Testimony of

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Thank you for inviting me to share my thoughts with you today. The Committee is to be commended for its commitment to looking into these transactions. Only by understanding what happened with Enron can we hope to learn the lessons necessary to prevent such events from occurring in the future.

And we must do what we can to see that such *abuses* don't happen again. Because there is no doubt that the integrity of our markets – and the faith that the ordinary investor has in their fairness -- have been severely damaged.

I began to realize this last February. I got a call from my senior executive in charge of our retail operations. He told me that he was seeing something he had never seen before. Investors were calling to sell out their entire accounts and request a check for the entire proceeds. Normally, if an investor thinks the market is overvalued they will sell out their account but will put the funds into money market accounts until they wish to reinvest. But these people were opting entirely out of the market.

We made a special point of talking to these customers to see why they were taking this action and the answer was alarming. They said they no longer had faith in the integrity and fairness of the system and that the markets were against them. They cited Enron as the key reason.

When we lose the individual investor we have a serious problem. The U.S. capital markets are the envy of the world.

During the 1990s, we created tens of millions of new jobs – the only country in the world to do so. We funded an explosion of new technology and business activity. We are the economic engine that pulls the global economy. This is all made possible because of our unique capital-raising system. We cannot put that system at risk. Individual investors, through their investments in mutual funds and retirement accounts, fueled this expansion. Recently when I gave a speech for the Miami Herald, I was asked by an elderly gentlemen; "Miss Siebert, I lost a third of my money. Will they go to jail?"

So the problems we are discussing today are very important.
Corporate executives and financiers must not be allowed to circumvent the intent of our laws in order to manipulate the financial results they report, using sham transactions that technically may be legal but certainly aren't ethical or reflective of true economic activity. We cannot legislate or regulate integrity, but neither can we allow our financial institutions to operate without regard to even the most basic principles of business.

The transactions we are discussing today demonstrate the way that structured finance and complex investment products can be misused. Through financial engineering, companies like Enron were able to operate by legal loophole. And as we see today, some of our most respected and largest financial institutions were there to help them, participating in these questionable transactions and providing the funding that made them possible.

The distressing thing is that this type of behavior is not really new. Indeed, financial engineering has been with us for decades.

I have with me today copies of Congressional testimony I gave on two other occasions – in 1988 and in 1998. I'd like to read two short excerpts from these statements that I think underscore an important point that we should all recognize as we explore the issues we have before us today. Specifically, it relates to the use of derivatives in our capital markets and the role they have played in triggering the last three market downturns.

In 1988, I testified before the subcommittee on Telecommunications and Finance on program trading and portfolio insurance. This was in the wake of the stock market crash of October 1987. The major problem with the stock market, I said, was not the presence of large institutional players, but rather the way these investors were trading.

To quote from the testimony:
"Our problem stems from the institutions' trading stocks not for traditional reasons, but rather because of momentary imbalances in the futures and options markets, the so-called derivative markets. Program trades and index arbitrage end up bringing the volatility and rampant speculation of the futures pits to the floor of the Big Board. Futures have become the tail wagging the dog."

And, as we all remember, it was program trading based on derivatives -- otherwise known as portfolio insurance -- that fueled the unprecedented sell-offs that occurred on October 19, 1987.

In that case, there was a strong regulatory response that put collars on these automated trading programs to bring rationality back to the markets. Today, portfolio insurance no longer exists.

Ten years later, I was back before Congress again, this time before the House Committee on Banking and Financial Services. I was commenting on the near demise of Long Term Capital Management and its effect on global capital markets.

You'll recall that it took an unprecedented rescue package of this massively over-leveraged hedge fund to head off a meltdown in the global financial system. It would have caused catastrophic damage to both financial institutions and the investment community if the institutions had to liquidate Long Term's portfolio to meet margin calls.

To quote from my testimony:
"Simply stated, regulation has not kept up with advancements in technology and new financial products. Unregulated hedge funds using legal loopholes have borrowed vast amounts of money which they use to speculate in highly leveraged transactions."

I then went on to describe the family of products that made the Long Term Capital implosion possible – derivatives. Long Term Capital had relied upon foreign exchange derivatives trading to hedge its bets. And it bet wrong. Again we saw the stock market head south, driven downward by a derivative-induced crisis.

Of course, it could have been much worse. Using derivatives, Long Term Capital employed vast amounts of leverage to create a portfolio with the notional value of its positions worth over a trillion dollars. Had the Federal Reserve not stepped in to create a consortium of some of our leading financial institutions to provide an infusion of capital and systematically liquidate it, the effect of the margin calls could have been devastating to every corner of the global financial markets.

And so we meet again here on Capitol Hill in 2002. The current market crisis, like others before it, has parts of its genesis in the derivatives arena, that murky corner of the securities industry where futures, options, swaps, warrants and convertibles are the vehicles of choice.

And it's bigger than ever. The notional amount of derivatives in insured commercial bank portfolios was recently estimated at $40-50 trillion dollars.

Yet despite its size, the derivative market is largely opaque and unregulated, a fertile field for those looking to create the latest legal loophole.

Let's explore what happened with Enron for a minute, and how derivatives fueled the fire.

Using derivatives and off-balance sheet special purpose entities, Enron in some cases allegedly used "pre-paid" transactions that were really debt and made them look like revenues. Also using derivatives, Enron bought and sold energy contracts of the same amount, at the same price, on the same day. Their purpose? - To create the illusion of volume. These transactions were legal in the unregulated OTC energy trading markets, but would have been illegal in the listed commodities market where they would have been considered "wash sales."

In short, the deregulation of the energy markets coupled with the use of derivatives enabled the phony energy trading. All to create the illusion of activity and revenues; when, in reality, no real economic activity was being conducted by these "trades."

This not only affected Enron, but many other well established, old-line energy companies, which joined the fray as counter parties. There are at least a dozen formerly solid utilities that traded in this market. Many of them have had to eliminate or reduce dividends and have seen their stock prices drop precipitously. Many of their shareholders were not aware of the risk these companies incurred. They counted on the dividends.

One of the reasons so many other entities were hurt is the speed with which Enron went under. Significantly, it was the terms of Enron's bonds that caused this quick collapse, in particular the debt triggers that were in place. Under the bonds' indentures, changes in certain conditions -- like asset coverage, earnings results, credit rating downgrades -- put the bonds in violation of the terms in the indenture. In some cases the bonds became due and payable once these debt triggers were activated.

Yet with so much of Enron's activity taking place in off-balance sheet special purpose entities, no one had any way of knowing the risks that Enron – and all the companies that did business with it -- were undertaking. In many cases, the terms of these bonds were simply not publicly available.

And Enron was not alone. Many telecom companies entered into swaps. Their companies and bonds have also collapsed, causing losses of hundreds of millions of dollars to public pension plans.

What should we make of all this from a regulatory perspective?

We know that the last three market downturns can all be traced to movement in the derivatives field. In 1987, it was portfolio insurance and program trading. In 1998, it was Long Term Capital Management and the foreign exchange markets. And in 2001 it started with Enron energy trades and off-balance-sheet special purpose entities.

And we should note that regulatory responses to the first two did nothing to stop the third. And I'm afraid nothing we do today can prevent the next debacle, unless we address the core problems, which are the lack of management accountability and the lack of transparency of these new financial tools. This financial engineering permitted the illusion of economic activity. Is there any wonder why investors do not trust the system?

Attempts to restore the system to health or prevent further crisis with regulations alone will fail. The professionals who create these schemes must be accountable. Sure, the SEC and accounting oversight board can shut down specific transaction types, but whatever they do will undoubtedly become obsolete over time.

I spent the better part of five years as the Superintendent of Banking of New York State and learned something very important:

Regulations pertaining to financial products have never been able to stay ahead of fast-moving, new technology. The advent of ever more complex financial products and investment vehicles are created and promoted by accountants, banks, lawyers and corporate financiers. Time and again, such new products have allowed companies to operate and influence reported earnings using legal loopholes made possible by financial engineering.

And it must be said that these tools have their legitimate uses. We should not be in the business of stifling new types of trading and finance. So rather than crafting new regulations covering off-balance-sheet special purpose entities and other specific transaction types, our focus should be on assigning accountability within our public corporations, providing investors with more information, and demanding principled behavior from our financial institutions. The penalties must be commensurate with the abuses.

For instance, the SEC has implemented new regulations that require that officers and directors report trades within two or three days, including those facilitated with derivatives, which up to now have not had to be reported on a timely basis. And, of course, CEOs and CFOs of public companies must also now certify in a signed declaration that the company's financial reporting is correct.

However, we must go further to bring greater accountability and transparency, because I really believe many of the dubious transactions of the sort we are considering today cannot stand public scrutiny.

First, I would recommend that the certification statement be strengthened so that officers must certify that their financial disclosures "reflect economic reality." And that certification must cover any transaction that was created for the purpose of having an effect on reported earnings, whether it's on or off the balance sheet.

Second, I would propose greater transparency or regulation of the derivatives industry and loan transactions involving derivatives, especially those involving banks and investment banks as counter parties. Towards that end, I would suggest that we try to bring more people with a trading background in derivatives into our regulatory agencies. The SEC should work closely with the federal and state bank regulators.

Third, we must address the leverage issue in the derivatives market. We have international bank regulations and will have international accounting standards in the future. Global margin requirements could help rein in some of the leverage abuses now taking place in the derivatives area. The U.S. should take the lead in establishing global margin and reporting regulations for securities and derivatives.

Fourth, I would suggest that complete terms of bond indentures, especially debt triggers, be listed in schedules available on request or preferably on companies' web sites, even if they pertain to off balance entities.

And finally, we must demand that the corporate finance industry adopt and abide by some basic principles. Certainly, transactions for their clients should have an easily understood and genuine business purpose. Structured finance – even at its most aggressive – should not be employed to circumvent the intent of our securities and tax laws. Commercial and investment banks should have review panels in place to ensure that every deal adheres to such basic principles.

Certainly, there is much in the transactions you have brought to light today that must be considered by our regulators – the SEC, as well as those overseeing banking at the state and federal level. I hope as they do so they can be guided in part by some of the ideas outlined above.

Thank you very much for your attention.