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FCIC memo of staff interview with Warren Spector, Bear Stearns

Warren Spector

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MEMORANDUM FOR THE RECORD

Event: Meeting with Warren Spector, former president, co-chief operating officer, member of the Executive Committee and member of the Board of Directors at Bear Stearns

Type of Event: Group meeting

Date of Event: March 20, 2010

Team Leader: Tom Krebs

Location: 1285 Avenue of the Americas, New York, NY; Paul Weiss conference room

Participants - Non-Commission:

- Warren Spector, formerly with Bear Stearns
- Meredith Turner, Wachtell Lipton
- David Anders, Wachtell Lipton
- Jamie Ginott, Wachtell Lipton
- Brad Karp, Paul Weiss
- Jessica Carey, Paul Weiss
- Matthew Cipolla, Paul Weiss

Participants - Commission:

- Tom Krebs
- Mina Simhai

MFR Prepared by: Mina Simhai

Date of MFR: April 20, 2010

Summary of the Interview or Submission:

This is not a transcript of the meeting and should not be quoted as such

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Warren Spector's Background

Mr. Spector joined Bear Stearns in 1983 as a trader in the mortgage section of the government bonds department. Eventually he came to manage the mortgage traders. In the 1990s he also joined the Management Committee of Bear Stearns and was on the Executive Committee from 1993 through 2001. From 1995 (when John Sites left Bear Stearns) through 2001, he was the head of all fixed income trading at Bear Stearns. In 2001, he became the co-president and chief operating officer of Bear Stearns and stopped running the fixed income department, focusing instead on all sales and trading, including equities, and all other Bear Stearns activities.

Warren Spector's Prior Testimony

Mr. Spector has not given any depositions. He did meet with U.S. Attorneys in Brooklyn and has testified (briefly) before a grand jury. He has not been involved in any civil litigation.

Marking Tier 1, 2 and 3 Assets / Role of Risk Management in Verifying Marks

Warren Spector advised that all positions at Bear Stearns were supposed to be marked every day. For more liquid securities (e.g. non-Tier 3 assets), marks could be set by looking at the NYSE prices. For relatively liquid bonds (Mr. Spector was not sure if these would be considered Tier1 or Tier 2 assets) marks were derived based on the yield spread, e.g. T-bills plus applicable margin. Traders were responsible for generating the marks, and they used computer models (rather than obtaining actual quotes) to do so. Each day traders were to evaluate whether the assumptions used in the models should change, but the models themselves were not updated regularly.

Mr. Spector advised that Bear Stearns' Level 3 assets were also marked daily, using a more elaborate calculation. While the practice was to regularly mark Tier 3 assets, the marks tended not to change for several days; then the trader would change the assumptions and the marks would change. Like the Tier 1 and 2 assets, traders would generally use models to determine marks, rather than obtaining quotes.

According to Mr. Spector, Bear Stearns' Risk Management department was responsible for price verification. Risk Management also possessed pricing expertise. Oftentimes Risk Management would engage in confidential discussions with other firms for the purposes of confirming or verifying prices or marks. Risk Management verified marks 3 ways: (1) Risk Management personnel would obtain prices from independent services, or would check prices against those of other dealers. If the Risk Management personnel had concerns, they would report them to the trading manager. (2) Risk Management would use their own assumptions, and they became secondary (secondary to traders) experts on particular products. (3) Any time Bear Stearns was involved in secured lending (*i.e.* repo), collateral was required to be posted, and Bear Stearns knew what the margin was.

Mike Alix ran Risk Management and reported to the Executive Committee of Bear Stearns on a regular basis, usually once a month, often times more frequently. From time to time Bear Stearns would use an independent pricing service.

Bear Stearns Hedge Funds

Mr. Spector advised that the hedge funds were reasonably well known by at least 4/5 members of the Executive Committee. Mr. Spector also advised that scrutiny over the 2 hedge funds increased over time. When they were performing well, senior management did not pay much attention to them. As the hedge funds had problems in the spring and summer of 2007, Mr. Spector's knowledge of them increased. Tom Marano provided updates to the Executive Committee. Mr. Spector stated that the Executive Committee considered issues of liquidity, equity and risk management.

Assets in the Hedge Funds / Origin of the Hedge Funds. Mr. Spector claimed not to know the assets composing the Bear Stearns hedge funds in 2007, which he called the "high grade funds". He did recall that one of the funds was created in 2003, was Ralph Cioffi's idea, and had done reasonably well for several years. Mr. Spector had a general knowledge of the assets underlying the two hedge funds, but did not recall any specific detail as to the securities and those funds. Instead, he described what the funds were designed to do: namely, hold asset-backed securities with AAA ratings and virtually no defaults, be levered approximately 8 to 10 times, create a fund with stable high returns, and create a team of people to support that fund who had the ability to identify the best securities to be purchased for the two hedge funds. The funds would generate extra profits through trading. It was his general understanding that the funds would purchase a wide variety of asset-backed securities, including mortgage related securities and aircraft lease related securities, but he also said that the fund had more credit card related securities than anything else. He stated that sometimes securities are worth more than they are trading at. He also advised that some of the assets held by the hedge funds had been created by Bear Stearns. He also stated that Mr. Cioffi may have received better information from his own traders than from competitors.

While Mr. Spector did recall many meetings of the Bear Stearns Executive Committee during the month of June 2007 relating to the Hedge Funds, he could not recall meetings on any specific dates nor could he recall the substance of any specific meeting Generally meetings related to discussions of the size and extent of the fund's difficulties. Mr. Spector advised that the Board of Directors received reports on performance of the 2 Bear Stearns hedge funds on a regular basis during May, June and July of 2007. My mid-summer of 2007, the Board of Directors was meeting on the hedge funds daily, or at least several times a week. As the problems at Bear Stearns Asset Management ("BSAM") became more apparent, Bear Stearns (the parent company) moved more people to BSAM to try to address the problems. For example, Tom Marano (head of mortgages) as well as lawyers and experts on repo were seconded to BSAM.

Mr. Spector advised that the hedge funds probably did not mark their assets every day, but he was not certain.

Mr. Spector did not recall whether Goldman Sachs lowered its valuations of mortgage securities held in the hedge funds in April 2007, but he did state that the mortgage-backed securities market was a highly a liquid market. Thus, he did not have an opinion with respect to the impact made on the funds by Goldman's low valuation of some of the assets of the funds.

Mr. Spector advised that he did remember significant variations in valuations between firms generally, and Goldman was more aggressive than other firms in lowering prices of assets when the markets became illiquid.

MA Litigation. Tom Krebs asked Mr. Spector about the action instituted by the state of Massachusetts against the two hedge funds wherein it was alleged that the outside directors of the two hedge funds had failed to specifically review and authorize related party transactions by and between the two hedge funds and Bear Stearns' mortgage origination desks. Mr. Spector said he was not aware of this litigation, although he did recall the general counsel of Bear Stearns coming to him due to concerns about the appearance of a conflict of interest. He did state that a full trading ban was instituted between the two hedge funds and any department at Bear Stearns and he supported that ban. He also noted the ban may have been subsequently lifted.

Selling Assets. Mr. Spector advised that Bear Stearns was under pressure to help its customers and do all it could to avoid a fire sale. The Executive Committee debated the value left in the hedge funds. When Mr. Spector was asked for advice on deleveraging he advised "sell what you are long and buy what you are short." Mr. Spector stated the hedge funds were trying to sell securities to its lenders, and at the same time the Executive Committee was deciding whether to provide repo to the 2 hedge funds.

Decision of The Bear Stearns Companies Inc. ("TBSCI") to provide up to $3.2 billion to the Hedge Funds. When asked about his involvement in the commitment by Bear Stearns to infuse $3.2 billion into the hedge funds, Mr. Spector said Bear Stearns ultimately decided to do it because they were concerned about "reputational risk," meaning that the infusion of additional capital would help Bear Stearns customers by preventing a fire sale of the assets owned by the hedge funds. He also advised that the financing provided was repo.

According to Mr. Spector, ultimately TBSCI provided between $1.2 and $1.6 billion in repo to the hedge funds, and he considered that amount "small potatoes," although he did acknowledge that it sounds like a lot. When reflecting on this, Mr. Spector stated I don't know if the firm did the right thing or the wrong thing. Mr. Spector said TBSCI was doing all it could to preserve value.

Merrill Lynch Seizing Collateral from Hedge Funds. When asked whether he was aware of the fact that Merrill Lynch had seized $800 million in collateral from the hedge funds sold $100 million of those "bonds" through an auction, Mr. Spector stated that Bear Stearns had asked Merrill to tell Bear Stearns whether it conducted an auction and the prices it received in connection with the auction. He claims that Merrill Lynch never told Bear Stearns what bid prices had been received. Mr. Spector said this a very chaotic time and he couldn't say that Merrill's actions caused negative effects or that he blamed Merrill Lynch for the hedge funds' failure. Bear Stearns, a big player in the market, was forced to sell, which drove prices down.

Mr. Spector's Decision to Provide $25 million to the Hedge Funds. At the end of February of 2007 (or possibly early March of 2007), Rick Marin came to Mr. Spector and asked that Bear Stearns infuse additional capital into the two hedge funds. Mr. Spector stated this was when he first became aware that the sub-prime market was down. He was pleasantly surprised that the 2 hedge funds were doing so well (*e.g.* they were relatively stable), and the structure of the funds seemed to be holding up. However, prices on sub-prime mortgages and related securities were falling and clients were nervous. Mr. Spector decided to provide $25 million to the 2 hedge funds because he was told by Mr. Marin: (1) if the prices stayed where they currently were, hedge fund returns would be high (approximately 30%) and the hedge funds would continue to be profitable, (2) providing the funding would help the customer franchise and (3) the subprime market was underpriced. According to Mr. Spector, these statements were supported by FAST, Bear Stearns' mortgage research department. Mr. Spector described this as a reasonably straightforward decision, and Bear Stearns had the capital to do it. Based on Mr. Marin's request and the support from FAST, Mr. Spector authorized the investment of additional $25 million into the two Bear Stearns hedge funds.

Risk Management at Hedge Funds / Structure of BSAM. Mr. Spector advised that he was not involved in the day-to-day risk management of the hedge funds and could not speak to the risk controls in place at BSAM. However, there was a risk group within BSAM that reported to CEO Richard Marin. Mr. Spector did not recall the name of the person in charge of BSAM's risk group. John Geissinger was BSAM's Chief Investment Officer; he was a trader and was responsible for all BSAM's books. Mr. Spector did distinguish between trading of securities in the hedge funds and the "business" of the hedge funds. Barry Cohen and Mike Guarasci were in charge of the hedge fund business. Mr. Cohen, Mr. Guarasci and Mr. Geissinger, along with the head of the risk group, reported to Richard Marin. According to Mr. Spector, BSAM was run as if it were a separate company. Issues of liquidity risk for BSAM were dealt with by Richard Marin and John Geissinger. Mr. Spector recalled a meeting with Mr. Geissinger and Mr. Marin in 2004 or 2005 where they were asked to present plans for monitoring the liquidity of the two hedge funds.

Due Diligence. Mr. Spector was not involved in conducting due diligence on the assets of the hedge funds. He advised that members of Ralph Cioffi's team (which consisted of about 20 people) would have been 90% responsible for due diligence on the assets bought by the 2 hedge funds. Mr. Geissenger oversaw due diligence.

Bear Stearns' Mortgage Securitization Business

Bear Stearns did have a mortgage originator.

Mr. Spector advised he has not been involved in pricing mortgage securities for the last 10 years.

When asked whether or not Bear Stearns had retained any of the tranches for its securitized CDOs and MBS deals, Mr. Spector stated that it was Bear Stearns policy to sell all the tranches that it could upon the initial offering, but often times Bear Stearns retained some interests, for sale in the future. He stated that sometimes Bear Stearns' "trickled out" those retained securities. Generally, Bear Stearns liked to retain as little as possible from securitizations so that they could free up their balance sheet to do more securitizations. Tom Marano would monitor which tranches of securitizations that stayed on Bear Stearns' books and look into whether certain tranches were mispriced if there was a high concentration of a particular tranche from the securitizations. Unlike commercial banks, investment banks do not hold portfolios of loans.

During Mr. Spector's tenor at Bear Stearns, Bear's mortgage securitization business grew dramatically, a fact that Mr. Spector was very proud of. When Mr. Spector joined Bear Stearns mortgage securitization was less than 1% of revenue, and during his tenure, it increased to approximately 10%.

When asked who were the main purchasers of Bear Stearns originated CDOs, he said it was the who's who of fixed income.

Mr. Spector stated "securitization is powerful and valuable, but it can be misused." He believes it's good that lenders can sell off loans, because it allows them to generate capital that allows them to make more loans. Although Mr. Spector stated securitization was good for the public, he did acknowledge there were problems in the mortgage business. He stated that when you describe securitization today it sounds like the "the business of selling poison to children." He believed the problems stemmed from widespread financial illiteracy across the country. He advocated increased and simpler disclosure. He also recommended restricting the type of mortgage products sold.

CSE Program

Mr. Spector initially did not recall what the CSE program was. After being reminded that the CSE program was the SEC's Consolidated Supervised Entities program, he stated that Sam Molinaro and Bob Upton would have been in charge of that and he, to his knowledge, never met with representatives of the SEC in connection with the CSE program.

Bear Stearns Repo in 2006 and 2007

Mr. Spector did state that repo was a mechanism for the financing of Bear Stearns. He discussed 2 categories of Repo: (1) Repo that includes matched book (e.g. taking in collateral from clients, lending it out, and making money on the interest) and Bear Stearns' own repo, and (2) the stock loan and stock borrowing book, the relationship between the prime brokerage business (which he described as borrowing and lending to hedge funds) in Bear Stearns clearance business. He stated that Bear Stearns securities lending business was almost exclusively restricted to stocks and their repos were almost exclusively restricted to bonds. He did however admit that some MBS were hard to borrow against because the prices to borrow funds were very high. He made the point to discuss hard to borrow securities versus easy to borrow securities (easy to borrow securities are securities that everybody wants to have in their portfolio). Mr. Spector stated he did not know the specific amount of repo transactions that Bear Stearns did, but tens of billions seemed plausible. In the ordinary course of business Bear Sterns would borrow repo funds back by billions of dollars of MBS and ABS.

Compensation / Severance Package / Resignation

When asked why he believed Mr. Cayne asked Mr. Spector to resign, he stated that Mr. Cayne said we have a major problem with the hedge funds, so you need to go. Mr. Spector did not receive a further explanation. The press reported that Mr. Spector made $36.9 million in 2006 – Mr. Spector said that figure sounded possible but he did not remember the exact amount of his 2006 pay. Mr. Spector also stated Bear Stearns never attempted to claw back any part of his 2006 pay. He advised that his salary was 36CFR1256.56: Privacy, and the rest of his pay was a bonus. He also explained that as a member of the Executive Committee he participated in the Executive Committee bonus pool (which was approved by the shareholders). 50% of this bonus was pre-tax cash, 7.5% was in options, and 42.5% was in stock.

Mr. Spector advised he did not receive a severance package. Both he and his assistants were paid their salary through the end of 2007 (he resigned on August 5, 2007).

When asked how many shares Mr. Spector owned when he resigned he stated he did not remember, but thought it was around 36CFR1256.56 He stated that in the 1990s he participated in Bear Stearns Capital Accumulation Plan (CAP), which allowed employees to defer compensation, and at one point, he owned approximately 36CFR1256.56 shares in Bear Stearns. However, in 2004 the CAP rules changed, and an employee could no longer defer more than 50% of their compensation. f an employee had stock that was deferred more than 5 years it would be distributed to the employee. Over the 2 years following the change in the rule Mr. Spector received between 36CFR1256.56: Privacy shares, which he subsequently sold.

Mr. Spector noted that when he resigned from Bear Stearns on August 5, 2007, Bear Stearns was still profitable and he did not recall any firm wide issues at that time.

Why Did Bear Stearns Fail?

When asked what he thought caused Bear Stearns to fail was he stated that, "it was caused by a loss of confidence," but he did not know what triggered it. He stated that during that time the financial industry, including asset backed securities, mortgages and leveraged lending (Bear Stearns was involved in all three) were under great pressure, and no on Wall Street knew where Bear Stearns was losing money. Also, Wall Street did not know whether Bear Stearns' hedging strategies were working or not.

When Mr. Spector left Bear Stearns in August 2007, he believed Bear Stearns was adequately capitalized.

Everquest

Mr. Spector claimed little knowledge of Everquest, the late spring / early summer IPO wherein Mr. Cioffi attempted to sell assets of the two hedge funds to a new entity, Everquest Financial. Mr. Spector stated he did not know what the goal of the Everquest deal was, and when it was pulled it was clear to Wall Street that the deal was dead anyway.

Check the Box If There Are Any Particularly Interesting Quotes: _X_

Mr. Spector was paid approximately $36.9 million in 2006. In 2007 he was asked to resign due to the performance of the 2 Bear Stearns hedge funds that filed for bankruptcy in July 2007, and Bear Stearns did not attempt to claw back any portion of Mr. Specter's 2006 compensation.

Mr. Spector believes that securitization is a good thing, but stated when you describe it today it sounds like the "the business of selling poison to children."