

The Nationalization of Bear Stearns

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Originally Published in *Traders Magazine* on March 19, 2008

<http://www.tradersmagazine.com/news/100364-1.html>

This week, Bear Stearns was nationalized. It is now a property of the United States and its taxpayers.

Now, I know that JPMorgan is nominally the owner of Bear Stearns, having paid all of two dollars a share in JPMorgan stock. But the Federal Reserve financed the transaction, to the tune of \$30 billion. And, the Fed is apparently making all the business decisions. Put aside the JPMorgan front, and the Fed owns and operates Bear Stearns.

It tickles me that all this happened during an ultra-conservative Republican administration that has even managed to privatize the U.S. Army. While amusing, we will set to one side the ideological debate that ensues when the federal government acquires a piece of private enterprise.

More to the point, the Fed's actions raise novel regulatory issues. As a matter of jurisdiction, the Fed regulates banks and bank holding companies. Bear Stearns is not a bank. It is a broker-dealer. The regulator for broker-dealers is the SEC. So it is only natural to wonder why the Fed thought it was their business to regulate a broker-dealer. And what was the SEC was doing while the Fed was busy buying Bear Stearns?

As it happens, the SEC has produced a Q&A on their website that answers that last question directly. Turns out that the SEC was in close contact with the Fed. The SEC's Division of Trading and Markets, Division of Investment Management, Division of Enforcement and Division of Corporation Finance all wrote letters to the Fed regarding certain regulatory issues arising in connection with JPMorgan's Fed-financed takeover of Bear Stearns.

What the SEC was not doing was arranging its own shotgun marriage with some other broker-dealer using SEC financing. The SEC can't do that because it doesn't have access to that kind of money. The Fed, on the other hand, manufactures the stuff. I'm sure the letters written by four major SEC Divisions were helpful and eased the process. It would have been even more helpful if the SEC could have come up with a few trainloads of cash.

The Fed is to be praised for having taken decisive action on short notice. The failure of Bear Stearns would have been a calamity for the markets and our national economy, with international implications. It is true that in taking this action, the Fed bulldozed down a whole host of constitutional and statutory limitations on

agency prerogatives and disregarded corporate law imperatives, at a minimum. But the alternatives were horribly depressing. Perhaps the host of lawyers that used to work on transactions for Bear Stearns can be usefully employed sorting out the mess.

Looking to the future, these events call into question the regulatory status of the SEC and the Fed. Our division of labor between securities and banking regulators is something of a U.S. invention that harkens back to the Great Depression. At the risk of revealing my age, I can remember a time when it was believed important to separate investment banks, which are broker-dealers, from commercial banks. The distance between the Fed and the SEC reflects this separation. Those distinctions have broken down in recent years and were somewhat artificial to begin with.

The fact is that clearing and settlement, as well as margin lending, looks and smells like the sort of thing commercial banks do when they take deposits and make commercial loans. These activities were a large part of the business of Bear Stearns.

Recognizing the congruence of functions, in many countries securities regulators are employed by the central bank. This certainly makes sense if we think that the Fed will have to repeat from time to time the actions it took with Bear Stearns this week.

It is a bit early to determine how the Fed's actions this week will be viewed by historians. Much depends on what happens next. My crystal ball says that we will view the nationalization of Bear Stearns in retrospect as something that needed to be done. If so, I believe we will see calls to reorganize financial services regulation so that it is clear the Fed can do it again, under a carefully prescribed set of guidelines. There are many ways to do this, but in the end, clearing, settlement and lending will be under the control of the Fed.

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