BLB&G

Bernstein
Litowitz
Berger &
Grossmann LLP

Advocate

FOR INSTITUTIONAL INVESTORS

A Securities Fraud and Corporate Governance Quarterly

First Quarter 2008

Lessons From Bear Stearns' Demise:

How Better Regulation and Oversight Can Restore Order and Confidence in the Market

By Matthew Jubenville

In just one weekend, $18 billion of shareholder value at Bear Stearns simply evaporated. In the ensuing chaos, JP Morgan was able to convince Bear Stearns — with persuasive assistance from the U.S. Federal Reserve Bank — to sell itself at a fire sale price. While the deal is not completed, it is abundantly clear that Bear Stearns shareholders will most certainly suffer enormous losses.

The causes behind Bear Stearns' demise are as numerous as they are complicated. The most obvious villain is found in the morass of defaulting investments related to the subprime mortgage market, this year's "bogeyman" for many problems in the financial markets. In the first few months of this year, Bear Stearns — like many other Wall Street investment firms — was forced to write down bad investments in mortgage-backed securities and other mortgage-related assets (collectively, "MRA"). However, Bear Stearns' fate was sealed by its extensive entanglement in the complicated and risky financial derivatives market which made the firm a potential catalyst for a catastrophic market meltdown.

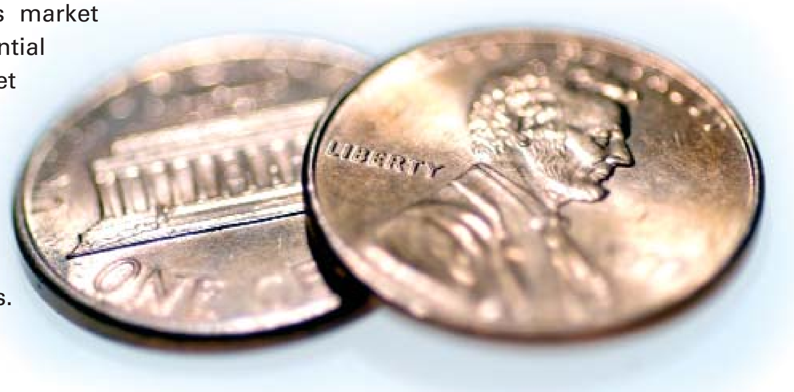
The causes of Bear Stearns' failure — and the solution engineered by the Fed — reflect the evolution of U.S. policies over the past 30 years. Beginning with the Reagan administration, and even as financial instruments became more complicated, powerful derivatives lobbying groups worked to make regulation and oversight of derivatives less restrictive. Instruments such as the credit default swap became exceedingly popular — and profitable — but were completely exempted from any form of regulation. This vacuum allowed derivative-related exposure to mount to staggering proportions virtually unchecked.

In bailing out Bear Stearns — to JP Morgan's benefit — the Fed claimed it was staving off a more catastrophic collapse of U.S. markets, which might result if panic ensued. Shareholders and taxpayers must learn from this costly lesson and restore confidence and order by improving regulation, oversight and enforcement.

Unprecedented Fed Action

Beginning in late 2006, Bear Stearns, a firm historically revered for its innovation and expert risk management, began to experience growing losses in its MRA portfolio. By June 2007, two Bear-managed hedge funds which had been

Continued on next page.



BEAR STEARNS

Continued from page 1.

forced to take on the deteriorating MRA had failed and were effectively worthless. By the end of 2007, Bear had been forced to write down over $2.5 billion relating to its MRA, and no end to the losses was in sight.

By March 10, 2008, despite Bear's explicit public statements to the contrary, rumors circulated that Bear's situation had worsened and it now faced a liquidity crisis resulting from the plummeting value and illiquid nature of its MRA investment portfolio. Further, Goldman Sachs, which had previously committed to stand in for institutions that were worried about Bear's ability to make good on its credit default swap obligations, sent an email to its hedge fund clients indicating it would no longer do so. As a result of mounting concerns, hedge funds and other important Bear clients, began withdrawing billions from the investment bank, resulting in "significant deterioration" in the firm's liquidity position. The run was on.

Over the weekend of March 15-16th, Bear's liquidity position became so severe that the firm teetered on the edge of bankruptcy. Upon learning of the gravity of the situation, JP Morgan, with the explicit backing of the Fed, offered to purchase Bear for $2 per share. JP Morgan ultimately increased its bid to $10 per share, an offer which represented a roughly 95% decline in Bear's value from just a year earlier. As part of the deal, the Fed provided a special non-recourse lending facility to JP Morgan for up to $29 billion in illiquid MRA. In a related move, the Fed set up the Primary Dealers Credit Facility ("PDCF") which allowed select "primary dealers" (a list including Wall Street's most influential investment banks and securities dealers) to borrow from the Fed's discount window using selected MRA as collateral.

Inside Look

Max Berger

As the subprime mortgage meltdown and resultant credit crunch continues to metastasize, and the stock market continues to decline, investors are learning firsthand the harm that results from a lack of regulatory oversight and enforcement. Wall Street banks brazenly packaged and sold toxic mortgage-backed securities to the investing public, and precariously leveraged their fundamental health with exotic derivatives plays. Investors have suffered significant losses, toxic securities now permeate the U.S. financial sector, Bear Stearns has imploded and shareholders and taxpayers are left picking up the pieces.

This quarter, the *Advocate* focuses on how the financial markets got to this point of vulnerability. This issue analyzes how the lack of regulatory oversight and enforcement of the exotic mortgage products peddled by Wall Street caused the current credit crisis. In "Lessons From Bear Stearns' Demise: How Better Regulation And Oversight Can Restore Order And Confidence In The Market" (our cover story), firm associate Matt Jubenville provides an insightful analysis of the systematic failures at Bear Stearns, the dramatic rescue by the Federal Reserve and the regulatory reforms that are necessary to revive the economy and protect innocent investors.

In a related essay on page 4 —"Regulatory Underkill" (originally published in the March 21 issue of *The Wall Street Journal*) — former SEC Chairman Arthur Levitt demonstrates why securities markets need more oversight, and not less. In this piece, Chairman Levitt explains the origins of the credit crunch and examines the entities, including the credit rating agencies and the SEC, whose actions (or, inactions) contributed to the current market turmoil. In this regard, *Advocate* editor Ben Galdston provides an analysis of compelling statistics on pages 8 and 9, demonstrating that our economy is best served by keeping a close eye on those with access to the cookie jar.

This issue also includes a discussion of Treasury Secretary Henry Paulson's recent proposal to do away with the SEC. In "Strange Timing: Paulson Proposes The End of the SEC" on page 5, firm associate David Webber examines Paulson's proposal, analyzing the implications for the investing public and discussing the inherent weaknesses in Paulson's proposal.

I also direct your attention to the regular "Eye on the Issues" column. Firm associate Laura Gundersheim has again provided a perceptive compilation of the most significant recent developments in securities litigation and regulation and corporate governance.

We trust that you will find this issue of the *Advocate* both informative and insightful. As always, we welcome your comments, questions and input.

Max W. Berger

The action taken by the Fed was drastic and unprecedented. A bit of background on the Fed is helpful to understand why. The Fed was formally created in 1913, borne of a series of financial panics that culminated in 1907. The Fed's charter, as stated in the Federal Reserve Act, is "[t]o provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." Among other things, the Fed can elect to extend credit through its discount window if it decides a particular bank failure could threaten the stability of the overall financial system. The most significant exercise of this power came in 1984 when the Fed bailed out Continental Illinois Bank and Trust Co. by lending it $3.6 billion. The Fed referred to Continental Illinois, the seventh-largest commercial bank at the time as "to big too [let] fail."

This safety net is provided to commercial banks in exchange for submitting to regulation by a wide variety of agencies. Only in "unusual and exigent circumstances," can the Fed use the discount window to loan money to entities other than commercial banks ("nonbanks"). This exception is so limited that the Fed has not loaned to a nonbank since the Great Depression. In the case of Bear and the PDCF, however, the Fed not only put up $29 billion in taxpayer money to prevent the failure of a nonbank, it also opened up the discount window to nonbanks on a semi-permanent basis. Why was this necessary?

Derivatives: History and Regulation

To understand the reasons for the Fed's unprecedented action, one must look to the murky world of financial derivatives. Derivatives are instruments whose value is "derived" from an underlying asset. Beginning in the 1990s, derivatives gained popularity, as investment banks began to appreciate their utility in managing individual and institutional portfolio risk. Concurrently, Wall Street discovered that the derivatives business was extremely profitable. The result of these two phenomena was an explosion in the variety of derivatives as investment banks devised increasingly exotic products to meet investor demand.

Because derivatives' value is merely based on an underlying asset, the gains and losses associated with a derivative are amplified compared to the fluctuation of the underlying asset. Accordingly, when used improperly, or for speculative purposes, these instruments can result in massive one-sided losses compared to the capital actually invested. It is for this reason that Warren Buffet once referred to derivatives as "financial weapons of mass destruction."

Derivatives fall into two categories. First there are exchange-traded derivatives ("ETD") such as futures and options which are traded on public exchanges such as the CME Group, Inc., Korea Exchange and Eurex. Second, there are derivatives which are negotiated privately outside the bounds of an exchange. These instruments, which include credit default swaps, swaptions, and innumerable other exotic instruments, are known as over-the-counter ("OTC") derivatives. The OTC market is massive, with over $516 trillion in outstanding notional value as of June 2007. This is five times the value of the world's stock and bond markets combined.

As such a significant part of the financial markets, one would think that derivatives would be highly regulated. This is not the case. ETDs are regulated as financial products by the Commodity Futures Trading Commission and the brokers who sell them are regulated by the SEC. However, per the Commodity Futures Modernization Act of 2000 ("CFMA"), the OTC market is completely exempted from regulation.

As a result of this exemption, much of the trading in the OTC market transacts behind closed doors and derivative holdings and valuations are unknown to analysts, investors and regulators. There are no standard contracts, capital or liquidity requirements, or valuation methodologies, and what can be offered over the counter is left to the creativity of the contracting parties. The eventual trading of these instruments is also unregulated, which means that someone holding an exotic derivative, or even a credit default swap, may not know if their counterparty has the financial wherewithal to uphold their end of the bargain.

Because derivatives' value is merely based on an underlying asset, the gains and losses associated with a derivative are amplified compared to the fluctuation of the underlying asset. Accordingly, when used improperly, or for speculative purposes, these instruments can result in massive one-sided losses compared to the capital actually invested. It is for this reason that Warren Buffet once referred to derivatives as "financial weapons of mass destruction." There have been numerous near-catastrophes involving large derivatives bets that went sour. For example, in 1994, Orange County, CA, had to declare bankruptcy after reporting a $1.5 billion loss, attributable to derivatives investments. Then in 1998, hedge fund Long-Term Capital Management nearly failed thanks to over $4 billion in losses which were the result of leveraged derivatives bets.

Despite these near disasters, which

Continued on page 10.

Reprinted with the permission of the author. This article originally appeared in the March 21, 2008 issue of *The Wall Street Journal.*

Regulatory Underkill

"Securities markets need more oversight, not less"

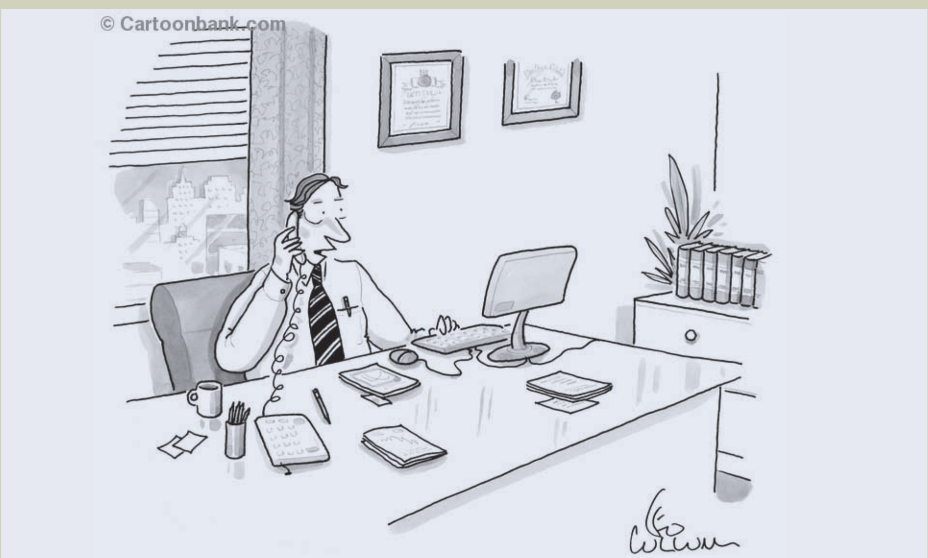
By Arthur Levitt, Jr.

A little more than a year ago, some of the most eminent voices in the business community and leading policy makers — including the senior senator from New York, New York City's mayor, the head of the New York Stock Exchange, the leadership of the U.S. Chamber of Commerce and the Secretary of the Treasury — warned that Wall Street's predominance in the world economy was in danger of being eclipsed.

Their concern was not with diminishing transparency, lax accounting standards, or the growing inability to measure the risk of new financial instruments and opaque trading mechanisms. No, their concern was regulatory overkill — that the NYSE was losing listings to overseas markets. How ironic that this group was fixated on a questionable measure of market health, while the seeds of today's market turmoil were being nourished not by regulatory excess, but by fundamental failures in oversight at almost every level.

With this week's downfall of Bear Stearns, and the worsening of the credit crunch, it is clear that there was a breakdown in how Main Street and Wall Street interacted with each other and the global capital markets. Wall Street's new financial products created incentives for Main Street mortgage lenders to offer loans to previously unqualified borrowers.

With easy credit, millions of people bought homes, propping up the market for securities built from these mortgages. Meanwhile, key standard-setters were asleep at the wheel; federal regulators turned from impartial referees to industry enablers; and important gatekeepers became knotted in conflicts of interest. As a result of these regulatory failures, investors have been left with opacity instead of transparency, fueling their mistrust and the current panic roiling the markets.



"I was spreading some risk around, and apparently it all wound up in your portfolio."

How did this happen?

First of all, the combination of structured financial products and subprime mortgages fundamentally changed the lending business. No longer did those doing the lending have to expose themselves to the credit risks of the borrowers. Instead, they packaged their loans for sale to the investing public. With no exposure, loan originators offered mortgages to just about anyone they could find. Unlike the state regulators who sounded alarms, almost all federal banking regulators (except Ned Gramlich, the late Fed governor) stood by cheering securitization as underwriting standards deteriorated.

Accordingly, state and federal banking regulators, under the oversight of Congress, need to act now — together — to create enhanced underwriting standards for loans, ensuring that lending practices are commensurate with the risks, and that the lender and borrower are fully informed of these risks.

With [the] downfall of Bear Stearns, and the worsening of the credit crunch, it is clear that there was a breakdown in how Main Street and Wall Street interacted with each other and the global capital markets.

We must strengthen the licensing standards and oversight of mortgage brokers and originators, as proposed by the President's Working Group on Financial Markets. And we must increase the capital requirements for monoline insurers, as well as greatly enhancing their disclosures of actual and potential ranges of losses from different product lines.

The second factor behind today's market turmoil was the strong ratings bestowed upon the new securitized debt instruments by credit rating agencies. What investors relying upon these ratings didn't know was that the agencies' objectivity was severely compromised — as they were helping issuers construct the very financial instruments they eventually judged. Meanwhile, the Securities and Exchange Commission (SEC) lacked sufficient power and resources to inspect and take corrective supervisory or enforcement actions. As a result, this conflict of interest persisted.

Credit rating agencies need to adopt, as they have proposed, systems that more accurately reflect the risks of differing types of debt. But Congress should give the SEC greater authority to examine the reasonableness of the ratings issued, to take enforcement actions if necessary, and to be able to set independence standards for the rating agencies as the SEC now does for auditors.

The third factor responsible for today's troubles is that, once structured financial products were purchased, investors had little ability to discover how exposed banks were to these products' risks. Failing to recognize and understand the changing risks and accompanying lack of transparency for investors, the Financial Accounting Standards Board (FASB), and the SEC that oversees it, allowed Structured Investment Vehicles (SIV) and conduits to be kept off bank balance sheets.

Because this loophole was not closed when it was first recognized more than five years ago, we are today still trying to figure out the depth and severity of the current crisis. If the FASB is to maintain its credibility with investors, it will need to bring the off-balance sheet risks and losses associated with both SIV's and other securitizations onto companies' financial statements, with full disclosure, within the next 12 months.

Finally, the management and boards of directors of these financial services firms, such as Bear Stearns and probably others, failed to put in place adequate

Continued on page 9.

Strange Timing: Paulson Proposes the End of the SEC

By David Webber

On March 29, 2008, in the midst of a financial crisis largely caused by unregulated financial products, Treasury Secretary Henry Paulson revealed his blueprint for an overhaul of the U.S. financial regulatory system which effectively abolishes the SEC. A former co-chief executive of Goldman Sachs, Secretary Paulson has proposed that the Wall Street watchdog be merged with the Commodity Futures Trading Commission, and that the combined entity's role be subservient to that of a newly constituted Federal Reserve. It's no surprise that a recent *Wall Street Journal* article described Wall Street as a "winner" under the plan, noting that "so many people read the plan as a move toward lighter regulation."

You could be forgiven for thinking that the SEC had already ceased to exist, given several anti-investor positions it has taken since Christopher Cox became its Commissioner. Under Commissioner Cox, the SEC opposed investors on the subject of scheme liability in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, amended Rule 14a limiting shareholder access to company proxies, decreased spending on enforcement, decreased penalties against companies by half, and now has the highest rate of employee turnover in five years. All of these are regrettable developments.

But the lessons of the current crisis strongly suggest not that the SEC should be abolished, but that its role as a vigorous advocate on behalf of investors should be revived. Under Commissioner William H. Donaldson, a

You could be forgiven for thinking that the SEC had already ceased to exist, given several anti-investor positions it has taken since Christopher Cox became its Commissioner.

Bush appointee, the SEC punished mutual funds engaged in market timing, regulated hedge funds and increased the voice of shareholders in corporate governance. Under Commissioner Arthur Levitt, who served during the Clinton administration, the SEC similarly functioned as it should — as an advocate for investors.

Chairman Paulson's blueprint calls for some welcome reforms, including establishment of a federal Mortgage Origination Commission to increase supervision over mortgage lending. Had such a regulatory entity with specialized knowledge of mortgage lending already existed, the present crisis in the subprime mortgage market might have been avoided. Likewise, Wall Street is far too important an economic driver not to have a regulatory entity devoted to it exclusively. It's not time for the SEC to retire, but for it to get back to the business of vigorously policing the markets.

David Webber is an associate in BLB&G's New York office. He can be reached at DavidW@blbglaw.com.

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Laura Gundersheim

Senators Call for Review of SEC

Senate Securities, Insurance and Investment Committee Chairman Jack Reed and Senate Banking Committee Chairman Christopher Dodd have asked the Government Accountability Office ("GAO") to investigate whether the U.S. Securities and Exchange Commission ("SEC") has been sufficiently aggressive in fighting fraud and whether the agency has enough enforcement staff and funding to properly police the markets amid the current credit crisis. The GAO will examine whether the enforcement division "has sufficient staff and funds to perform its mission and whether there have been fundamental changes in operation to the way they handle cases." The Senators called for the review after SEC sanctions and disgorgements fell more than 50 percent in 2007, high turnover left staff levels at their lowest since the late 1990s, and spending on enforcement dropped dramatically. Both Senators believe that enforcement and adequate resources are critical components of strong oversight. However, despite the current market turmoil, the SEC asked for less than a 1 percent increase in its budget for 2009. This is the second time in 18 months that a member of Congress has called for a review of the SEC's vigilance. *Reuters, Bloomberg News, April 1-2, 2008; The New York Times, April 8, 2008.*

Brokers of Auction-Rate Securities Under Investigation

The SEC and the Financial Industry Regulatory Authority to investors ("FINRA") are working together to investigate how brokers sold auction-rate securities. Auction-rate securities are bonds issued by cities, student-loan agencies and closed-end funds that have interest rates reset by auction every 7 to 35 days. The recent credit crisis led to the failure of hundreds of auctions, leaving investors with assets in securities they are unable to sell. Brokers had pitched auction-rate securities as liquid, super-safe investments with interest rates slightly superior to those of conventional money-market funds. Brokers did not, however, warn investors about the possibility of failed auctions. In a survey sent in recent weeks to financial companies, FINRA seeks a breakdown of total auction-rate securities holdings by customer type, how auction-rate securities are classified on customer statements, how firms marketed the products and the number of complaints relating to auction-rate securities the firms have received since October 1, 2007. FINRA also recently started a "sweep" investigation into the topic. A sweep investigation is a broad look at industry practices, but does not necessarily mean enforcement action will take place. *The Wall Street Journal, April 8, 2008.*

President Bush Nominates Two Democrats to the SEC

President Bush has announced they he intends to nominate two former SEC staff members to fill empty seats on the SEC panel. The five-seat body has been operating with just three commissioners, all Republicans, since late January 2008. Elisse Walter, a former deputy director of the SEC's corporation finance division, and Luis Aguilar, a former SEC lawyer, will be nominated for the vacant positions. Walter is currently an executive vice president with the FINRA and previously worked as general counsel at the Commodity Futures Trading Commission. Aguilar is currently a partner at the law firm McKenna Long & Aldridge and previously worked as general counsel at a unit of Invesco Ltd., a mutual fund company. Both Aguilar and Walter are Democrats. By law, no more than three commissioners can be of the same political party as the president. Walter and Aguilar, who must be confirmed by the Democratic-controlled Senate, were recommended to Bush by Senate Majority Leader Harry Reid of Nevada in November. The nominees would fill seats vacated by Democrats Annette L. Nazareth at the end of January and Roel C. Campos last fall. *Dow Jones News Service, The Associated Press, The Wall Street Journal, March 28, 2008.*

Department of Justice Deferred Prosecutions Under Scrutiny

The House Judiciary Subcommittee recently held hearings to look into a Justice Department practice known as "deferred prosecutions." Deferred prosecutions are used to settle certain white-collar criminal cases out of court, but often require companies to pay fines, enter into compliance programs and hire outside monitors. Deferred prosecutions are on the rise; between 2002 and 2005, there were twice as many deferred prosecution agreements as in the previous 10 years. This increase has continued with 20 deferred prosecutions in 2006 and 35 such deals in 2007. Local U.S. Attorneys have great discretion in creating these agreements and are responsible for assigning the lucrative monitoring positions that accompany the agreements. As part of the hearings, the Judiciary Subcommittee wanted former U.S. Attorney General John Ashcroft to explain how the Ashcroft Group, the lobbying and consulting firm he started after he left government, won a no-bid contract worth $28 million to $52 million. Ashcroft's task under the contract was to monitor an out-of-court settlement between the Justice Department and an Indiana medical device manufacturer, Zimmer Holdings Inc., which was accused of making kickbacks to doctors who used its equipment. Christopher Christie, the U.S. attorney in New Jersey and a former employee of Ashcroft when he ran the department, recommended Ashcroft for the contract. *The Houston Chronicle, February 29, 2008.*

SEC Advisory Committee Report Proposes Reforms

The Advisory Committee on Improvements to Financial Reporting issued an interim report to the SEC which includes 12 developed proposals, as well as conceptual approaches representing the Committee's initial views on matters, and currently identified matters for further consideration. Among the key themes of the report are: increasing emphasis on the investor perspective in the financial reporting system; consolidating the process of setting and interpreting accounting standards; promoting the design of more uniform and principles-based accounting standards; creating a disciplined framework for the increased use of professional judgment; and taking steps to coordinate Generally Accepted Accounting Principles (GAAP) in the U.S. with International Financial Reporting Standards (IFRS). Formed by the SEC in July 2007, the Committee was tasked with examining the U.S. financial reporting system and to recommend changes to increase the usefulness of financial information to investors, while reducing the financial reporting system's complexity. The Committee's final report is some months away. The Committee includes representatives from the Financial Accounting Standards Board and the Public Company Accounting Oversight Board. *http://www.sec.gov/about/offices/oca/acifr/acifr-pr-021408-final.pdf.*

Insider Trading Study Forces SEC to Investigate Investment Banks

An academic study by three European professors entitled "The Dark Role of Investment Banks in the Market for Corporate Control," concluded that investment banks serving as advisors to acquiring companies purchased stock in the target company 19% of the time as opposed to a purchase rate of 10.5% by investment banks not involved in the deal as advisors. This study led federal regulators, including the SEC, to begin investigating whether banks hired as advisors for large deals have purchased large chunks of shares just before the announcement of the deal based on inside information. The SEC's investigation is ongoing. *Securities Law 360, February 1, 2008.*

Quarterly Quote...

"Bear Stearns' balance sheet, liquidity, and capital remain strong....Our liquidity position has not changed at all, our balance sheet has not changed at all..."

Bear Stearns CEO Alan Schwartz on CNBC, March 12, 2008, when its stock was trading at $61.58, just days before the collapse of the company and its buyout by JPMorgan Chase for $2 per share on March 16, 2008.

SEC Focuses on Oversees Investment Instead of US Regulatory Protections

The SEC has begun exploring possible regulatory changes that would ease American investors access to overseas capital markets and "further implement the concept of mutual recognition for high-quality regulatory regimes in other countries." The proposed regulatory changes include signing agreements with foreign regulators based on comparability assessments of the various regimes, adopting a formal process to recognize jurisdictions with multiple regulators, such as Canada and the European Union, and reducing the minimum amount of assets investors must have in order to engage with non-U.S. brokers. Lowering the minimum from $100 million to $25 million would allow more investors to execute trades without having to go through intermediaries. A number of U.S. Senators do not agree that moving regulation abroad is appropriate at this time. Led by Senator Jack Reed, these senators believe that the SEC should "more appropriately focus its efforts on assessing existing U.S. regulatory protections." *Securities Law 360, March 25, 2008.*

Laura Gundersheim is an associate in BLB&G's New York office. She can be reached at LauraG@blbglaw.com.

By The Numbers...

What costs the American public more …

Government regulation? Securities litigation? Unrestrained greed?

By Ben Galdston

In recent years, pro-business advocacy groups have waged an unprecedented campaign to reverse corporate governance reform and roll back regulation. In so doing, they have warped public sentiment to blame trial lawyers and shareholder advocacy groups for a perceived lack of international competitiveness and various other market ailments. While most of the groups publish quasi-scientific "studies" to support their claims — each uniformly warning of dire consequences if pro-business measures are not implemented — other groups have resorted to more juvenile tactics. One advertisement from the "Washington Legal Foundation" even depicted class action plaintiffs as extortive monkeys. At bottom, all of the groups lay blame for current economic problems on the high cost to business caused — in their view — by regulation and litigation.

However, recent events have exposed the fallacies underlying these arguments. Under an administration that fostered a laissez-faire regulatory environment, government law enforcement mechanisms have largely broken down while corporate greed ran amok at investor expense.

In the last 16 months alone, problems related to the subprime mortgage meltdown have resulted in $312 billion in asset writedowns and credit losses at commercial investment banks. The human cost caused by the subprime mortgage debacle is equally astonishing. Wall Street has cut 49,000 jobs in just the past 10 months related to the mortgage industry collapse.

These figures are only the beginning. The total cost to the American public caused by the latest wave of fraud likely is incalculable because the decline has touched nearly every industry from construction to consumer goods.

It is not a unique phenomenon, either. One only need look back 7 years ago to the "Dot Com" collapse, which obliterated an estimated $3.5 to $7 trillion in market capitalization — much of it due to financial fraud and unrestrained greed.

So what really is to blame for the state of our economy and what should we do to fix it? The answers are complicated but eliminating private litigation rights and loosening regulation just makes no sense.

"Class action settlement costs have increased from $150 million in 1995 to $3.5 billion in 2005…Litigation is a factor to be seriously considered (for reform)….The average costs of SOX (Sarbanes-Oxley) Section 404 in 2004, its first year of implementation, were $4.36 million for an average company….The Committee believes that the costs of Section 404 are substantial… and the precise quantification of benefits is uncertain."

Interim Report from the Committee for Capital Markets Regulation (December 2006)

Ben Galdston is co-editor of the Advocate and an associate in the firm's California office. He can be reached at beng@blbglaw.com.

Banks, Brokers Cut 49,000 Jobs as Subprime Losses Mount

Firm	Positions Cut
Citigroup	15,200
Merrill Lynch	5,220
Lehman Brothers	4,990
Bank of America	3,650
Washington Mutual	3,000
Morgan Stanley	2,940
HSBC	1,650
Bear Stearns	1,550
WestLB	1,530
UBS	1,500
Goldman Sachs	1,500
Credit Suisse	1,320
Wachovia	943
National City	900
KeyCorp	740
Royal Bank of Canada	500
Fortis	500
Wells Fargo	500
Deutsche Bank	450
Royal Bank of Scotland	200
JPMorgan Chase	100
TOTAL	**48,883**

Some company names have been abbreviated.
SOURCE: Bloomberg, April 22, 2008

By The Numbers...

Subprime Losses Reach $312 Billion

Firm	Writedown (in $ billions)	Credit Loss (in $ billions)	Total (in $ billions)
Citigroup	35.3	5.6	40.9
UBS	38.0		38.0
Merrill Lynch	31.7		31.7
Royal Bank of Scotland	14.9		14.9
Bank of America	9.2	5.7	14.9
Morgan Stanley	12.6		12.6
HSBC	3.0	9.4	12.0
JPMorgan Chase	5.5	4.2	9.7
Credit Suisse	9.6		9.6
IKB Deutsche	9.0		9.0
Washington Mutual	0.3	8.0	8.3
Deutsche Bank	7.4		7.4
Wachovia	4.9	2.4	7.3
Credit Agricole	6.5		6.5
Mizuho Financial Group	5.4		5.4
Canadian Imperial (CIBC)	4.1		4.1
Societe Generale	3.8		3.8
Bayerische Landesbank	3.6		3.6
Wells Fargo	0.9	2.7	3.6
E*Trade	2.5	0.9	3.4
Lehman Brothers	3.3		3.3
Barclays	3.3		3.3
WestLB	3.2		3.2
Bear Stearns	3.2		3.2
National City	0.5	2.6	3.1
Goldman Sachs	3.0		3.0
Dresdner	2.7		2.7
Nomura Holdings	2.5		2.5
ABN Amro	2.4		2.4
Fortis	2.3		2.3
HSH Nordbank	2.3		2.3
Bank of China	2.0		2.0
LB Baden-Wuerttemberg	2.0		2.0
Natixis	1.9		1.9
BNP Paribas	1.3	0.3	1.6
UniCredit	1.6		1.6
DZ Bank	1.5		1.5
Caisse d'Epargne	1.3		1.3
Gulf International	1.0		1.0
European banks not listed above	9.4		9.4
Asian banks not listed above	6.9	0.4	7.3
North American banks listed above	2.8	0.9	3.7
TOTALS*	**268.6**	**43.1**	**311.7**

**Totals reflect figures before rounding. Some company names have been abbreviated for space.*
SOURCE: Bloomberg, April 28, 2008

REGULATORY UNDERKILL

Continued from page 5.

risk-management systems. Moreover, the Fed, SEC, and the Office of the Comptroller of the Currency did not take any meaningful, proactive regulatory action to require needed improvements in risk management and public disclosure, ignoring the recommendations of their own Working Group on Public Disclosure made seven years ago.

At the very least, the board of every public company should adopt best practices in risk management and disclose those practices to investors, along with significant accompanying risks, and how they are managed.

Beyond these immediate fixes, what's needed to restore public confidence is a more wholesale reconsideration of how we can inject greater transparency into the markets and bring about a change in attitude on the part of business leaders and policy makers that puts the interests of investors first. This may require a more fundamental restructuring of how we regulate the markets — for instance, merging the SEC and the Commodities Futures Trading Commission to create a single securities regulator — and giving that regulator the resources and the authority to do its job, something the SEC currently lacks.

Ultimately, those who were so concerned with Wall Street's competitiveness need to realize that the true competitive advantage of America's capital markets has long been their high quality. With that quality in doubt, leaders and policy makers need to put their ideological fixations aside and commit themselves to giving investors the levels of transparency and accountability they deserve and expect from the world's strongest markets.

Only then will trust be restored, our markets' health revived, and a deep economic crisis averted.

Mr. Levitt was chairman of the SEC from 1993 to 2001.

BEAR STEARNS

Continued from page 3.

were allowed to proliferate uncontrolled due to the absence of capital requirements and liquidity regulations, past attempts in Congress to pass meaningful and comprehensive derivative regulation have been met with staunch opposition from the financial services and derivative lobbies. After each near miss cited above, Congress held hearings but failed to pass legislation, as derivative lobbyists such as the International Swaps and Derivatives Association ("ISDA") were successful in arguing against additional regulation. ISDA consistently maintained that derivatives were safe and controllable and further regulation and monitoring would be too complicated. Even in the absence of crises, this group and its 815 member institutions worldwide continue to be active, spending $900,000 in 2007 lobbying against altering the exemption created for OTC derivatives by the CFMA.

Bear Stearns' Massive Derivative Exposure

It is unclear exactly which event finally compelled the Fed to step forward and bail out Bear. One of the more compelling explanations, however, is related to the chaos that would have ensued in the credit default swaps market if Bear was allowed to fail. A credit default swap is essentially an insurance policy which pays off in the event of a bonds' default. At the time of its liquidity crisis, Bear was either the insured or insurer of credit default swaps valued at $2.5 trillion. Further, speculation in swaps insuring Bear's own bonds was running wild. If the firm were allowed to sink into bankruptcy, not only would Bear not be able to make good on any of its credit default swaps obligations, but billions, and maybe trillions of dollars would be owed to parties who had speculative bets on Bear to fail.

Consequences could have been as severe as a systematic run on all counterparties, resulting in a cascade of commercial and investment bank failures. Because the OTC markets are unregulated, and no one knows exactly who holds what, or where the effects might be most severe, the consequences were unpredictable and frightening. Thus, the Fed was forced to act.

As Timothy Geithner, the president of the New York Fed noted on April 3, 2008:

> The sudden discovery by Bear's derivatives counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets...In short, we judged that a sudden, disorderly failure of Bear would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy...

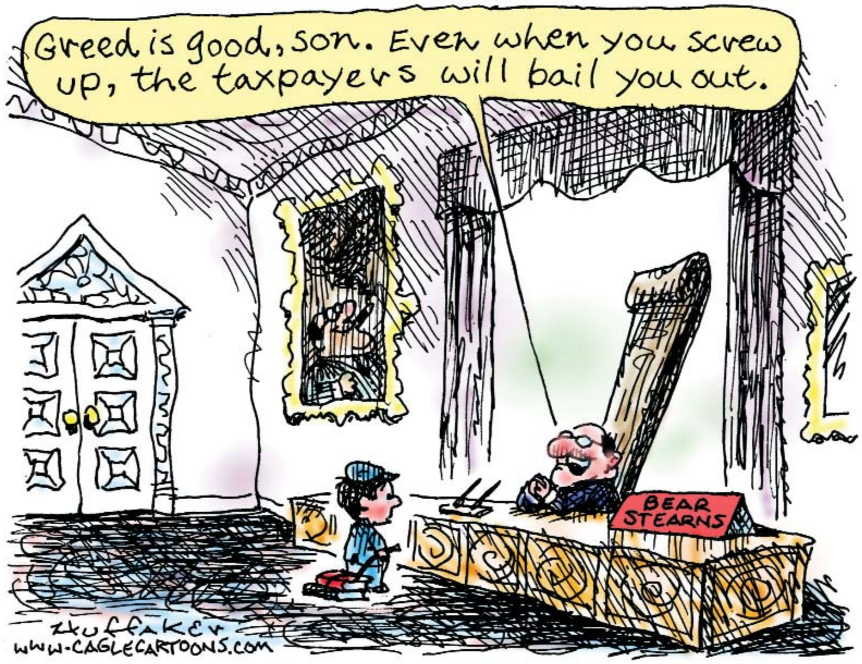
Consequences could have been as severe as a systematic run on all counterparties, resulting in a cascade of commercial and investment bank failures. Because the OTC markets are unregulated, and no one knows exactly who holds what, or where the effects might be most severe, the consequences were unpredictable and frightening. Thus, the Fed was forced to act.

If the Fed had access to additional information about Bear's credit default swap portfolio, and therefore was able to make a more informed decision about how drastically Bear's bankruptcy would affect the derivatives markets, it is possible that it may have decided to simply let the firm fail. Bear was only the fifth-largest investment bank on the Street at the time, and if its implosion could have been confined, the Fed may not have invoked its little-used power. But the

The Advocate For Institutional Investors

is published quarterly by Bernstein Litowitz Berger & Grossmann LLP, 1285 Avenue of the Americas, New York, NY 10019, 212-554-1400 or 800-380-8496. The materials in this newsletter have been prepared for information purposes only and are not intended to be, and should not be taken as, legal advice. Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions.

BLB&G



unknown magnitude of the credit default swap problem related to a Bear bankruptcy suddenly made it "too big to fail." This explanation is further bolstered by the fact that the Fed established the PDCF. Many of the primary dealers are smaller than Bear, but share similar MRA exposure and derivative entanglements. Failure of any one of these parties could prove catastrophic to the financial system, and the backstop provided by the PDCF eliminates this systemic risk.

Regulatory Reform

The fact that the Fed was forced to step in and lend taxpayer money to non-banks to avoid a systemic crisis signals that the current regulatory framework is fundamentally flawed, and that reform is necessary on a number of fronts. For example, the Fed is not properly equipped to monitor investment banks, and the increasingly complex portfolios of products they offer. What form these regulatory reforms will take is a question that will likely remain unanswered until the next administration takes office. Already, Treasury Secretary Henry Paulson's proposed reform plan is being hotly debated, as it proposes to assign the Fed even broader monitoring powers, while merging the SEC and CFTC.

What is certain, however, is that the time is now for increased disclosure and monitoring rules relating to credit default swaps and other OTC derivatives. Companies who profit from these instruments should be compelled to clarify exactly what balance sheet impact derivatives have. Furthermore, in exchange for the benefits of access to the Fed backstop, those dealing in the OTC market must have rules for capital requirements and liquidity. Anything less and U.S. taxpayers risk a gargantuan moral hazard problem. There is no doubt that this increased monitoring will be a technical challenge because of the complexity of some OTC instruments. Failing to do so, however, could lead to an exponentially more costly and destructive financial crisis.

Matthew Jubenville is an associate in the firm's California office. He can be reached at MatthewJ@blbglaw.com.

Contact Us

We welcome input from our readers. If you have comments or suggestions, please contact Editors **Hannah Ross** in our New York office at 212-554-1400 / hannah@blbglaw.com or **Benjamin Galdston** in our California office at 888-924-1888 / beng@blbglaw.com.

If you would like more information about our firm, please visit our website at

www.blbglaw.com

Editors: Hannah Ross and Benjamin Galdston
Marketing Director: Alexander Coxe
"Eye" Editor: Laura Gundersheim
Contributors: Ben Galdston, Matthew Jubenville, Arthur Levitt and David Webber

BLB&G
BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP

800-380-8496
E-mail: blbg@blbglaw.com

New York
1285 Avenue of the Americas
New York, New York 10019
Tel: 212-554-1400

California
12481 High Bluff Drive, Suite 300
San Diego, CA 92130
Tel: 858-793-0070

Louisiana
2727 Prytania Street, Suite 14
New Orleans, LA 70130
Tel: 504-899-2339

New Jersey
220 St. Paul Street
Westfield, NJ 07090
Tel: 908-928-1700

288

Announcing the 2008 Forum for Institutional Investors — The Premier Annual Industry Conference for Fiduciaries

forum ii
Forum for Institutional Investors 2008

New York City
October 23-24, 2008
www.forumii.org

Protecting Shareholder Value
The Credit Crisis and Beyond

- ✓ *Get an inside look at how the credit crisis is impacting the international financial community and how the regulatory and legal landscapes affecting your holdings are changing.*
- ✓ *Hear internationally renowned authorities speak about protecting the interests of public pension and institutional portfolios.*
- ✓ *Learn how institutional investor activism is effecting systemic change within corporate culture globally.*
- ✓ *Know and understand best practices for protecting portfolio assets against securities fraud.*

ABOUT THE VENUE

The 2008 Forum will be held at the magnificent **New York Palace Hotel,** located in the heart of midtown Manhattan. This luxurious hotel, originally built in 1882, is renowned for its elegance and rich history.

Our distinguished international faculty will include:

Dennis Berman, *Mergers & Acquisitions Editor, The Wall Street Journal*

James Cox, *Duke Law School*

Professor Harvey Goldschmid, *Dwight Professor of Law at Columbia University and Former SEC Commissioner*

Joseph Grundfest, *Co-director of the Rock Center for Corporate Governance, Stanford Law School*

Donna Nagy, *C. Ben Dutton Professor of Law, Indiana Law School*

Harvey Pitt, *Former chairman of the United States Securities Exchange Commission*

Paul Sarbanes, *Former U.S. Senator and Co-Author of the Sarbanes-Oxley Act*

Dr. Daniel Summerfield, *Director of Responsible Investments, Universities Superannuation Scheme*

PLUS…**James Carville,** *Media Personality and political icon and* **Mary Matalin,** *Conservative commentator and former presidential advisor*

Sponsored by Bernstein Litowitz Berger & Grossmann LLP

BLB&G

Our Media Partner

IPE Investment & Pensions Europe