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Sunday, September 28, 2008

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Shelby,

I am writing to comment on the financial rescue plan currently under consideration by the US House and the US Senate. In the appendix, we provide a four step plan for dealing with the crisis.

Our comments follow a series of warnings we have issued since 1998:

- In October 1998, in a petition to the United States Court of Appeals for the District of Columbia Circuit[1], we cited evidence that growing financial market malfeasance greatly exacerbated risks in financial markets, reducing the safety and soundness of large financial institutions. We went on to note that:

  > *"The nature of financial market activities is such that significant dislocations can and do occur quickly, with great force. These dislocations strike across institutional lines. That is, they affect both banks and securities firms. The financial institution regulatory structure is not in place to effectively evaluate these risks, however. Given this, public safety is at risk."*

- On June 15, 2000, I testified before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (GSE's) of the US Congress. I suggested that the GSE's (Fannie Mae and Freddie Mac) be subject to a through "Social Audit." A Social Audit is an examination of the performance of an enterprise relative to certain social objectives. It also includes a review of ethical practices at the firm. Had they been subject to this audit, certain flaws in their operation, including certain ethical shortcomings, may have been revealed earlier and in a better market in which to make corrections.

- On May 9, 2003, we wrote to you to comment on an award of Federal Government tax credits to a firm fined by the SEC for allowing undue influence by investment banking interests on securities research.

[1] Cunningham v The Federal Reserve Board of Governors. Case Number 98-1459.

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- On February 22, 2006, we wrote to you to comment on a Senate Banking Committee hearing on Credit Rating Agencies held on March 7, 2006. In that letter, we referenced our comments to the SEC on NRSROs and rating agencies. (Our comments are available on-line at: http://www.sec.gov/rules/proposed/s70405/wcunningham9442.pdf)

We have attached copies of our earlier correspondance.

We are stunned to learn that banking and financial market regulators are considering using taxpayer funds to finance the creation of a separate entity to hold "toxic" financial instruments. This is a dangerous suggestion that will not solve the problem. This has the added disadvantage of eventually forcing the U.S. Government to follow Wall Street into bankruptcy.

At best, this approach is akin to moving a fire from, say, your living room to your dining room. At either location, the fire will continue. The proposed separate entity simply provides more oxygen to the fire, whatever its location.

We are further stunned to learn that banking and financial market regulators are considering using most, if not all of the reserves collected from 1913 to 2008 by the Federal Reserve System:

1. to purchase a set of financial instruments with limited information on what, exactly, they are buying,
2. to purchase a set of financial instruments with limited value,
3. to purchase a set of financial instruments with potentially unlimited risk,
4. to purchase a set of financial instruments with virtually no information on how long the Fed will have to hold them, and,
5. to do all of this under severe time pressure.

Many of these newer financial instruments can never now turn a profit. They are directional bets on the state of a given company, market, or asset, bets that went wrong. As such, they are event driven assets. Once the event occurs (change in credit rating for Bank A from BBB to CCC, for example) the value of the instrument is set. They are, like strings of option contracts, wasting assets.

These toxic instruments were created not to stabilize markets, since clearly, they have failed to do so. They were created to evade regulatory safeguards and to maximize commission revenue.[2] They did so by being opaque and hard, if not impossible, to value. Few serve any truly useful

[2] See: Infectious Greed, Frank Partnoy, 2003, Henry Holt and Company, New York, NY.

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function. This confirms what we wrote on our blog on April 3rd: *With the development of toxic (derivative and subprime lending) financial products, the relationship between investment banks and the economy has turned fully parasitic.*

We note that, for 100 years, standardized futures contracts and options (derivatives) have been used to stabilize markets. We would not think of buying all outstanding futures contracts traded on the Chicago Board of Trade. We are being asked to do so for a private exchange run by a group of firms in New York because they are holding the financial system, and by extension the economy, hostage.

In addition, this approach will not prevent the US economy from moving into a depression. The only solution that both protects the taxpayer and reduces the probability that the US will enter recession or depression is the creation of an entity holding real property, not contracts or investments tied to real property. (You might consider repurposing Fannie Mae and Freddie Mac for this task.)

To protect the public and the markets, these newer financial instruments should be extinguished. *To put the fire out, put the fire out.* To extinguish these instruments one must know what and where they are. To uncover this information, we suggest the creation of a database showing the transaction chain (seller, buyer, intermediary) for each and every financial instrument.[3] We suggest doing so before authorizing the expenditure of funds.

Reviewing commissions paid to brokers is the way to get information on all relevant transactions. [4]

While this is a large task, it is analogous to what the federal government does under the Home Mortgage Disclosure Act. The Home Mortgage Disclosure Act database is a collection of information concerning home mortgage loan applications. The database is maintained by the FFEIC, the Federal Financial Institutions Examination Council, and contains 17 million records annually. The federal government has good experience in dealing with massive sets of information. [5] In addition, computing power and data storage is increasingly inexpensive.

Instruments should be reviewed one-by-one by an objective panel of experts to determine economic value and utility. Legal contracts supporting those without either should be vacated immediately by the US Congress.

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[3] We note the State of NY is moving to do so with credit default swaps (CDOs).
[4] As a former Wall Street institutional broker, I can assure you that the one accurate database on Wall Street is the commission database that determines compensation.
[5] We suggest you contact Dr. Glenn Canner at the Federal Reserve Board in Washington, DC.

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We suggest you create and deploy an emergency “swat team” of 500 Justice, Treasury, SEC, Federal Reserve and CFTC lawyers, examiners, accountants and economists to obtain the commission and transaction data. This will allow the completion of this task in 15 days.

Finally, we believe there should be a 30 day "cooling off" period. The fact that you have forced Congress to more deliberately consider legislation has already calmed global markets. Despite the Administration’s assurances to the contrary, there is no legitimate reason to rush. We understand that a cooling off period may mean forcing banks to lend on a short term basis to the 1,000 largest corporations in the US. This is:

a. Where the Federal Reserve should be focused and
b. Cheaper than the alternative, spending $700 billion at once.
c. More likely to prevent a recession or depression.

Mr. Ranking Member, you have done this country a great service by forcing more deliberation concerning the Financial Rescue Plan and Process. In this way, you continue to meet your obligation to enhance the long term stability of the U.S. financial system. I applaud you for doing so in a balanced, thoughtful manner.

Thank you.

Sincerely,

William Michael Cunningham
Social Investing Adviser

cc: The Honorable Barney Frank, Chairman, House Financial Services Committee

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Appendix

Summary

1. Create and deploy an emergency "swat team" of 500 Justice, Treasury, SEC, Federal Reserve and CFTC lawyers, examiners, accountants and economists.
2. Suspend trading on the NYSE for two days. Place "swat team" members in all major brokerage firms.
3. Assign the swat team to develop a database showing the exact nature of the relevant investment transactions and instruments:
    a. Describe and detail the transaction chain (seller, buyer, intermediary.) To do so, to obtain the commission and transaction data. (By doing this, you will show a determination to act and to get in front of the problem by being fully informed as to its nature and dimensions. Markets will calm once you both:
        i. outline the plan of action, and
        ii. take this step.)
    b. *Reviewing commission paid (the commission database) from all firms (commissions paid to firms, brokers and salespeople) is the way to get transaction chain information for all relevant transactions*.
4. Review relevant transactions and instruments on a one-by-one basis.
5. Reverse relevant transactions and instruments with no economic value: extinguish underlying legal contract. Rescind corporate charters and remove limited liability protection for relevant Special Purpose Vehicles (SPVs) and Structured Investment Vehicles (SIVs.)
6. Once Step 3 above has been carried out, the Government will be in a position to purchase real property, *not contracts or investments tied to real property*, for instruments and transactions that have been reversed. We note that tax credits may be used at this stage, and this stage only.