collect deposits and make investments in underwritings the banks stood to profit from created the conflicts of interest that

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<sup>47</sup> Congress Investigates A Documented History 1792-1974 p. 2563.

<sup>48</sup> FDIC Legal Opinion The Legality of Discount Brokerage Services When Offered By Insured Nonmember banks General Counsel's Opinion No. 6, *48 Fed. Reg. 22989, May 23, 1983*, attached as Exhibit 25.

would lead to the speculative abuses the 1933 Banking Act was designed to avoid;

2. Depository institutions possess enormous financial power, by virtue of their control of other people's money; depositor funds should be restricted to funding ordinary business purposes;
3. Stock speculation is risky and can lead to enormous losses. Such losses could threaten the integrity of deposits. In turn, the Government insures deposits and could be required to pay large sums if depository institutions were to collapse as the result of securities losses.
4. Depository institutions are supposed to be managed to limit risk. Their managers thus may not be conditioned to operate prudently in more speculative securities businesses. An example is the crash of real estate investment trusts sponsored by bank holding companies a decade ago.<sup>49</sup>

The protection of the Glass-Steagall Act was removed in 1999. Subsequent to the removal of the law, the old speculation with the credit and wealth of the nation took hold resulting in the Derivative Market Crash of 2008. Forgotten were the cardinal principles behind the reform following the Great Market Crash of 1929:

[I]ts cardinal principles I conceive to be, first, restoring as a rule of moral and economic conduct, a sense of fiduciary obligation; and, second, establishing social responsibility, as distinguished from individual gain, as the goal.<sup>50</sup>

There is substantial evidence to show that the Derivative Market Crash of 2008 was in large measure caused by the repeal of the Glass-Steagall Act in 1999. The period following the repeal was marked by widespread “deregulation” in banking and securities and the merger between commercial and investment banks.

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<sup>49</sup> For an example of the arguments against repeal of the 1933 Banking Act see 29 June 1987 Congressional Research Service: Glass-Steagall Act: Commercial vs. Investment Banking Jackson William D., attached as Exhibit 26.

<sup>50</sup> 7 May 1934 Congressional Record, 73<sup>rd</sup> Congress, 2<sup>nd</sup> Session, 8160-8164.

### III. THE WORLDWIDE DERIVATIVE BANKING SYSTEM

“By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives”<sup>51</sup>

“[Y]ou or your colleagues could produce a nearly riskless security”<sup>52</sup>

“[T]hey took the market by storm”<sup>53</sup> Alan Greenspan

A derivative<sup>54</sup> is a financial instrument that derives its value from a separate asset, called the “underlying.” The underlying is typically an asset or an investment vehicle such as a mortgage, commercial real estate, bond, commodity or stock.<sup>55</sup> The growth of the derivative market stemmed from banks that sought to reduce risk associated with the fluctuating values of the underlying, such as a borrower default on a residential mortgage. The process of transferring risk from one entity to another is commonly referred to as hedging. This desire to hedge risk led to the creation and rapid spread of risk dispersion tools called “derivative products.”

A “derivative product” is a financial contract whose value depends on a risk factor, such as (1) the price of a bond, commodity, currency, share, etc; (2) a yield or rate of interest; and (3) an index of prices or yields.<sup>56</sup>

The potential of credit derivatives was hailed as a major breakthrough for banking institutions that sought to simultaneously increase their lending capabilities and keep the risks

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<sup>51</sup> 19 March 1999 Remarks by Chairman Alan Greenspan *Financial derivatives* Before the Futures Industry Association, Boca Raton, Florida, <http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm>.

<sup>52</sup> Ibid 9.

<sup>53</sup> Greenspan, Alan. *The Age of Turbulence* pp. 371-372, <http://books.google.com/books?id=mBGE9JycgrEC&pg=PA371&lpg=PA371&dq>.

<sup>54</sup> The word 'derivative' originates from mathematics and refers to a variable, which has been derived from another variable. Derivatives are so called because they have no value of their own. They derive their value from the value of some other asset, which is known as the underlying, <http://www.rediff.com/money/2005/apr/19perfin1.htm>.

<sup>55</sup> FASB Statement of Financial Accounting Standard No. 133.6; Stulz, Rene M. *Demystifying Financial Derivatives*, p. 20, attached as Exhibits 29 and 30.

<sup>56</sup> The William Margrabe Group, Inc., Consulting, Presents *Derivatives Dictionary*, attached as Exhibit 31.

associated with lending off their balance sheets. The promise of credit derivatives was identified early in a July 1997 Business Week article by Blythe Masters:

‘The potential for growth is enormous,’ says Blythe Masters, global head of credit derivatives at J.P. Morgan, which claims a global market share of about 20%. ‘They deepen the liquidity with which loans are bought and sold and will help make the pricing of credit risk more rational.’ Adds Barry Finkelstein, a director for structured products at Merrill Lynch & Co., credit derivatives ‘are on everybody's radar screen. It's difficult to be a full-service derivative house without being in the credit-derivative markets.’<sup>57</sup>

JP Morgan Chase, which was a leader in the expansion of the credit derivative market, issued a guide describing the different types of derivatives available and how they operate on the market. The guide, called the “JP Morgan Chase Derivative Guide,” explains the three dimensions through which financial derivatives expanded:

Derivatives growth in the latter part of the 1990s continues along at least three dimensions.

Firstly, new products are emerging as the traditional building blocks – forwards and options – have spawned second and third generation derivatives that span complex hybrid, contingent, and path-dependent risks.

Secondly, new applications are expanding derivatives use beyond the specific management of price and event risk to the strategic management of portfolio risk, balance sheet growth, shareholder value, and overall business performance.

Finally, derivatives are being extended beyond mainstream interest rate, currency, commodity, and equity markets to new underlying risks including catastrophe, pollution, electricity, inflation, and credit.<sup>58</sup>

The JP Morgan Chase Derivative Guide illustrated the rampant expansion of the derivative markets to outgrow its original purpose of spreading risk. As the guide explains, the credit derivative market offered investment vehicles to hedge the risk of everything from home loans, to auto loans, to education loans, to weather conditions. The credit derivative markets became, in essence, a virtual casino run by Wall Street smooth talkers where hedge bets were taken on virtually every kind of investment.

Again, Alan Greenspan noted how the recently created credit derivative swap (CDS) had taken “the market by storm”:

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<sup>57</sup> 21 July 1997 Business Week article “Dizzying New Ways to Dice Up Debt Suddenly, credit derivatives-deal that spread credit risk-are surging”, attached as Exhibit 34.

<sup>58</sup> The J.P. Morgan Guide to Credit Derivatives (Introduction), attached as Exhibit 35.



A market vehicle for transferring risk away from these highly leveraged loan originators can be critical for economic stability, especially in a global environment. In response to this need, the CDS was invented and took the market by storm.<sup>59</sup>

J.P. Morgan Chase derivative managers admit that the explosive growth of credit derivatives was “[A]ided and abetted by sophisticated product development and the expansion of product applications beyond price management to the strategic management of portfolio risk.”<sup>60</sup>

As stated above, former Fed Chair Alan Greenspan has conceded subprime loans pooled into credit derivative products are at the core of the problem. Greenspan explained how the explosive growth of both the domestic and international housing markets caused record levels of demand for capital to fund mortgage loans. Banks sought to originate loans and quickly sell the debt by bundling groups of loans and selling them as investment vehicles. Ratings agencies, such as Moody’s and Standard & Poor’s, assigned top level investment ratings to these mortgage bundles which led to high demand and rapid sales. Once sold, the banks used the funds to originate new loans. Greenspan explained, “[The] surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem.”<sup>61</sup>

To illustrate, the debt liability in the U.S. created by the housing demand and mortgage craze resulted in a total of about 25 million subprime and Alt-A loans with an unpaid principal balance of \$4.5 trillion.<sup>62</sup> By 15 March 2008, the BBC reported widespread losses associated with the subprime losses. Table 2 illustrates some of those losses:

**Table 2: Bank Subprime Losses**

<b>Bank</b>	<b>Subprime Loss</b>	<b>Bank</b>	<b>Subprime Loss</b>
Citigroup:	\$18bn	Barclays:	\$2.6bn
Merrill Lynch	\$14.1bn	Royal Bank of Scotland:	\$2.6bn
UBS	\$13.5bn	IKB:	\$2.6bn
Morgan Stanley	\$9.4bn	Freddie Mac:	\$2bn

<sup>59</sup> Greenspan, Alan *The Age of Turbulence* p. 171-172; see Vernimmen on line Financial Dictionary [http://www.vernimmen.com/html/glossary/definition\\_credit\\_derivative\\_product\\_company.html](http://www.vernimmen.com/html/glossary/definition_credit_derivative_product_company.html)

<sup>60</sup> Ibid 58.

<sup>61</sup> Ibid 4.

<sup>62</sup> 9 December 2008 Statement of Edward J. Pinto before the House Committee on Oversight and Government Reform, attached as Exhibit 111.

HSBC:	\$3.4bn	JP Morgan Chase:	\$3.2bn
Bear Stearns:	\$3.2bn	Wachovia:	\$1.1bn
Deutsche Bank:	\$3.2bn	Credit Suisse:	\$1bn
Bank of America:	\$3bn	Paribas:	\$197m <sup>63</sup>

The rapid growth of the derivative industry was fueled by the rapid growth of different types of credit derivatives. Purchasers were given one type of credit derivatives to “go short” on the reference entity’s credit, allowing a large gain if the reference entity suffered credit decline.<sup>64</sup> In other words credit derivatives were shaped to allow buyers to bet on the demise of the reference entity’s credit rating. This form of leveraging became a massive unregulated casino where investors traded risk on everything from mortgages to bonds, to commodities, to auto loans.

#### **A. CREDIT DEFAULT SWAPS**

Credit derivatives take many forms. At the most basic level is the credit default swap. Credit Default Swaps (CDS) are contracts that transfer credit risk from a protection buyer to a credit protection seller.<sup>65</sup> A CDS is designed explicitly to shift credit risk between the parties; its value is derived from the credit performance of one or more corporation[s], sovereign entities or securities.<sup>66</sup> Under a CDS contract, an entity commonly seeks to insure one of its assets from risk of default. This entity is referred to as the “protection buyer.”

Typically, the buyer holds an asset that pays a revenue stream. An example is a home mortgage. The buyer, or Party A, pays the “protection seller,” Party B, to assume the mortgage default risk. Party B receives the periodic payment and only pays Party A in the event there is a “credit event,” which is typically defined in the ISDA Master Agreement, Schedule or Confirmation.

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<sup>63</sup> 17 March 2008 BBC Report Rescue for troubled Wall St bank, attached as Exhibit 36.

<sup>64</sup> Ibid 58.

<sup>65</sup> *Eternity Global Master Fund Ltd. V. Morgan Guar. Trust Co. of N.Y.* 375 F. 3d 168, 171-172 (2<sup>nd</sup> Cir. 2004), attached as Exhibit 32. Vernimmen on line Financial Dictionary [http://www.vernimmen.com/html/glossary/definition\\_credit\\_derivative\\_product\\_company.html](http://www.vernimmen.com/html/glossary/definition_credit_derivative_product_company.html).

<sup>66</sup> Mingle, David. Head of Research International Swaps and Derivatives Association p. 3, attached as Exhibit 33.

The CDS allows Party A to keep the asset on its books but removes the risk of a default. Conversely, Party B does not put the liability it has assumed on its books but does report the income for providing credit protection.

As stated, another credit derivative products that helped to expand the derivative market include “credit shorts,” “total rate of return swaps” and “credit default swaps on indices.”<sup>67</sup> Credit derivatives were also used to allow purchasers to “go short” on the reference entity’s credit, allowing a large gain if the reference entity suffered credit loss.<sup>68</sup>

Originally, these derivatives were risk dispersion vehicles used by banks as insurance against loan losses. However, derivatives exploded into a multi-trillion business that helped to mask rather than hedge potential losses. They proved to be the present version of the dangerous, unregulated and highly-speculative investment vehicles issued in the period prior to the Great Crash of 1929. Credit risk was treated like a commodity that could be traded like pork bellies and junk bonds.<sup>69</sup>

## **B. COLLATERALIZED DEBT OBLIGATION**

Another credit derivative is the “collateralized debt obligation” (CDO). A CDO is the most common type of credit derivative tied to the “bundling” or “securitization” of groups of fixed-assets. The holder of the bundle is commonly referred to as a “special purpose entity,” or SPE. A CDO is defined as a:

[P]ool of debt contracts housed within a special purpose entity (SPE) whose capital structure is sliced and resold based on differences in credit quality. In a ‘cash flow’ CDO, the SPE purchases a portfolio of outstanding debt issued by a range of companies, and finances its purchase by issuing its own financial instruments, including primarily debt but also equity. Credit rating agencies rate the various tranches of the SPE’s debt, whose terms vary depending on seniority.<sup>70</sup>

The tranches are categorized based on their risk. A tranche is a division or portion of a pool or whole. The typical categories include, “senior” tranches which have the highest credit rating; “mezzanine” tranches which have a medium grade credit rating; and “equity” which have the lowest. The tranches are then sold or traded to investors with the lowest interest applied to the higher credit ratings. Conversely, higher interest rates are assigned to lower grade tranches signifying the riskier investment.

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<sup>67</sup> Ibid 58.

<sup>68</sup> Ibid 58.

<sup>69</sup> Ibid 66.

<sup>70</sup> Partnoy, Frank; Skeel David A., Jr.; The Promise and Perils of Credit Derivatives University of Pennsylvania Law School 2006, <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1129&context=upenn/wps>.

### C. SYNTHETIC COLLATERALIZED DEBT OBLIGATION

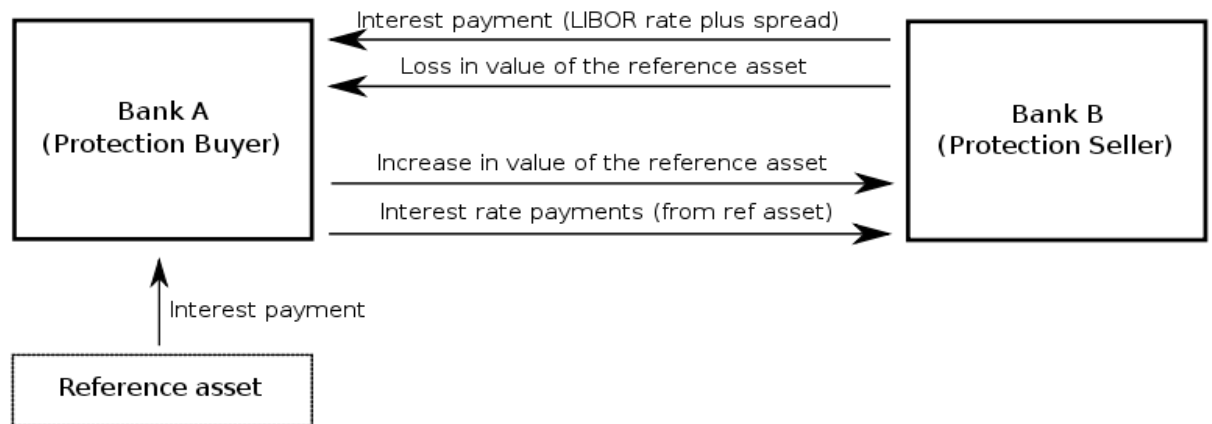
A third credit derivative is a variation of the CDO called a “synthetic CDO.” With a synthetic CDO:

[T]he SPE does not purchase actual bonds, but instead typically enters into several credit default swaps with a third party, to create synthetic exposure to the outstanding debt issued by a range of companies. The SPE then issues financial instruments, which are backed by credit default swaps rather than any actual bonds.<sup>71</sup>

### D. TOTAL RETURN SWAP

A Total Return Swap, or TR Swap, is importantly distinct from a Credit Swap in that it exchanges the total economic performance of a specified asset for another cash flow. In other words, the swap transfers both the credit risk and the market risk of an asset from one entity to another. That is, payments between the parties to a TR Swap are based upon changes in the market valuation of a specific credit instrument, irrespective of whether a Credit Event has occurred.<sup>72</sup>

A diagram of a TR Swap<sup>73</sup> shows:



<sup>71</sup> Partnoy, Frank; Skeel David A., Jr.; *The Promise and Perils of Credit Derivatives* University of Pennsylvania Law School 2006.

<sup>72</sup> ISDA Brief of Amicus Curiae in Support of the Brief of Defendant-Appellant in the US Court of Appeals Second Circuit in *Aon Financial Products, vs. Societe Generale*, attached as Exhibit 37, p. 3-4; also see ISDA website <http://isda.org/> then go to Opinions and Legislation.

<sup>73</sup> Dufey, Gunter; and Rehm, Florian; “An Introduction to Credit Derivatives,” attached as Exhibit 53.

For example, Bank A issues a loan and is receiving interest payments. Bank A enters in a TR swap with Bank B. Per the agreement, Bank A pays interest rate it receives for the loan to Bank B plus capital gains or whatever appreciation of the value of the asset. In return, Bank B assumes the asset on its balance sheet, insures the total value of the asset, and pays to Bank A an interest rate based on LIBOR and any negative appreciation on the asset. In the event of a credit event, Bank B pays to Bank A the value of the asset. The practical benefit for Bank A is that it insures the asset value. The value for Bank B is that, in effect, it obtains an asset yet keeps it off the balance sheet.<sup>74</sup>

As with all investment vehicles that promise to be above risk, credit derivatives were seen unrealistically as providing protection from loss. Former Fed Chair Greenspan claimed credit derivatives protected mortgage market intermediaries from the risk of credit losses, in words that now seem short sighted, given the collapse of the mortgage and credit derivative markets:

Likewise, record amounts of home mortgage refinancing and accompanying declines in mortgage asset durations have not imperiled the principal intermediaries in the mortgage markets, in substantial part because these institutions were able to use derivatives to transfer a significant portion of the convexity risk associated with prepayments of fixed-rate mortgages to investors in callable debt and issuers of puttable debt.<sup>75</sup>

As Blythe Masters, Global Head of Credit Derivatives Marketing at J.P. Morgan Chase in New York, pointed out: “In bypassing barriers between different classes, maturities, rating categories, debt seniority levels and so on, credit derivatives are creating enormous opportunities to exploit and profit from associated discontinuities in the pricing of credit risk.”<sup>76</sup>

## **E. EXPLOSION IN GROWTH**

The explosion of the amount of funds invested in credit derivatives is staggering. The Office of the Comptroller of the Currency (“OCC”) has tracked the dramatic growth of derivative contracts. For example, in the second quarter 1998 U.S. Banks held \$129 billion in credit derivatives, in the second quarter 2008 they held \$15.5 trillion.<sup>77</sup>

In its 2007 Annual Report, released in April 2008, the ISDA reported that the “notional amount outstanding of credit default swaps (CDS) grew 37 percent to \$62.2 trillion in the second

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<sup>74</sup> Ibid 73.

<sup>75</sup> Ibid 8.

<sup>76</sup> Ibid 58.

<sup>77</sup> Second Quarter 1998 and Second Quarter 2008 OCC Reports on Bank Trading and Derivatives Activities, attached as Exhibits 38 and 39.

half of 2007 from \$45.5 trillion at mid-year.”<sup>78</sup> The ISDA’s Mid-Year 2008 Market Survey showed the value at \$54.6 trillion.

On 8 October 2008 Securities & Exchange Commission (SEC) Chairman Christopher Cox estimated the value that credit default swaps insure at \$58 trillion. Chairman Cox put that vast sum in context: “To put into context this \$58 trillion of value that credit default swaps insure: \$58 trillion is more than the gross domestic product of every country on earth, combined.”<sup>79</sup>

#### F. MAJOR BANKS AND WORLDWIDE COMPANIES HOLD AND PROMOTE DERIVATIVES

As the OCC report shows, the nation’s largest financial institutions hold most of the nation’s credit derivatives. Five large commercial banks represent 97 percent of the total industry notional amount and 89 percent of industry net current credit exposure.

In addition to the OCC, the Deposit Trust Clearing Corporation (“DTCC”) also keeps tracks of derivatives purchases, except its coverage is worldwide. Table 3 illustrates the derivative holdings of major U.S. banks as reported by the both the OCC and DTCC.

**Table 3: Major Bank Credit Derivative Notional November 2008**

Bank Name	OCC Total Derivatives	DTCC Derivatives
JPMorgan Chase Bank NA	\$91.2 billion	\$63.6 billion
Bank of America NA	\$39.7 billion	\$52.3 billion
Citibank National Assn	\$37.1 billion	\$68 billion
Wachovia Bank National Association	\$4.4 billion	\$45 billion
Merrill Lynch	\$59 million	\$93 billion
Wells Fargo Bank	\$46 billion	\$1.5 billion
<b>TOTAL</b>	<b>\$218.5 billion</b>	<b>\$323.4 billion</b>

The DTCC’s Information Warehouse is a worldwide central registry for credit default swaps. It keeps track of “the vast majority of credit default swaps traded.”<sup>80</sup> DTCC reported in November 2008 that global notional value of credit swaps for top 1,000 reference entities at \$15.2 trillion.<sup>81</sup>

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<sup>78</sup> 16 April 2008 ISDA News Release ISDA Publishes Year-End 2007 Market Survey,” attached as Exhibit 40.

<sup>79</sup> Ibid 6.

<sup>80</sup> DTCC News and Information for DTCC customers DTCC Addresses Misconception About Credit Default Swaps, attached as Exhibit 41.

<sup>81</sup> 14 November 2008 DTCC Trade Information Warehouse Top 1000 Reference Entities, Gross and Net National amounts, attached as Exhibit 42.

ISDA has been a major force behind the promotion of credit derivatives. ISDA claims to be the largest financial trade association in the world, representing the leading participants in the privately negotiated derivatives industry. It was chartered in 1985, and comprises more than 800 member institutions from 46 countries on six continents. ISDA members include most of the world's major institutions that deal in and are leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants.<sup>82</sup>

A primary way ISDA has pushed credit derivatives has been through the creation of standard agreements. In fact, the ISDA "Master Agreement" is the primary document used to consummate credit default swap and other derivative transactions.<sup>83</sup> The ISDA has also been active in trying to recognize its central role in shaping the credit derivative industry. The United States Second Circuit Court of Appeals cited the ISDA brief in deciding an important legal question about the scope of credit default swaps:

As amicus [ISDA] correctly points out, they [CDS contracts] 'do not, and are not meant to, indemnify the buyer of protection against loss. Rather CDS contracts allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation.'<sup>84</sup>

The ISDA has in large measure helped to provide the unregulated and complex market in which credit derivatives have operated. Concerns are now being raised about the market the ISDA has helped to foster. The SEC Chairman has warned against the securities markets becoming a "baroque cathedral of complexity":

Our capital markets provide the means by which millions of Americans put their savings to work in our economy. But the financial system has failed recently to fulfill that purpose. It must not become merely a baroque cathedral of complexity dedicated only to its own limitless compensation in the short term, without regard to the long-term risks it has created that now threaten the entire nation's sustenance and growth.<sup>85</sup>

The SEC Chairman has acknowledged the "significant opportunity that exists for manipulation in the \$58 trillion credit default swaps market."<sup>86</sup> The SEC now sees the derivative market "is completely lacking in transparency, and virtually unregulated."<sup>87</sup> The "regulatory

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<sup>82</sup> Ibid 72.

<sup>83</sup> Ibid 72.

<sup>84</sup> *AON Financial Products v. Societe Generale*, 476 F. 3d 90 (Second Circuit 2007), attached as Exhibit 43.

<sup>85</sup> Ibid 28.

<sup>86</sup> Ibid 13.

<sup>87</sup> Ibid 13.

black hole for credit default swaps,” according to the SEC “is one of the most significant issues we are confronting in the current credit crisis, and it requires immediate legislative action.”<sup>88</sup>

These complex interconnections pose risk to the financial system precisely because of the complete lack of information about who is exposed to whom. They have created a situation that is ripe not only for rumor and misinformation, but potentially fraud. This is of even greater concern because the over-the-counter market for credit default swaps has given rise to a new phenomenon: the rise or fall of prices in the swaps market has begun to serve as a signal to the markets about the pricing of the underlying debt and equity securities.<sup>89</sup>

#### IV. DERIVATIVE MARKET COLLAPSE OF 2008

“It’s either a meltdown or the greatest buying opportunity ever; I’m leaning more towards the former.” Matt Tannin Bear Stearns Subprime Hedge Fund Manager 11 March 2007

“It is in the nature of a speculative boom that almost anything can collapse it.” John Kenneth Galbraith, *The Great Crash of 1929*

The Derivative Market Crash of 2008 was triggered when Bear Stearns collapsed. Bear Stearns went down once Moody’s Investor Services lowered Bear Stearns credit ratings for 162 derivative tranches in 15 different Bear Stearns derivative products on 10 March 2008.

On Monday, March 10, 2008, Moody’s Investors Service (referred to as Moody’s) downgraded certain series of mortgage backed debt issued by the Bear Stearns Alt-A Trust<sup>90</sup>, and rumors began to circulate in the market that there were significant liquidity problems at Bear Stearns itself. Later that day, Moody’s clarified that it had not taken any rating action regarding Bear Stearns’ corporate debt rating and that Bear Stearns’ current ratings outlook was stable.<sup>91</sup>

The Moody’s negative rating report on Bear Stearns in March 2008 was preceded by several months of financial disasters at Bear Stearns arising out of the melt down of the

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<sup>88</sup> Ibid 28.

<sup>89</sup> Ibid 28.

<sup>90</sup> Loan products aimed at borrowers whose credit and/or other issues make them less likely to qualify for a prime mortgage loan program. Interest rates for these types of loans are slightly higher than prime loans. This definition of *ALT-A Loans* contributed by [gulf-coast-associates](http://www.realestatewebmasters.com/glossary/A/ALT-A_Loans).  
[http://www.realestatewebmasters.com/glossary/A/ALT-A\\_Loans](http://www.realestatewebmasters.com/glossary/A/ALT-A_Loans)

<sup>91</sup> 2008 Schedule 14A Bear Stearns Information Required in a Proxy Statement, p.27, attached as Exhibit 44.



company's structured finance department, which was managed by Bear Stearns Asset Management.

Another hint of the threat credit derivatives posed to the banking system came on 11 July 2008 when U.S. bank regulators took over IndyMac Bancorp, which was heavily involved in credit derivatives.<sup>92</sup> Regulators seized the bank after Fitch Ratings lowered its credit to a junk bond status. IndyMac had tried to raise \$900 million in a futile effort to stay alive.<sup>93</sup> There was a run on Indy Bank by depositors who withdrew more than \$1.3 billion in less than two weeks. The bank had credit derivative related debt of \$74.8 billion held in off-balance-sheet-trusts as of December 31, 2007.<sup>94</sup>

IndyMac's demise was less spectacular than Bear Stearns' fall, but its business activities have invited a federal grand jury investigation. On 24 July 2008 Associated Press reported that federal grand jury subpoenas had been issued for IndyMac, Countrywide, and New Century Financial Corp.<sup>95</sup>

#### **A. BEAR STEARNS COLLAPSE TRIGGERS BANK CRISIS**

Bear Stearns derivative driven downfall was sparked by the collapse of three Bear Stearns derivative hedge funds. This failure resulted in the indictment of the two Bear Stearns executives who managed those funds, an SEC fraud complaint and two civil fraud suits by Bear Stearns derivative counterparties.<sup>96</sup> We know more about the insider workings of the Bear Stearns-Bank of America-Barclays derivative wheeling and dealing because it is laid out in a series of legal filings, including the indictment of the Bear Stearns officials, Barclay and Bank of America lawsuits against Bear Stearns, Bear Stearns hedge funds bankruptcy, and State of Massachusetts case against Bear Stearns.

The Bear Stearns hedge funds were structured in 2003 as two feeder and one master fund, a typical arrangement within hedge funds. The structure allows the fund to collect monies from separate sources and take advantage of tax loopholes from foreign and domestic investors, called feeders. An offshore entity is created to provide overall tax protection of the funds, called the master fund, which serves as the central investment source.

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<sup>92</sup> 11 July 2008 FDIC Press Release "FDIC Establishes IndyMac Federal Bank." In 1985, Countrywide founded IndyMac as a real estate investment trust. In January 2000 IndyMac converted to IndyMac the bank, with Countrywide holding a sizeable ownership interest in IndyBank. (IndyMac 2002 SEC 10K Report p. 9), attached as Exhibit 45.

<sup>93</sup> 11 July 2008 Dow Jones Newswires US Regulators Close IndyMac Bankcorp, attached as Exhibit 46.

<sup>94</sup> 2007 IndyMac Bancorp SEC 10-K Report p. 66, attached as Exhibit 47.

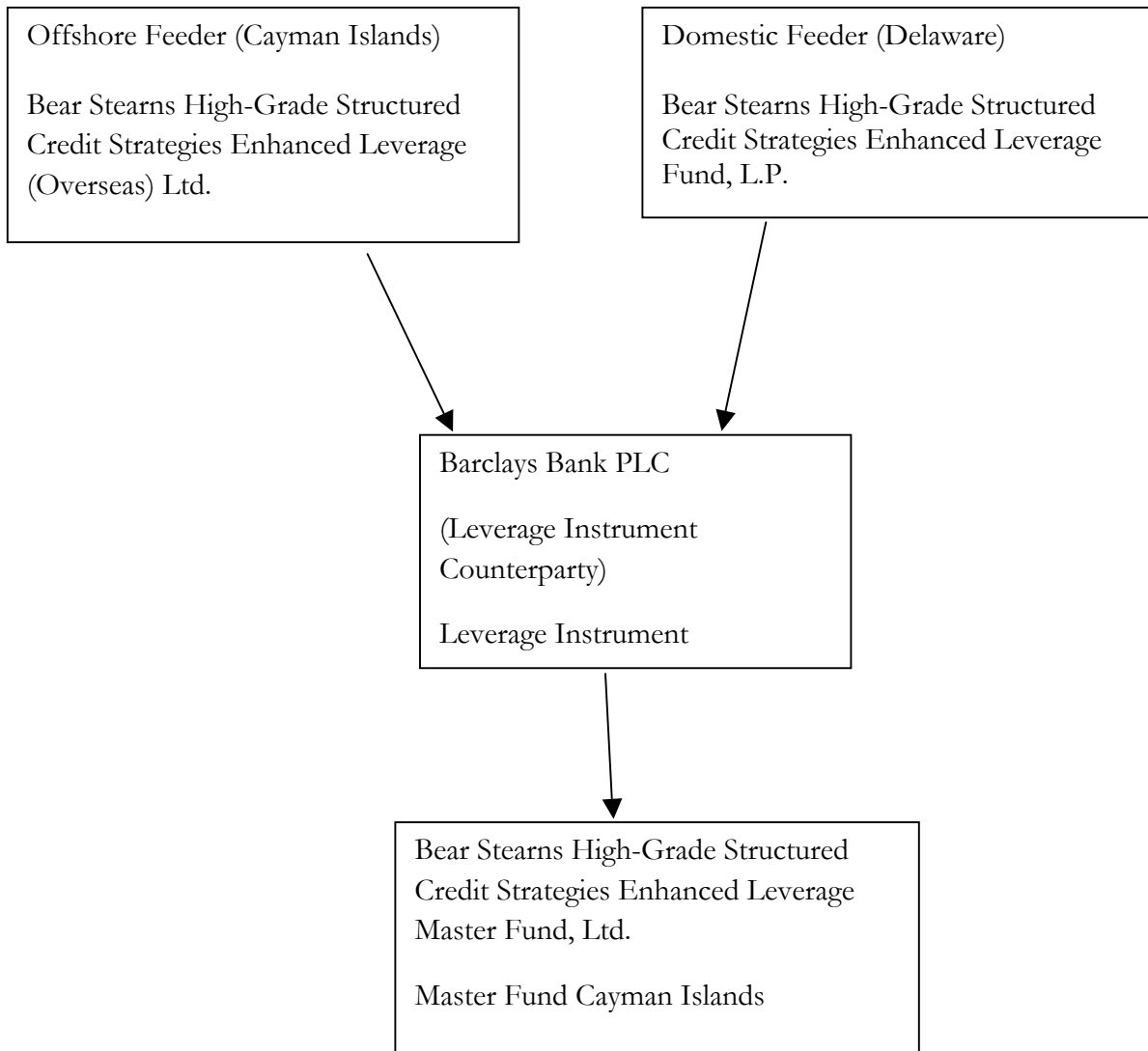
<sup>95</sup> 24 July 2008 AP story Grand Jury investigating lenders, attached as Exhibit 48.

<sup>96</sup> 18 June 2008, U.S. Grand Jury Indictment in US v. Ralph Cioffi and Matthew Tannin CR 08 415 US District Court Eastern District of New York, attached as Exhibit 49

The Barclays and Bear Stern hedge funds were structured as follows: (1) Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage (Overseas) Ltd; (2) Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund, L.P; and, (3) Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.

Barclays sold a total credit swap to provide leverage to Bear Stearns hedge funds, as depicted in the following diagram provided by Barclays in its fraud complaint against Bear Stearns:<sup>97</sup>

*Attachment to Barclays Bank PLC, v. Bear Stearns Asset Management Inc.*



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<sup>97</sup> 19 December 2007 Civil Complaint Barclays Bank PLC, v. Bear Stearns Asset Management Inc., Ralph Cioffi, Matthew Tannin, Bear, Stearns & Co. Inc., and the Bear Stearns Companies Inc, attached as Exhibit 50.

Between 7 June and 26 June 2007, Bear Stearns announced that its investors could no longer redeem their investments in the three hedge funds. Investors were told these hedge funds had lost 100 percent of their respective values, resulting in a total investor loss of approximately \$1.4 billion.<sup>98</sup> On 30 July 2007, the hedge funds filed for bankruptcy-like liquidation.<sup>99</sup>

On 14 November 2007, the State of Massachusetts brought an administrative complaint against Bear Stearns for violations of securities laws because of alleged misconduct in connection with the three hedge funds. The complaint stated:

The collapse and bankruptcy of the Bear Stearns High-Grade Structured Credit Strategies Fund (“High Grade Fund”) and the Enhanced Leverage Fund (“Enhanced Leverage Fund”) (collectively, “Funds” or “BSAM Funds”) during June and July 2007 has cost investors and creditors billions of dollars.<sup>100</sup>

The complaint stated the banking industry’s demand for increased capital to issue more mortgage debt drove Bear Stearns hedge funds to create new and wildly speculative investment vehicles. The Bear Stearns managers created a combination of illiquid structured debt securities, national mortgage market turmoil, exotic credit derivative contracts, fair value pricing, aggressive and even “enhanced” leverage. However, the supercharged race for competitive returns ultimately overwhelmed the portfolio and risk managers at Bear Stearns Asset Management (BSAM).<sup>101</sup> The complaint stated:

\*\*

Unbeknownst to investors, the very controls and procedures established to safeguard their interests did not survive the daily ordeals of trading and managing and leveraging.<sup>102</sup>

\*\*

The result of this poor conflict management was that hundreds transactions did not obtain the approvals required by Federal law and promised in the offering documents. Of the transactions that required prior approval by the unaffiliated Directors, 78.95% were missing such approvals in 2006, 58.55% in 2005, 20.73% in 2004 and 18% in 2003.<sup>103</sup>

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<sup>98</sup> Ibid 96.

<sup>99</sup> 30 August 2007 Opinion p. 4 US Bankruptcy Court Southern District of New York, In re: *Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* (In Provisional Liquidation), attached as Exhibit 51.

<sup>100</sup> 14 November 2007 State of Massachusetts Administrative Complaint *In the Matter of Bear Stearns Asset Management* (Docket No. E-2007-0064), attached as Exhibit 52.

<sup>101</sup> Ibid 100.

<sup>102</sup> Ibid 100.

<sup>103</sup> Ibid 100.

On 19 December 2007, Barclay's Bank sued Bear Stearns, and the hedge fund managers Ralph Cioffi and Matthew Tannin for fraud. Barclays Bank's civil complaint against its counter party in two hedge funds provides an insider view of the banking derivative system. The complaint stated:

1. This action arises from one of the most high-profile and shocking hedge fund failures in the last decade: In a matter of days in June 2007 Bear Stearns' and BSAM's [Bear Stearns Asset Management] reputation as one of the premier credit investment franchises on Wall Street collapsed along with two Bear Stearns hedge funds, formerly with approximately \$20 billion in assets...
3. Barclays is the sole participating shareholder in and thus has the sole direct exposure to the mast fund of the BSAM structure now under SEC and U.S. scrutiny, the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (the "Enhanced Fund")...
5. It is now clear that the BSAM Defendants have long known that the Enhanced Fund and its underlying assets were worth far less than their stated values in the early months of 2007-values that BSAM itself had determined in most instances-and were at risk for further losses. The BSAM Defendants concealed the fund's failing net asset value ("NAV") from Barclays and investors in related feed fund for as long as possible, instead of revealing the drop in value in, and the increased risk to, the Enhanced Fund, and instead of taking immediate and effective corrective action to correct the problems with the Enhanced Fund. This cover-up and failure to respond in accordance with BSAM's fiduciary duties to Barclays only caused greater losses and more spectacular collapse of the Enhanced Fund.
6. Barclays entered its transaction involving the Enhanced Fund, as set forth in detail below, only after extensive, one-on-one negotiations in which the BSAM Defendants held themselves out as having a proprietary, extraordinarily sensitive and effective risk management system and as having special access to pricing (or "marking") information and marking expertise that they would employ for the benefit of Barclays. \*\*
7. Barclays now knows that from March 2006 into at least mid-June 2007, BSAM \*\* deceived Barclays through a series of misrepresentations first, to secure Barclays' provision of its initial leverage for and financial stake in the "enhanced" fund structure; second, to secure a significant increase in Barclays' economic commitment to the structure in March 2007; and third, to deceive Barclays and keep it in the structure with ongoing positive reports about the Enhanced Fund's performance, even into mid-June 2007, until Barclay's' losses had snow-balled. \*\*

The Barclays complaint refers to investigations by the U.S. Attorney and SEC. The Barclays complaint against Bear Stearns was filed in December 2007.<sup>104</sup>

On 18 June 2008 two Bear Stearns executives who managed the three Bear Stearns hedge funds, Ralph Cioffi and Matthew Tannin, were indicted by a federal grand jury for conspiracy to commit securities fraud, securities fraud, insider trading, and wire fraud.<sup>105</sup> The story of the Bear Stearns demise is described in a grand jury indictment, SEC fraud complaint, bankruptcy filings, fraud suits by counter parties, and state administrative complaint. Bear Stearns illustrates the systemic, worldwide damage that unregulated banking practices have caused. The world banking system is functioning only because of over \$10 trillion of taxpayer funds committed by central bank, treasury and political authorities.

Bank of America was next to pursue litigation against Bear Stearns. On 29 October 2008, Bank of America filed a civil complaint against Bear Stearns also related to the three Bear Stearns hedge funds.<sup>106</sup> The complaint alleged that Bear Stearns induced Bank America to structure and market a \$4 billion transaction known as a "CDO-squared."<sup>107</sup>

Bank of America alleged it had a "longstanding and extensive business relationship with Bear Stearns" and that the bank relied upon Bear Stearns "because of the stellar reputation enjoyed by BSAM, Cioffi, and Tannin."<sup>108</sup>

Bank of America charges that Bear Stearns "entire investment strategy-which involved enormous leverage and thinly-traded assets- was unsustainable."<sup>109</sup> The complaint alleges that on 22 May 2007 Bear Stearns deceived Bank of America into purchasing "\$2.89 billion of assets earmarked to become the Collateral" from the Bear Stearns hedge funds.<sup>110</sup> Bank of America further alleges Bear Stearns knew well that the hedge funds were in dire financial condition, which facts, Bear Stearns did not disclose.<sup>111</sup>

On 17 July 2007, Bear Stearns, according to the complaint, informed investors that the funds had little or no value.<sup>112</sup>

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<sup>104</sup> Ibid 97.

<sup>105</sup> Ibid 96.

<sup>106</sup> 29 October 2008 Bank of America Complaint filed in Bank of America against Bear Stearns Asset Management, Ralph Cioffi, Matthew Tannin, and Raymond McGarrigal, attached as Exhibit 54.

<sup>107</sup> Ibid 106.

<sup>108</sup> Ibid 106.

<sup>109</sup> Ibid 106.

<sup>110</sup> Ibid 106.

<sup>111</sup> Ibid 106.

<sup>112</sup> Ibid 106.

Moody's announced downgrade of Bear Stearns credit derivatives in March 2008, which triggered Bear Stearns' collapse. Moody's Investor Service "downgraded the ratings of 163 tranches from 15 transactions issued by Bear Stearns ALT-A Trust." Moody's reported that "Seventy-eight downgraded tranches remain on review for possible further downgrade. Additionally, 155 tranches were placed on review for possible downgrade."<sup>113</sup> The news of this widespread downgrading of the Bear Stearns, sponsored debt was immediate and deadly:

**Moody's** Investors Service has downgraded the ratings of 163 tranches from 15 transactions issued by **Bear Stearns** ALT-A Trust. Seventy eight downgraded tranches remain on review for possible further downgrade. Additionally, 155 tranches were placed on review for possible downgrade. The collateral backing these transactions consists primarily of first-lien, fixed and adjustable-rate, Alt-A mortgage loans.

The ratings were downgraded, in general, based on higher than anticipated rates of delinquency, foreclosure, and REO<sup>114</sup> in the underlying collateral relative to credit enhancement levels. Complete rating actions are as follows:

Issuer: **Bear Stearns** ALT-A Trust 2005-7

- Cl. I-M-1, Downgraded to A1 from Aa2,
- Cl. I-M-2, Downgraded to Ba1 from A2,
- Cl. I-B-1, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,
- Cl. I-B-2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,
- Cl. I-B-3, Downgraded to Ca from Ba2,
- Cl. II-B-2, Downgraded to A2 from Aa2,
- Cl. II-B-3, Downgraded to A3 from Aa3,
- Cl. II-B-5, Downgraded to Ba1 from A2,
- Cl. II-B-6, Downgraded to Ba3 from A3,
- Cl. II-B-4, Downgraded to Baa2 from A1,
- Cl. II-B-7, Downgraded to B3 from Baa1,
- Cl. II-B-8, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,
- Cl. II-B-9, Downgraded to B3 from Baa3; Placed Under Review for further Possible Downgrade,

Issuer: **Bear Stearns** ALT-A Trust 2005-8

- Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,
- Cl. I-2A-2, Placed on Review for Possible Downgrade, currently Aaa,
- Cl. I-M-1, Downgraded to Ba3 from Aa2,

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<sup>113</sup> 10 March 2008 Moody's Investors Service Press Release: Moody's Downgrades Bear Stearns Alt-A Deals, attached as Exhibit 55.

<sup>114</sup> REP is defined as real estate owned, meaning that Bear Stearns was holding real estate that was supposed to be an income producing part of the investment.

Cl. I-M-2, Downgraded to B3 from A2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Caa1 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-2, Downgraded to Caa2 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-3, Downgraded to Ca from Ba2,  
Cl. II-B-1, Downgraded to Aa3 from Aa1,  
Cl. II-B-2, Downgraded to Baa1 from Aa2,  
Cl. II-B-3, Downgraded to B1 from A2,  
Cl. II-B-4, Downgraded to B3 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. II-B-5, Downgraded to Ca from Ba2,

Issuer: **Bear Stearns** ALT-A Trust 2005-9

Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from A2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Caa2 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-2, Downgraded to Caa2 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-3, Downgraded to Ca from Ba2,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-4A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-5A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-5A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-6A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-6A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-M-1, Downgraded to A2 from Aa1,  
Cl. II-M-2, Downgraded to Baa1 from Aa2,  
Cl. II-M-3, Downgraded to Baa3 from Aa3,  
Cl. II-M-4, Downgraded to Ba3 from A1,  
Cl. II-M-5, Downgraded to B3 from A2,  
Cl. II-B-1, Downgraded to B2 from A3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to B3 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,

Issuer: **Bear Stearns** Alt-A Trust 2005-10

Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B1,  
Cl. I-B-2, Downgraded to Ca from B3,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-4A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-4X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-5A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-5X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to Baa3 from Aa1,  
Cl. II-B-2, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to B2 from Aa3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-4, Downgraded to B3 from A3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-5, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-6, Downgraded to B3 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-7, Downgraded to Ca from Ba3,  
Cl. II-B-8, Downgraded to Ca from B3,  
Cl. II-B-9, Downgraded to Ca from B3,

Issuer: **Bear Stearns** Alt-A 2006-1

Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B1 from Aa2,  
Cl. I-M-2, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B1,  
Cl. I-B-2, Downgraded to Ca from Caa1,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1X-2, Placed on Review for Possible Downgrade, currently Aaa,



Cl. II-1A-3, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-3X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-X-B1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. II-X-B2, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to Ca from B1,  
Cl. II-X-B3, Downgraded to Ca from B1,

Issuer: **Bear Stearns** Alt-A Trust 2006-2

Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B2,  
Cl. I-B-2, Downgraded to Ca from Caa1,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-X-B1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to Ca from Ba1,  
Cl. II-X-B2, Downgraded to Ca from Ba1,  
Cl. II-B-3, Downgraded to Ca from B3,

Issuer: **Bear Stearns** Alt-A Trust 2006-3

Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to Caa1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa2 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from Ba3,  
Cl. I-B-2, Downgraded to Ca from B3,  
Cl. I-B-3, Downgraded to Ca from Caa3,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-4A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-X-B1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. II-X-B2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to Ca from B3,  
Cl. III-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-4A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-4A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-4X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-5A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-5A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-6A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-6A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-B-1, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,

Cl. III-B-2, Downgraded to B3 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. III-B-3, Downgraded to Ca from B2,

Issuer: **Bear Stearns** Alt-A Trust 2006-4

Cl. I-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-2A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-3A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to Caa1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa2 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B2,  
Cl. I-B-2, Downgraded to Ca from Caa2,  
Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2X-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-3, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-4, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3A-5, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-3X-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B1 from Aa1; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to B3 from Aa3; Placed Under Review for further Possible Downgrade,  
Cl. II-B-4, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-5, Downgraded to Ca from Ba1,  
Cl. II-B-6, Downgraded to Ca from B1,  
Cl. II-B-7, Downgraded to Ca from B3,  
Cl. II-B-8, Downgraded to Ca from B3,  
Cl. III-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-2A-1, Placed on Review for Possible Downgrade, currently Aaa,

Cl. III-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-3A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3A-3, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3A-4, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. III-3X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-3X-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-B-1, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. III-B-2, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. III-B-3, Downgraded to Ca from B1,

Issuer: **Bear Stearns** Alt-A Trust 2006-5

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B2,  
Cl. I-B-2, Downgraded to Ca from Caa1,  
Cl. I-B-3, Downgraded to Ca from Caa3,  
Cl. II-A-3, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-X-3, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to B3 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to Ca from B1,

Issuer: **Bear Stearns** Alt-A Trust 2006-6

Cl. I-M-1, Downgraded to Caa1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa3; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from B2,  
Cl. I-B-2, Downgraded to Ca from Caa1,  
Cl. I-B-3, Downgraded to Ca from Caa2,  
Cl. II-A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B2 from Aa2,  
Cl. II-BX-1, Downgraded to B2 from Aa2,  
Cl. II-B-2, Downgraded to B1 from A2; Placed Under Review for further Possible Downgrade,

Cl. II-BX-2, Downgraded to B1 from A2; Placed Under Review for further Possible Downgrade,  
 Cl. II-B-3, Downgraded to B2 from Baa2; Placed Under Review for further Possible Downgrade,  
 Cl. III-1X-2, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-1X-3, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-1X-4, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-1X-5, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-1X-6, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-1A-2, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-2, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-3, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-4, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-5, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2X-6, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2A-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-2A-2, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. III-B-1, Downgraded to B2 from Aa1; Placed Under Review for further Possible Downgrade,  
 Cl. III-BX-1, Downgraded to B2 from Aa1; Placed Under Review for further Possible Downgrade,  
 Cl. III-B-2, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
 Cl. III-BX-2, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
 Cl. III-B-3, Downgraded to Ca from Ba1,  
 Cl. III-BX-3, Downgraded to Ca from Ba1,  
 Cl. III-B-4, Downgraded to Ca from B3,

Issuer: **Bear Stearns** Alt-A Trust 2006-7

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. I-M-1, Downgraded to Caa1 from Aa2; Placed Under Review for further Possible Downgrade,  
 Cl. I-M-2, Downgraded to Ca from Ba1,  
 Cl. I-B-1, Downgraded to Ca from B3,  
 Cl. II-1A-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
 Cl. II-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
 Cl. II-3A-2, Placed on Review for Possible Downgrade, currently Aa1,  
 Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
 Cl. II-3X-1, Placed on Review for Possible Downgrade, currently Aaa,

Issuer: **Bear Stearns** Alt-A Trust 2006-8

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from Ba3,  
Cl. I-B-2, Downgraded to Ca from B2,  
Cl. I-B-3, Downgraded to Ca from Caa1,  
Cl. II-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-BX-1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to B3 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. II-BX-2, Downgraded to B3 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to Ca from Ba2,  
Cl. III-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. III-B-1, Downgraded to Ba1 from Aa2,  
Cl. III-B-2, Downgraded to B1 from A2; Placed Under Review for further Possible Downgrade,  
Cl. III-B-3, Downgraded to B1 from Baa2; Placed Under Review for further Possible Downgrade,

Issuer: **Bear Stearns** Alt-A Trust 2007-1

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from Ba2,  
Cl. I-B-2, Downgraded to Ca from Ba3,  
Cl. I-B-3, Downgraded to Ca from B3,  
Cl. I-B-4, Downgraded to Ca from Caa3,  
Cl. II-1A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-1X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-2A-2, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-2X-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. II-B-1, Downgraded to B1 from Aa2,

Cl. II-BX-1, Downgraded to B1 from Aa2,  
Cl. II-B-2, Downgraded to B1 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. II-B-3, Downgraded to Ca from B1,

Issuer: **Bear Stearns** ALT-A Trust 2007-2

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-M-1, Downgraded to B3 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. I-M-2, Downgraded to Caa1 from Baa2; Placed Under Review for further Possible Downgrade,  
Cl. I-B-1, Downgraded to Ca from Ba3,  
Cl. I-B-2, Downgraded to Ca from B2,  
Cl. I-B-3, Downgraded to Ca from Caa2,  
Cl. I-B-4, Downgraded to Ca from Caa3,  
Cl. II-A-3, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-X-3, Placed on Review for Possible Downgrade, currently Aa1,  
Cl. II-B-1, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-BX-1, Downgraded to B1 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. II-B-2, Downgraded to Ca from Ba1,  
Cl. II-B-3, Downgraded to Ca from B3,

Issuer: **Bear Stearns** ALT-A Trust 2007-3

Cl. I-A-1, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. I-A-2, Placed on Review for Possible Downgrade, currently Aaa,  
Cl. M-1, Downgraded to B2 from Aa2; Placed Under Review for further Possible Downgrade,  
Cl. M-2, Downgraded to B3 from Baa1; Placed Under Review for further Possible Downgrade,  
Cl. B-1, Downgraded to Ca from Ba1,  
Cl. B-2, Downgraded to Ca from Ba2,  
Cl. B-3, Downgraded to Ca from B2,  
Cl. B-4, Downgraded to Ca from Caa2,  
Cl. II-A-1, Placed on Review for Possible Downgrade, currently Aaa.<sup>115</sup>

The deterioration of Bear Stearns' credit rating for its sponsored derivatives sent holders of the derivatives scrambling. Bear Stearns' other customers grew concerned about Bear Stearns' ability to continue in business. Counterparties balked at entering credit agreements or extending credit to Bear Stearns. On Wednesday 12 March 2008 a rush of Bear Stearns account holders started withdrawing their funds from the company at a rate that gathered speed and force

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<sup>115</sup> Ibid 113.

throughout the day. At the same time, an increasing number of credit derivative counterparties suspended ordinary business with Bear Stearns.

## **B. BEAR STEARNS AND WASHINGTON MUTUAL DISAPPEAR INTO JP MORGAN CHASE**

On Thursday, March 13, 2008, JPMorgan Chase tried to save Bear Stearns with promised credit extensions. When that did not work, the Federal Reserve Bank stepped in and pledged billions of dollars of taxpayer funds through the New York Federal Reserve Bank (New York Fed) discount window.<sup>116</sup>

On Friday, 14 March 2008, Standard and Poor's, Moody's and Fitch Ratings all announced they were lowering Bear Stearns' credit to junk bond status.<sup>117</sup> Again, Moody's downgrade of Bear Stearns ratings was ominous. Moody's Investors Service Press Release read:

### **Moody's downgrades Bear Stearns to Baa1; continues to review down**

14 March 2008

Moody's Investors Service Press Release

Approximately \$80 billion of debt securities affected

**Moody's** Investors Service downgraded the long-term ratings of The **Bear Stearns** Companies Inc. ("Bear") to Baa1 from A2 and its short-term ratings to Prime-2 from Prime-1. The ratings continue to be on review for a possible downgrade.

The rating action was in response to the rapidly deteriorating liquidity position of Bear, which necessitated an emergency secured funding line from JPMorgan Chase back-stopped by the Federal Reserve Bank of New York. The 28-day funding facility represents a temporary liquidity respite for Bear as it looks to identify a long-term resolution to its liquidity problems.

Bear's liquidity situation deteriorated precipitously over the last two days, severely constraining the company's financial and operating flexibility. **Moody's** said Bear did not face any sizeable net write-downs or credit losses, and its franchise was intact. Nevertheless, the liquidity crisis is the result of diminishing confidence in Bear by its counter-parties and customers, compounded by persistently negative market conditions.

The downgrade also incorporates **Moody's** opinion that Bear's customer franchise has been hurt by this crisis, and it will continue to erode if a long-term stabilizing solution is not quickly achieved. The ratings review will focus on the financial and strategic alternatives under consideration by Bear and the likelihood for a timely resolution.

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<sup>116</sup> Ibid 91, Pages 27-28.

<sup>117</sup> Ibid 91. Page 28.



Given the fluidity of the situation, **Moody's** will re-address its ratings within 7-10 days. If Bear is unable to restore counter-party confidence to stabilize its liquidity and customer franchise, the ratings could be downgraded further; most likely within the Baa range. However, **Moody's** recognizes that Bear has a number of attractive franchises that could facilitate a strategic solution. Should a transaction occur that alleviates these pressures, it is likely that Bear's ratings would move higher.

The **Bear Stearns** Companies Inc. is an international investment bank and financial services firm headquartered in New York, NY that had 14,153 employees and reported \$80.3 billion in total long-term capital at November 30, 2007. Bear generated net revenues of \$5.9 billion for 2007. The following entities were downgraded and left on review for possible further downgrade:

..Issuer: **Bear Stearns** Bank plc

- ....Senior Unsecured Deposit Program, Downgraded to Baa1 from A2
- ....Senior Unsecured Commercial Paper, Downgraded to P-2 from P-1
- ....Senior Unsecured Medium-Term Note Program, Downgraded to Baa1 from A2
- ....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa1 from A2

..Issuer: **Bear Stearns** Capital Trust I

- ....Preferred Stock Preferred Stock, Downgraded to Baa2 from A3

..Issuer: **Bear Stearns** Capital Trust III

- ....Preferred Stock Preferred Stock, Downgraded to Baa2 from A3

..Issuer: **Bear Stearns** Caribbean Asset Holdings, Ltd.

- ....Senior Unsecured Medium-Term Note Program, Downgraded to Baa1 from A2

..Issuer: **Bear Stearns** Companies Inc. (The)

- ....Commercial Paper, Downgraded to P-2 from P-1
- ....Issuer Rating, Downgraded to Baa1 from A2
- ....Junior Subordinated Shelf, Downgraded to (P)Baa2 from (P)A3
- ....Multiple Seniority Shelf, Downgraded to a range of (P)Ba1 to (P)Baa1 from a range of (P)Baa1 to (P)A2
- ....Preferred Stock Preferred Stock, Downgraded to Ba1 from Baa1
- ....Subordinate Regular Bond/Debenture, Downgraded to Baa2 from A3
- ....Senior Unsecured Conv./Exch. Bond/Debenture, Downgraded to a range of (P)Baa1 to Baa1 from a range of (P)A2 to A2
- ....Senior Unsecured Medium-Term Note Program, Downgraded to Baa1 from A2
- ....Senior Unsecured Regular Bond/Debenture, Downgraded to a range of (P)Baa1 to Baa1 from a range of (P)A2 to A2
- ....Senior Unsecured Shelf, Downgraded to (P)Baa1 from (P)A2

..Issuer: **Bear Stearns** Global Asset Holdings, Ltd.  
....Senior Unsecured Conv./Exch. Bond/Debenture, Downgraded to a range of (P)Baa1 to Baa1 from a range of (P)A2 to A2  
....Senior Unsecured Medium-Term Note Program, Downgraded to Baa1 from A2  
....Senior Unsecured Regular Bond/Debenture, Downgraded to a range of (P)Baa1 to Baa1 from a range of (P)A2 to A2

..Issuer: **Bear, Stearns** Securities Corporation  
....Issuer Rating, Downgraded to A3 from A1  
....Senior Unsecured Short-Term Rating, Downgraded to P-2 from P-1

..Issuer: **Bear Stearns** Capital Trust III  
....Preferred Stock Shelf, Downgraded to (P)Baa2 from (P)A3

..Issuer: **Bear Stearns** Capital Trust IV  
....Preferred Stock Shelf, Downgraded to (P)Baa2 from (P)A3

..Issuer: **Bear Stearns** Capital Trust V  
....Preferred Stock Shelf, Downgraded to (P)Baa2 from (P)A3

..Issuer: **Bear Stearns** Finance LLC  
....Preferred Stock Preferred Stock, Downgraded to Ba1 from Baa1  
....Preferred Stock Shelf, Downgraded to (P)Ba1 from (P)Baa1

..Issuer: **Bear Stearns** Bank plc  
....Senior Unsecured Deposit Program, Downgraded to P-2 from P-1

..Issuer: **Bear Stearns** Caribbean Asset Holdings, Ltd.  
....Senior Unsecured Medium-Term Note Program, Downgraded to P-2 from P-1

..Issuer: **Bear Stearns** Global Asset Holdings, Ltd.  
....Senior Unsecured Medium-Term Note Program, Downgraded to P-2 from P-1  
Outlook Actions:

..Issuer: **Bear Stearns** Bank plc  
....Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Capital Trust I  
....Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Capital Trust III  
....Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Capital Trust IV  
....Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Capital Trust V  
...Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Companies Inc. (The)  
...Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Finance LLC  
...Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear Stearns** Global Asset Holdings, Ltd.  
...Outlook, Changed To Rating Under Review From Stable

..Issuer: **Bear, Stearns** Securities Corporation  
...Outlook, Changed To Rating Under Review From Stable <sup>118</sup>

At day's end on Friday 21 March 2008, Bear Stearns had outstanding borrowings of approximately \$32.5 billion from the New York Fed and approximately \$3.7 billion through repurchase agreements with JPMorgan Chase. JP Morgan Chase lent another \$9.7 billion.

Senior management at Bear Stearns determined the company would not be able to open Monday 24 March 2008, and made plans to file bankruptcy.<sup>119</sup> On Monday morning, 24 March 2008, the New York Federal Reserve Bank stepped in and with the help of JPMorgan Chase, saved Bear Stearns from having to file bankruptcy. Instead, as with Washington Mutual Bank, Bear Stearns and its billions of dollars of bad derivative debt disappeared into JP Morgan Chase.

### C. COUNTRYWIDE AND MERRILL LYNCH DISAPPEAR INTO BANK OF AMERICA

Bank of America bought Countrywide and Merrill Lynch when both companies were on the brink of bankruptcy due to their exposure to derivative losses. Bank of America now is one of the top six banks holding derivatives along with JP Morgan Chase, CitiBank, Wachovia Bank, and HSBC Bank.<sup>120</sup>

Bank of America is also on the receiving end of fraud cases arising out of the Derivative Market Crash of 2008. Bank of America's acquisition of Countrywide Home Loan<sup>121</sup> carried with it the debt obligation of more than \$85 billion in derivatives.<sup>122</sup>

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<sup>118</sup> 14 March 2008 Moody's Investors Service Press Release: Moody's downgrades Bear Stearns to Baa1; continues to review, attached as Exhibit 56.

<sup>119</sup> Ibid 91, Page 34.

<sup>120</sup> Ibid 77. Second Quarter 2008 Report on Bank Trading and Derivatives Activities, attached as Exhibit 39.

<sup>121</sup> 11 January 2008 Bank of America Press Release: Bank of America Agrees to Purchase Countrywide Financial Corp, attached as Exhibit 58.

<sup>122</sup> Ibid 81.

It is also widely believed that executives at Countrywide engaged in apparent widespread fraud through a corporate culture of selling mortgages without requiring any financial documents. The company was writing loans that homeowners could not afford and could not repay. In short, Countrywide set the stage for a financial time bomb.

Investors are still pursuing major damage claims against Countrywide which could move Bank of America, Countrywide's owner, into financial crisis. So far, the case against Countrywide has fared well. A federal court ruling in Los Angeles sustained a civil complaint against Countrywide Financial Corporation. The court found the charges made in the complaint were sufficient to state a claim. According to the complaint, Countrywide:

[S]teadily increased the origination of "non-conforming" loans, which are inherently less safe than conforming loans because they cannot be sold to government-sponsored entities.<sup>123</sup>

According to a former Countrywide Vice-President, the hedge fund he worked on failed to meet the requirements of "FASB 133," a standard metric for hedging activities. Furthermore, he was asked by Countrywide management to improperly remove bad loans retroactively from the portfolio.<sup>124</sup>

The Court also found persuasive the allegations in the complaint that Countrywide executives "enriched themselves" by selling vast quantities of stock in "illegal, insider sales."<sup>125</sup> According to the Complaint against Countrywide, the sales of insider stock "were made at inflated prices" and without disclosure of "a whole host of associated false and misleading statements" that deceived investors as to the true financial condition of Countrywide and the nature of the loans that were being originated by Countrywide.<sup>126</sup>

The complaint alleges that from the illegal sales of Countrywide securities to the unsuspecting public, the Countrywide defendants "realized proceeds of about \$850 million between 2004 and the end of 2007."<sup>127</sup>

The Complaint describes "a drastic drop in common stock value, from \$45 in February 2007 to less than \$5 in January 2008, government investigations into lending practices and accounting, significant liquidity constraints that limit its ability to conduct business, and damage to goodwill and reputation."<sup>128</sup>

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<sup>123</sup> 14 May 2008 Order In Re Countrywide Financial Corp. Derivative Litigation, attached as Exhibit 59.

<sup>124</sup> Ibid 122.

<sup>125</sup> Ibid 122.

<sup>126</sup> Ibid 122.

<sup>127</sup> Ibid 122.

<sup>128</sup> Ibid 122.

#### D. LEHMAN BROTHERS COLLAPSES

While Bear Stearns was collapsing another Wall Street institution, Lehman Brothers,<sup>7</sup> was also folding. Lehman fell for many of the same excessive derivative practices as befell Bear Stearns. Lehman Brothers most recent quarterly filing said it bought and sold \$729 billion in derivatives with a fair net value of \$16.6 billion.<sup>129</sup> Lehman also “securitized approximately \$146 billion and \$133 billion of residential mortgage loans in 2005 and 2006.”<sup>130</sup>

On 9 June 2008, before the markets opened, Lehman announced \$700 million in additional losses due to ineffective hedges and a net loss of approximately \$5.14 per share for the second quarter of 2008.<sup>131</sup> Fitch, Inc. (“Fitch”) and Moody’s Investor Services (“Moody’s”) downgraded Lehman’s credit rating, and the price of Lehman’s common stock fell, closing down nearly 9 percent to \$29.48.<sup>132</sup>

While Lehman was losing billions, Chief Executive Officer Richard Fuld reportedly took out almost \$500 million for a slew of expensive purchases. These included a lavish multi-million dollar home (10,000 sq. feet) in Greenwich, Connecticut; a \$21 million apartment on Park Avenue in New York City; a \$13 million beachfront vacation home in Florida; a million dollar ski house in Sun Valley, Idaho; and a multi-million dollar art collection.<sup>133</sup>

By 15 September 2008, Lehman’s share price declined over 94 percent from the previous day to \$0.21 per share. That same day, Lehman filed its petition for bankruptcy--the largest corporate bankruptcy in the history of the United States.

The Federal Bureau of Investigation (“FBI”), as well as the United States Department of Justice, is reportedly investigating Lehman and its senior executives for securities and criminal conduct.<sup>134</sup>

Lehman Brothers’ officers have been sued for engaging in the one of the most far reaching frauds in American history, according to the complaint filed against the company by the County of San Mateo.<sup>135</sup> Lehman is charged with engaging in “the worst example of fraud committed by modern day robber barons of Wall Street.”

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<sup>129</sup> 16 September 2008 Credit Default Swaps Complicate Lehman Bankruptcy, attached as Exhibit 60.

<sup>130</sup> 2006 10K Report Lehman Brothers p 41, attached as Exhibit 61.

<sup>131</sup> 13 November 2008 County of San Mateo press release announcing suit against Lehman Brothers executives and cpa; Complaint *San Mateo County v. Lehman Brothers*, attached as Exhibits 63 and 64.

<sup>132</sup> Ibid 130.

<sup>133</sup> Ibid 130.

<sup>134</sup> Ibid 130.

<sup>135</sup> Ibid 130.

## E. BANK FAILURES WREAK HAVOC ON FINANCIAL MARKETS WORLD-WIDE

The Derivative Market Crash of 2008 has caused a worldwide banking crisis. The U.S. policy makers have used two tools to manage the crisis: mergers and taxpayer funded bailouts. Bear Stearns and Washington Mutual were swallowed by JP Morgan Chase. World Savings and Wachovia collapsed into Wells Fargo Bank. Countrywide and Merrill Lynch dissolved into Bank of America, and Citibank was saved only with billions in bailout money from the Federal Reserve System. Table 4 illustrates the mergers caused by the derivative market crash.

**Table 4: Bank Concentration After 2008 Derivative Market Crash**

Merging Bank	Merging Bank	Receiving Bank
Washington Mutual (no. 5 as of 30 June 07) ->	Bear Stearns ->	JP Morgan Chase (no. 1)
Countrywide Financial (no. 17) ->	Merrill Lynch (nos. 32, 43,50)->	Bank of America (no. 2)
World Savings Bank (New Century) (no 13)->	Wachovia (no. 4)->	Wells Fargo (no. 5) <sup>136</sup>

The Comptroller of the Currency reported that U.S. Commercial banks suffered \$9.97 billion of trading losses in the fourth quarter of 2007.<sup>137</sup> The median CDS spread for the top 100 global syndicated loan banks rose to 151 basis points<sup>138</sup> in September 2008 and declined only after several governments injected capital into major banks.<sup>139</sup> The major US banks are alive only by virtue of credit life support from the U.S. Treasury. Credit derivatives have fallen from \$58 trillion to \$32.5 trillion, according to the DTCC.<sup>140</sup>

Table 5 shows derivative positions of the major banks and the bailout money U.S. taxpayers have paid out.

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<sup>136</sup> FDIC Institution lists ranking banks by total assets as of 30 June 2007 and 30 September 2008, attached as Exhibit 71. Insurance Information Institute Largest U.S. Financial Services Firms by Revenues, attached as Exhibit 62.

<sup>137</sup> OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter 2008, attached as Exhibit 66.

<sup>138</sup> A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The relationship between percentage changes and basis points can be summarized as follows: 1% change = 100 basis points and 0.01% = 1 basis point.  
<http://www.investopedia.com/terms/b/basispoint.asp?viewed=1>

<sup>139</sup> 14 October 2008 Financial Counterparty Credit Default Swaps Analysis, attached as Exhibit 65.

<sup>140</sup> 10 November 2008 Business Week report "A light shed on credit default swap market,"  
[http://www.businessweek.com/investing/insights/blog/archives/2008/11/a\\_little\\_light.html](http://www.businessweek.com/investing/insights/blog/archives/2008/11/a_little_light.html);  
Depository Trust & Clearing Corporation 14 November 2008 report, attached as Exhibit 68.

**Table 5: Bank Derivative Position and Bailout Payments<sup>141</sup>**

<b>Bank</b>	<b>Derivative OCC</b>	<b>Derivative DTCC</b>	<b>Bailout</b>
Bank of America	\$39 billion	\$52.3 billion	\$15 billion
JP Morgan	\$91 billion	\$63.7 billion	\$25 billion
Citibank	\$37 billion	\$68 billion	\$25 billion
Wachovia	\$4.4 billion	\$45.6 billion	Not Specified
Goldman Sachs	Not Specified	Not Specified	\$10 billion
Morgan Stanley	Not Specified	\$93.6	\$10 billion
Merrill Lynch	Not Specified	\$93 billion	\$10 billion
Lehman	\$28 million	\$3 billion	Not Specified

The Federal Deposit Insurance Corporation (FDIC) reports that total derivatives notional \$183 trillion for the nation's banks.<sup>142</sup> The FDIC reports that bank industry net income was 87 percent below year earlier level:

The continued downturn in the credit cycle, combined with lingering weakness in financial markets and falling asset values, had a pronounced negative effect on banking industry performance in the second quarter.<sup>143</sup>

Moreover, the number of failed banks is growing and had the U.S. government intervened Citibank, Bear Stearns, Wachovia, Washington Mutual, Countrywide, and Merrill Lynch would have been added to the list, as shown in Table 6:

**Table 6: FDIC Failed Bank List:<sup>144</sup>**

<b>Bank Name</b>	<b>Closing Date</b>
PFF Bank and Trust, Pomona, CA	November 21, 2008
Downey Savings and Loan, Newport Beach, CA	November 21, 2008
The Community Bank, Loganville, GA	November 21, 2008
Security Pacific Bank, Los Angeles, CA	November 7, 2008
Franklin Bank, SBB, Houston, TX	November 7, 2008
Freedom Bank, Bradenton, FL	October 31, 2008
Alpha Bank & Trust, Alpharetta, GA	October 24, 2008
Meridian Bank, Eldred, IL	October 10, 2008

<sup>141</sup> Second Quarter 2008 OCC Quarterly Report on Bank Trading and Derivatives Table 1; 14 November 2008 DCTT Table 6 Top 1000 Reference Entities (Gross and Net Notional); 25 November 2008 Capital Purchase Program Transaction Report attached as Exhibits 39, 42, and 70.

<sup>142</sup> FDIC Quarterly Report for Second Quarter 2008, Table VIA Derivatives and Page 1, attached as Exhibit 69.

<sup>143</sup> Ibid 140.

<sup>144</sup> FDIC Failed Bank List as of 21 November 2008, attached as Exhibit 72.

Main Street Bank, Northville, IL	October 10, 2008
Washington Mutual Bank, Henderson, NV	September 25, 2008
Washington Mutual Bank FSB, Park City, UT	September 25, 2008
Ameribank, Northfork, WV	September 19, 2008
Silver State Bank, Henderson, NV	September 5, 2008
Integrity Bank, Alpharetta, GA	August 29, 2008
The Columbian Bank and Trust, Topeka, KS	August 22, 2008
First Priority Bank, Brandenton, FL	August 1, 2008
First Heritage Bank, Newport Beach, CA	July 25, 2008
First National Bank of Nevada, Reno, NV	July 25, 2008
IndyMac Bank, Pasadena, CA	July 11, 2008
First Integrity Bank, Staples, MN	May 30, 2008
ANB Financial, Bentonville, AR	May 9, 2008
Hume Bank, Hume, MO	March 7, 2008
Douglass National Bank, Kansas City, MO	January 25, 2008
Miami Valley Bank, Lakeview, OH	October 4, 2007
NetBank, Alpharetta, GA	September 28, 2007
Metropolitan Savings Bank, Pittsburg, PA	February 2, 2007

The most recent FDIC report on the overall health of the banking industry is troubling and illustrates that the condition of the banking system remains in decline:

Third quarter net income totaled \$1.7 billion, a decline of \$27.0 billion (94.0 percent) from the third quarter of 2007. The industry's quarterly return on assets (ROA) fell to 0.05 percent, compared to 0.92 percent a year earlier. This is the second-lowest quarterly ROA reported by the industry in the past 18 years. Evidence of a deteriorating operating environment was widespread. \*\*

Almost one in every four institutions (24.1 percent) reported a net loss for the quarter, the highest percentage in any quarter since the fourth quarter of 1990, and the highest percentage in a third quarter in the 24 years that all insured institutions have reported quarterly earnings.<sup>145</sup>

The list of venerable world financial institutions that are casualties of the credit derivative crash is not limited to banks.

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<sup>145</sup> FDIC All Institutions Performance Third Quarter Report, attached as Exhibit 73.



## F. THE COLLAPSE OF AIG

One of the nation's largest insurance companies, American International Group ("AIG"), was also crippled by the 2008 Derivative Market Crash and has survived only because the federal government has invested or committed over \$150 billion.

AIG was permitted by deregulation to become a major derivative player. It operated its derivative business through AIG Financial Products Corp. and AIG Trading Group Inc. and their respective subsidiaries (collectively, AIGFP).<sup>146</sup> AIGFP "participates as a dealer in a wide variety of financial derivatives transactions."<sup>147</sup>

AIG has reported a loss of \$11.5 billion on AIGFP super senior credit default swap portfolio in its 2007 and that the company continues to suffer from high levels of finance receivables delinquencies.<sup>148</sup> Again, one of the nation's largest and most diversified insurance companies is being kept alive by corporate welfare payments from the U.S. Treasury.

## V. FUNDAMENTAL PRINCIPLES ABANDONED IN BANK AND INSURANCE COMPANY BAILOUT

"We must not put the Government any further in debt because of failed banks." President Franklin Roosevelt March 1933

"I believe that banking institutions are more dangerous than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and the corporations that will grow up around the banks will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered." Thomas Jefferson, Letter to the Secretary of the Treasury, Albert Gallatin (1802)

Kleptocracy: a term applied to a government that extends the personal wealth and political power of government officials and the ruling class

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<sup>146</sup> AIG 10 K Report 2007, attached as Exhibit 74.

<sup>147</sup> Ibid 145.

<sup>148</sup> Ibid 145.

(kleptocrats) at the expense of the population.  
(Wikipedia)<sup>149</sup>

Beginning with in March 2008, Federal Reserve assets and U.S. Treasury funds have been used to pay for an ever-widening commitment to banks and financial service companies taken down by the Derivative Market Crash of 2008. The federal government is using taxpayer funds to shift the market losses caused by the derivative market crash from market players to the American people as a whole.

On 11 March 2008, the Federal Reserve announced its Open Market Trading Desk would “expand its securities lending program” and “lend up to \$200 billion of Treasury securities.”<sup>150</sup> On 16 March 2008, the Federal Reserve announced the New York office of the Fed would “establish a Primary Dealer Credit Facility (PDCF) to “provide financing to participants in securitization markets.”<sup>151</sup>

On 24 March 2008, the Federal Reserve of New York announced it would “provide term financing to facilitate JPMorgan Chase & Co’s acquisition of the Bear Stearns Companies.”<sup>152</sup>

On 11 July 2008, the Federal Deposit Insurance Corp. (FDIC) established the IndyMac Federal Bank and took over the IndyBanc.<sup>153</sup>

On 13 July 2008, US Treasury Secretary Henry M. Paulson, Jr. announced the government would provide increased lines of credit and would purchase equity from Fannie Mae and Freddie Mac.<sup>154</sup>

On 19 September 2008, the Federal Reserve announced it would start buying short-term debt of Fannie Mae or Freddie Mac.<sup>155</sup>

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<sup>149</sup> 1 December 2008, Prepared Remarks of Assistant Secretary Patrick O’Brien, attached as Exhibit 75.

<sup>150</sup> 11 March 2008 Federal Reserve Bank of New York Press Release, Statement Regarding System Open Market Account Activity, attached as Exhibit 76.

<sup>151</sup> 16 March 2008 Federal Reserve Bank of New York Press Release, Federal Reserve Announces Establishment of Primary Dealer Credit Facility; PDC Facility: Program Terms and Conditions; PDCF: Frequently Asked Questions, Exhibits 77, 78, and 79.

<sup>152</sup> 24 March 2008 Federal Reserve Bank of New York Press Releases, Statement on Financing Arrangement of JP Morgan Chase’s Acquisition of Bear Stearns, Summary of Terms and Conditions Regarding the JPMorgan Chase Facility, Exhibits 80 and 81.

<sup>153</sup> 11 July 2008 FDIC Press Release FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, attached as Exhibit 82.

<sup>154</sup> 13 July 2008 US Department of Treasury Press Release, Paulson Announces GSE Initiatives, Exhibit 83.

<sup>155</sup> 19 September 2008 Federal Reserve Bank of New York Press Release, Statement Regarding Planned Purchase of Agency Debt, attached as Exhibit 84.

On 7 October 2008, the Federal Reserve announced the creation of the “Commercial Paper Funding Facility (“CPFF”) to “complement the Federal Reserve’s existing credit facilities to help provide liquidity to term funding markets.”<sup>156</sup>

On 3 October 2008, the President signed into law the Emergency Stabilization Act signed by the President on 3 October 2008.<sup>157</sup> This law provides authority to purchase and insure certain types of troubled assets.<sup>158</sup>

On 14 October 2008, Treasury announced it would distribute \$250 billion through a “Capital Purchase Program” (“CPP”) to U.S. financial institutions.<sup>159</sup>

On 21 October 2008, the Federal Reserve announced the creation of the Money Market Investor Funding Facility (MMIFF), to support a private-sector initiative designed to provide liquidity to U.S. money market investors.<sup>160</sup>

On 10 November 2008, the Treasury Department announced it would invest \$40 billion in AIG.<sup>161</sup> Additionally, AIG reported on 10 November 2008 that it was receiving an \$85 billion bridge loan, a \$37.8 billion securities lending facility, and a commercial paper funding facility of \$20.9 billion. These funds are being provided by the U.S. taxpayer.<sup>162</sup>

The Treasury Department identified a program called the Systemically Significant Failing Institution Program (“SSFI”) in an AIG term sheet released on the 10 November 2008.<sup>163</sup> The Treasury Department will determine whether to spend money on troubled companies under the

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<sup>156</sup> 7 October 2008 Federal Reserve Press Release; 14 October 2008 CPFF Program Terms and Conditions; 17 October 2008 CPFF Frequently Asked Questions, attached as Exhibits 85, 86, and 87.

<sup>157</sup> 3 October 2008 The White House Press Release, attached as Exhibit 88.

<sup>158</sup> Emergency Economic Stabilization Act of 2008, attached as Exhibit 89.

<sup>159</sup> 14 October 2008 US Department of Treasury Press Release Treasury Announces TARP Capital Purchase Program Description; Summary of Senior Preferred Terms; Process-Related FAQs for Capital Purchase Program, attached as Exhibits 90, 91, 92.

<sup>160</sup> 21 October 2008 Federal Reserve Press Release; MMIFF Frequently Asked Questions; MMIFF Program Terms and Conditions, attached as Exhibits 96, 97, and 98.

<sup>161</sup> 10 November 2008 US Department of Treasury Press Release announcing restructuring of AIG transaction; Treasury Department Tranche Report to Congress (Including Systemically Significant Failing Institution Program) (“SSFI”), attached as Exhibits 93 and 94.

<sup>162</sup> 10 November 2008 AIG Capital Structure and 3Q 2008 Earnings Investor Presentation; 10 November 2008 US Treasury Press Release “Treasury to Invest in AIG, attached as Exhibits 104 and 105.

<sup>163</sup> Ibid 160.

Emergency Economic Stabilization Act (EESA) based upon whether they are considered suitable for entry into the Systemically Significant Failing Institutions (SSFI) Program.<sup>164</sup>

On 23 November 2008, the U.S. Treasury Department announced “guarantees” and “protection” for Citigroup.<sup>165</sup>

On 25 November 2008, the U.S. Treasury officials announced the department would allocate funds for the consumer asset backed securities market established by the Federal Reserve Bank of New York.<sup>166</sup> Table 7 illustrates the government bailout programs following the 2008 Derivative Market Crash:

**Table 7: Description of 2008 Federal Funds Used for Bank And Financial Services Company Bailout**

<b>Date</b>	<b>Use of Taxpayer Funds</b>	<b>Amount</b>
11 March	Expand Securities Lending Program	\$200 Billion
16 March	Primary Dealer Credit Facility (PDCF)	Not Specified
24 March	Term Financing JP Morgan Bear Stearns Deal	Not Specified
11 July	IndyMac Federal Bank takeover of IndyMac Bank	Not Specified
13 July	Increased Lines of Credit and Purchases of Equity from Fannie Mae & Freddie Mac	Not Specified
16 Sept	Loan to American International Group	\$85 Billion
19 Sept	Purchase of Freddie Mac and Fannie Mae Short Term Debt	Not Specified
3 Oct	Emergency Economic Stabilization Act of 2008	Not Specified
7 Oct	Commercial Paper Funding Facility (“CPFF”)	Not Specified
14 Oct	Capital Purchase Program under Troubled Assets Relief Program (“TARP”)	Not Specified
21 Oct	Money Market Investor Funding Facility (MMIFF)	Not Specified
10 Nov	AIG Senior Preferred Stock Buy Under the Systemically Significant Failing Institution Program (SSFI)	\$40 Billion
23 Nov	Citygroup “Package of Guarantees” and “Protection” against loss	Not Specified

<sup>164</sup> 14 November 2008 US Treasury Trance Report to Congress; 14 November 2008 Testimony of Interim Assistant Secretary for Financial Stability Neel Kashkarl before the House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, attached as Exhibits 94 and 95.

<sup>165</sup> 23 November 2008 Treasury Department Press Release Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup; Summary of Terms of Citigroup, attached as Exhibits 99 and 100.

<sup>166</sup> 25 November 2008 Press Release Treasury Provides TARP Funds to Federal Reserve Consumer ABS Lending Facility; Remarks Secretary Paulson on Consumer ABS Lending Facility, attached as Exhibits 101 and 102.

Table 8 shows how much the Treasury Department has transferred the amounts shown below under the Capital Purchase Program (CPP) to buy preferred stock from these banks:

**Table 8: Preferred Stock Purchases by US Treasury from US Banks**

<b>Date</b>	<b>Seller</b>	<b>City</b>	<b>Amount</b>
10/28/2008	Citigroup Inc.	New York	\$25,000,000,000
10/28/2008	JPMorgan Chase & Co.	New York	\$25,000,000,000
10/28/2008	Wells Fargo & Company	San Francisco	\$25,000,000,000
10/28/2008	Bank of America Corporation	Charlotte	\$15,000,000,000
10/28/2008	The Goldman Sachs Group, Inc.	New York	\$10,000,000,000
10/28/2008	Morgan Stanley	New York	\$10,000,000,000
10/28/2008	Merrill Lynch & Co., Inc.	New York	\$10,000,000,000
11/14/2008	U.S. Bancorp	Minneapolis	\$6,599,000,000
11/14/2008	Capital One Financial Corporation	McLean	\$3,555,199,000
11/14/2008	SunTrust Banks, Inc.	Atlanta	\$3,500,000,000
11/14/2008	Regions Financial Corp.	Birmingham	\$3,500,000,000
11/14/2008	BB&T Corp.	Winston-Salem	\$3,133,640,000
10/28/2008	Bank of New York Mellon Corporation	New York	\$3,000,000,000
11/14/2008	KeyCorp	Cleveland	\$2,500,000,000
11/14/2008	Comerica Inc.	Dallas	\$2,250,000,000
10/28/2008	State Street Corporation	Boston	\$2,000,000,000
11/14/2008	Marshall & Ilsley Corporation	Milwaukee	\$1,715,000,000
11/14/2008	Northern Trust Corporation	Chicago	\$1,576,000,000
11/14/2008	Zions Bancorporation	Salt Lake City	\$1,400,000,000
11/14/2008	Huntington Bancshares	Columbus	\$1,398,071,000
11/14/2008	First Horizon National Corporation	Memphis	\$866,540,000
11/21/2008	Associated Banc-Corp	Green Bay	\$525,000,000
11/21/2008	City National Corporation	Beverly Hills	\$400,000,000
11/21/2008	Webster Financial Corporation	Waterbury	\$400,000,000
11/14/2008	TCF Financial Corporation	Wayzata	\$361,172,000
11/14/2008	Valley National Bancorp	Wayne	\$300,000,000
11/14/2008	UCBH Holdings, Inc.	San Francisco	\$298,737,000
11/21/2008	Trustmark Corporation	Jackson	\$215,000,000
11/14/2008	Umpqua Holdings Corp.	Portland	\$214,181,000
11/14/2008	Washington Federal Inc.	Seattle	\$200,000,000
11/21/2008	First Niagara Financial Group	Lockport	\$184,011,000
11/21/2008	Pacific Capital Bancorp	Santa Barbara	\$180,634,000
11/21/2008	Boston Private Financial Holdings, Inc.	Boston	\$154,000,000
11/14/2008	Provident Bancshares Corp.	Baltimore	\$151,500,000
11/21/2008	Western Alliance Bancorporation	Las Vegas	\$140,000,000
11/21/2008	Banner Corporation	Walla Walla	\$124,000,000
11/21/2008	Taylor Capital Group	Rosemont	\$104,823,000

11/21/2008	Columbia Banking System, Inc.	Tacoma	\$76,898,000
11/21/2008	Nara Bancorp, Inc.	Los Angeles	\$67,000,000
11/21/2008	Ameris Bancorp	Moultrie	\$52,000,000
11/21/2008	First Community Bankshares Inc.	Bluefield	\$41,500,000
11/21/2008	Heritage Commerce Corp.	San Jose	\$40,000,000
11/21/2008	Cascade Financial Corporation	Everett	\$38,970,000
11/21/2008	Porter Bancorp Inc.	Louisville	\$35,000,000
11/21/2008	Centerstate Banks of Florida Inc.	Davenport	\$27,875,000
11/21/2008	HF Financial Corp.	Sioux Falls	\$25,000,000
11/21/2008	Heritage Financial Corporation	Olympia	\$24,000,000
11/21/2008	Severn Bancorp, Inc.	Annapolis	\$23,393,000
11/21/2008	First PacTrust Bancorp, Inc.	Chula Vista	\$19,300,000
11/14/2008	Bank of Commerce Holdings	Redding	\$17,000,000
11/14/2008	1st FS Corporation	Hendersonville	\$16,369,000
11/21/2008	First Community Corporation	Lexington	\$11,350,000
11/14/2008	Broadway Financial Corporation	Los Angeles	\$9,000,000 <sup>167</sup>

As Table 9 shows, as of 25 November 2008 only one corporation had received relief Under the Department of Treasury's Systemically Significant Failing Institution program: AIG.

**Table 9: Systemically Significant Failing Institution Bail Out**

11/25/2008	AIG		\$40,000,000,000
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On 26 November 2008, AIG and the U.S. Department of Treasury completed the purchase and sale of 4,000,000 shares of Series D Fixed Rate Cumulative Perpetual Preferred Shares with taxpayers paying \$40 billion.<sup>168</sup>

Pro Publica, Reuters, and CNBC have estimated the potential cost of the bank bailout at more than \$8 trillion.<sup>169</sup>

The United States is paying for the bailout by borrowing money, borrowing that will bury the next generation. The looming problem economic catastrophe is that one day the U.S. government may be unable to find buyers of its bonds.

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<sup>167</sup> Ibid 141. 25 November 2008 US Treasury Department Troubled Asset Relief Program Capital Purchase Program Transaction Report, attached as Exhibit 70 (See also 9 December 2008 Capital Purchased Program Transaction Report included with Exhibit 70).

<sup>168</sup> 2008 Form 8-K for AIG, attached as Exhibit 103.

<sup>169</sup> Pro Publica <http://www.propublica.org/article/a-bailout-that-works>; <http://www.cnbc.com/id/27912307>; Copyright 2008 Reuters. [Click for restrictions](#).

President Roosevelt recognized the danger of putting the U.S. Government into debt to save failed banks. He stated, “we must not put the Government any further in debt because of failed banks. Now, the real mark of delineation between sound and unsound is when the Government starts to pay its bills by starting printing presses. That is about the size of it.”<sup>170</sup>

## VI. REFORMS NEEDED

“These laws are no panacea; nor are they self-executing. More than ever, we must maintain our vigilance.” --Ferdinand Pecora” *Wall Street Under Oath*, "A Word About the Future," 1939

“These old Wall Street boys are putting up an awful fight to keep the government from putting a cop on their corner.” Will Rogers

“[T]he banker must be always and only a banker, a trustee for the community.” A. Berle 1933

The safeguards put into place after the Stock Market Crash and banking collapse of 1929 were removed in 1999 and the history has repeated itself with the Derivative Market Crash of 2008. The famed reform attorney who led the U.S. Senate investigation into Wall Street abuses before 1929 predicted history would repeat itself:

Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reins of its former power. That its leaders are eminently fitted to guide our nation, and that they would make a much better job of it than any other body of men, Wall Street does not for a moment doubt. Indeed, if you now hearken to the oracles of The Street, you will hear now and then that the money-changers have been much aligned. You will be told that a whole group of high-minded men, innocent of social or economic wrongdoing, were expelled from the temple because of the excesses of a few. You will be assured that they had nothing to do with the misfortunes that overtook the country in 1929-1933; that they were simply scapegoats, sacrificed on the altar of unreasoning public opinion to satisfy the wrath of a howling mob blindly seeking victims. These disingenuous protestations are in the crisp legal phrase, "without merit." The case against the money-changers does not rest upon hearsay or surmise. It is based upon a mass of evidence, given publicly and under oath before the Banking and Currency Committee of the United States Senate in 1933-1934, by The Street's mightiest and best-informed men. Their testimony is recorded in twelve thousand printed pages [now in the National Archives]. It covers all the ramifications and phases of Wall Street's manifold operations. The public, however, is sometimes forgetful.

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<sup>170</sup> Ibid 38.

As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times." ... We may now need to be reminded what Wall Street was like before Uncle Sam stationed a policeman at its corner, lest, in time to come, some attempt be made to abolish that post.<sup>171</sup>

The breakdown of the regulatory framework that permitted or even encouraged the collapse of the world's banking system was complex and dynamic. First "many Federal and State law barriers to affiliations among banks and securities firms, insurance companies, and other financial service providers" were eliminated in 1999 by the Congress and President Clinton.<sup>172</sup> The Gramm-Leach-Bliley bill was represented to modernize the delivery of financial services "by changing the regulatory structure of financial services providers and rationalizing some of the ways in which they do business."<sup>173</sup>

In a memorandum to President Franklin Roosevelt from Roosevelt brain trust member Adolph Berle in 1933, in anticipation of the President's speech to the American Bankers Association, Berle argued that the long-run solution to the financial problems lay in separating the various functions of banks<sup>174</sup>:

A large part of our banking difficulties arise from the haphazard growth of our banking system. At no time has there been any attempt to delimit the functions, and to provide that in each department of banking there shall be orderly functioning, no department being at the risk of any other department. A start has been made towards this end in the Glass-Steagall Act and in certain restricted legislation but it has not dealt with the major problem.<sup>175</sup>

Berle, a key Roosevelt adviser, believed the 1933 Glass-Steagall banking reform law was not a long term solution:

As to the Glass-Steagall Act itself, I think I am safe in saying that most students of it agree that it is in a transitory phase. We have to regard it as a bridge or a transition rather than as permanent solution for the situation.<sup>176</sup>

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<sup>171</sup> Quote taken from 2 August 2001 letter from National Organization for Women-NYC to Johnathan G. Katz Secretary of the SEC, attached as Exhibit 106.

<sup>172</sup> 1 November 1999 S. 900/H.R. 10 Conference Report Statement of Managers Summary of Major Provisions <http://banking.senate.gov/conf/somfinal.htm>

<sup>173</sup> 16 December 1999 CRS Report for Congress Major Financial Services Legislation, The Gramm-Leach-Bliley Act (P.L. 106-102): An Overview p. 2 (F. Jean Wells Specialist in Economic Policy Government and Finance Division William D. Jackson), attached as Exhibit 107. See: <http://epic.org/privacy/glba/RL30375.pdf>

<sup>174</sup> Phillips, Ronnie J., *The Chicago Plan & New Deal Banking Reform* Page 60, attached as Exhibit 108.

<sup>175</sup> Ibid 173, Page 60.

<sup>176</sup> Ibid 173. Page 59.



Rather than extend the reform rationale begun in 1933 to make the banking system better serve the public interest financial interests, the Congress repealed Glass-Steagall in 1999.<sup>177</sup> Adolph Berle wanted to bankers to be “disinterested administrator of the credit and currency machinery of the country.”<sup>178</sup> The banker, according to Berle, “must be always and only a banker, a trustee for the community.”<sup>179</sup>

Alan Greenspan, who was appointed Chairman of the Federal Reserve Bank, led a “free market” 20-year assault on the Glass-Steagall Act.<sup>180</sup> Mr. Greenspan wrote in his autobiography openly of his effort to repeal Glass-Steagall:

I had long argued that the Glass-Steagall Act, which in 1933 separated the business of securities underwriting from commercial banking, was based on faulty history. Testimony before Congress in 1933 was filled with anecdotes that gave the impression that inappropriate use by banks of their securities affiliates was undermining overall soundness. Only after World War II, when computers made it possible to evaluate the banking system as a whole, did it become evidence that banks with securities affiliates had weathered the 1930s crisis better than those without affiliates. A few months before I took up my duties at the Fed, the Board introduced a proposal that would again allow banks to sell securities through affiliates, under very restrictive conditions. The Board continued to encourage easing the restrictions, and I testified many times for legislative change. It took until 1999 for Glass-Steagall to be repealed by the Gramm-Leach-Bliley Act. Fortunately, Gramm-Leach-Bliley, which restored sorely needed flexibility to the financial industries, is no aberration. Awareness of the detrimental effects of excessive regulation and the need for economic adaptability has advanced substantially in recent years. We dare not go back.<sup>181</sup>

Chairman Greenspan did not apparently understand the record of Wall Street abuses developed by the U.S. Senate Committee on Banking and Currency Investigation of Wall Street (The Pecora Wall Street Expose) between 1932 and 1934.<sup>182</sup> For example, the record developed before the Senate Banking Committee showed that: (1) millions of dollars of depositor money

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<sup>177</sup> CRS Report Major Financial Services Legislation, the Gramm, Leach, Bliley Act, attached as Exhibit 109.

<sup>178</sup> Ibid 173, Page 60.

<sup>179</sup> Ibid 173, Page 60.

<sup>180</sup> Greenspan, Alan The Age of Turbulence pp. 375-376.

<sup>181</sup> Greenspan, Alan The Age of Turbulence pp. 375-376.

<sup>182</sup> The Senate Committee on Banking and Currency Investigation of Wall Street (The Pecora Wall Street Expose) held hearings between 11 April 1932 and May 4, 1934. The Chairman of the Committee was Peter Norbeck (R-SD), 1932-1933 and Duncan U. Fletcher (D-FL), 1933-1936. The Committee conducted an Investigation of Wall Street banking and stock exchange practices that led to passage of the Securities Act of 1933, the Banking Act of 1933, and the Securities Exchange Act of 1934. Major Senate Investigations A Selected List, attached as Exhibit 110.

from the National City Bank was used to establish an investment bank, the National City Company; (2) 20% of National City's profits were set aside for senior executives; (3) shares of companies sold by National City were given to insider executives at substantially reduced prices; (4) loans that went unpaid were granted to insider executives; (5) sale of worthless foreign country bonds at grossly inflated prices; (6) sale of its parent bank's stock at inflated prices; (7) pay-to-play schemes.<sup>183</sup>

When the bubble burst in the late 1920s depositors and investors suffered greatly and they were outraged: "The best way to restore confidence in our banks is to take these crooked presidents out of the banks and treat them the same as they treated Al Capone when Capone avoided payment of his tax," was the opinion of Senator Burton Wheeler.<sup>184</sup>

The expose showing gross manipulation of the banking and investment customers went on for another year. The public understood that bankers were speculating with other people's money. They understood the moral hazard of allowing investment banks and commercial banks to operate out of the same tent. As Mr. Greenspan explains in his autobiography, the term "moral hazard" is "used in the insurance business to describe why customers take actions they would not so readily consider were they not insured against the adverse consequences of their behavior."<sup>185</sup>

Here the absence of regulation and lax enforcement created a moral hazard leading to the Derivative Market Crash of 2008. Mr. Greenspan described well the lax attitude of his regulators:

So while the staff recommendations at the Federal Reserve Board were directed to implementing congressional mandates, they were always formulated with a view toward fostering competition and letting markets work. There was less emphasis on 'thou shall not' and more on management accountability and disclosure that would enable markets to function more effectively. The staff also fully recognized the power of counterparty surveillance as the first line of protection against overextended or inappropriate credit.

Mr. Greenspan saw part of the role of regulators holding other regulators in check: "Sometimes several regulators are better than one. The solitary regulator becomes risk averse; he or she tried to guard against all imaginable negative outcomes, creating a crushing compliance burden. In the financial industries, where the Fed shares regulatory jurisdiction with the Comptroller of the Currency, the Securities & Exchange Commission, and other authorities, we tended to keep one another in check."<sup>186</sup>

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<sup>183</sup> Seligman, Joel *The Transformation of Wall Street* pp. 25-38.

<sup>184</sup> Seligman, Joel *The Transformation of Wall Street* pp. 25-38.

<sup>185</sup> Greenspan, Alan *The Age of Turbulence* pp. 374.

<sup>186</sup> Greenspan, Alan *The Age of Turbulence* pp. 375-376.

The U.S. Senate should convene a select committee supported by a professional staff of a size and competence sufficient to accomplish the mission of thoroughly investigating the causes of the Derivative Market Crash of 2008. The select committee would be modeled on the Pecora Commission that did an effective job of uncovering waste, fraud and abuse.

The Chairman of the SEC has made a similar recommendation: “That is why it is so important for the Congress to appoint a Select Committee, with representation from each of the existing standing committees with responsibility for financial services regulation, to rationalize the current dysfunctional patchwork of our regulatory system.”<sup>187</sup>

Rather than pour taxpayer funds into the failed banks, a plan of reorganization should be implemented. This would allow for an orderly and efficient transfer of good assets to survivor companies. Moreover, basic regulations should be adopted separating banks into commercial and investment divisions. Further study by the Congressional Select Committee and related legislative committees should proceed with the goal of structuring the banking and financial services industry to best advance the national public interest.

Further divisions can be informed by using the North American Industry Classification System (NAICS).<sup>188</sup> Bank regulations would affirmatively establish separate banking sectors for example natural resource and energy, communication, and transportation. The banking industry would be organized to serve the public interest.

This Report shows federal officials disregarded the hard lessons from the last implosion of the world banking system in 1929. President Franklin Roosevelt’s safeguards were taken down at great cost to the nation and the world:

Finally, in our progress toward a resumption of work we require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people's money, and there must be provision for an adequate but sound currency.<sup>189</sup>

In addition to repealing of the Gramm-Leach-Bliley Act, new legislation should be passed requiring collateralized derivatives to be registered as securities offerings under the 1933 Securities Act, hedge funds and hedge fund advisers to be registered under the Investment Company and Investment Advisers Act, defining credit default swaps as insurance subject to state insurance regulations, prohibiting credit swap speculation, and strengthening the bank holding company by extending its reach to investment banks.

## VII.

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<sup>187</sup> Ibid 28.

<sup>188</sup> Ibid 29.

<sup>189</sup> Ibid 27.

## CONCLUSION

“When this nation again comes to days of plenty and prosperity, let us seek to make it impossible for water and hot air to be sold to men and women of America for gold taken from their savings.”  
Ferdinand Pecora New York Times, February 19, 1933

The Derivative Market Crash of 2008 has resulted in a worldwide banking crisis. There is substantial and persuasive evidence showing the cause of the crash was unregulated acts and practices in the banking and financial services industry involving derivatives.

This Report urges the U.S. President and Congress lead an effort to reform the banking and financial services industry by taking effective action on the problem through three coordinated and interdependent initiatives: (1) insolvency reorganization for the troubled financial services firms; (2) reinstatement of banking, insurance and securities regulatory protections; and (3) reorganization of the banking and securities industry to service the national public interest.