Transcript

The Warning

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ANNOUNCER: Tonight on FRONTLINE, long before the economic meltdown, the story of one woman who tried to warn about the threat to the financial system.

MANUEL ROIG-FRANZIA, *The Washington Post*: She saw something that people either had not seen or refused to see. And she tried to sound the warning. Nobody listened.

Rep. SPENCER BACHUS (R), Alabama: What are you trying to protect?

BROOKSLEY BORN, CFTC Chair, 1996-'99: We're trying to protect the money of the American public.

ARTHUR LEVITT, SEC Chairman, 1993-'01: I was told that she was irascible, difficult, stubborn, unreasonable.

NARRATOR: Before the toxic assets poisoned the economy, she warned of their danger.

RON SUSKIND, Author, *The Price of Loyalty*: And that made her the enemy of a very, very large number of people.

NARRATOR: She would fight an epic battle with one of the most powerful men in Washington.

DAVID WESSEL, Author, *In Fed We Trust*: He was, as George Bush put it at the time, a rock star.

JOE NOCERA, *The New York Times*: It got pretty nasty pretty quickly.

MICHAEL GREENBERGER, CFTC Director, 1997-'99: Greenspan turns to her, she turns to him, his face is red and he's clearly quite upset.

NARRATOR: A story from inside the highest levels of the Clinton administration.

TIMOTHY O'BRIEN, *The New York Times*: They were all part of a very concerted effort to shut her up and to shut her down. And they did, in fact, shut her up and shut her down.

NARRATOR: Tonight on FRONTLINE, Alan Greenspan, Brooksley Born, and The Warning.

JIM CRAMER, CNBC: You need to get in the game!

NARRATOR: In 2005, economic cheerleaders dominated the airwaves.

JIM CRAMER: I'm betting on Microsoft. That stock is not done going up, either!

NARRATOR: Times were good. Alan Greenspan ruled the economy.

JIM CRAMER: When you can get a 3.7 percent yield with up side, that's a lot better than getting a

NARRATOR: Washington's hands-off attitude toward Wall Street seemed to be paying off.

JIM CRAMER: So now it's all systems go between now and

And I recommend a buy on it!

NARRATOR: It was time for a celebration.

WHITE HOUSE ANNOUNCER: Ladies and gentlemen, the recipients of the Presidential Medal of Freedom.

Pres. GEORGE W. BUSH: Alan Greenspan is one of the most admired and influential economists in our nation's history.

NARRATOR: The nation's highest civilian honor was bestowed on the man many called "the wizard."

Pres. GEORGE W. BUSH: always be known as one of the phenomenal

DAVID WESSEL, Author, *In Fed We Trust*: More than one story was written about Alan Greenspan as "the wizard," the man behind the curtain, the Wizard of Oz.

ARTHUR LEVITT, SEC Chairman, 1993-'01: Alan was a great wizard. No one understood what he said, but he said it in such a way that everybody bought it.

Rep. MAURICE HINCHEY (D), New York: What's going to happen when all of this stimulation starts to decline?

***ARTHUR LEVITT:** Everybody hung on every word.

ALAN GREENSPAN, Federal Reserve Chairman: Congressman, it depends on what is going on in the world generally.

DAVID WESSEL: The wizard, the man behind the curtain who mumbled in ways that ordinary people couldn't understand, but who appeared to be controlling absolutely everything.

ALAN GREENSPAN: Then we're going to get an exceptionally large amount of fiscal stimulus, which we're not going to want.

ARTHUR LEVITT: Very few people wanted to take him on or challenge him because he knew so much more than they did. And if he didn't, he certainly appeared to.

Pres. GEORGE W. BUSH: In 18 years as Fed chairman, he applied

NARRATOR: Five presidents had watched Alan Greenspan work his magic. it started back in the Ford administration.

ROGER LOWENSTEIN, Author, When Genius Failed: Alan Greenspan was a financial consultant who was hired by Gerry Ford, first to be head of his Council of Economic Advisers in the '70s.

NARRATOR: But Alan Greenspan was not your stereotypical economist.

ROGER LOWENSTEIN: He was also very charming and a man about Washington.

NARRATOR: He played jazz clarinet, had made himself rich on Wall Street. And he had embraced an unusual political guru

AYN RAND: I'm challenging the moral code of altruism.

NARRATOR: the Libertarian philosopher Ayn Rand.

AYN RAND: Everybody is enslaved to everybody.

JOE NOCERA, *The New York Times*: Greenspan is a disciple. She is the great champion of government as a destructive force that just gets in the way.

MIKE WALLACE, 60 Minutes: Can I ask you to capsulize your philosophy?

AYN RAND: I am opposed to all forms of control. I am for an absolute laissez-faire, free, unregulated economy. Let me put it briefly. I am for the separation of state and economics.

NARRATOR: Greenspan talked about Rand in his autobiography.

[Alan Greenspan, *The Age of Turbulence*: "Ayn Rand became a stabilizing force in my life. It hadn't taken long for us to have a meeting of the minds mostly my mind meeting hers."]

NARRATOR: Rand stood in the Oval Office as her star pupil was sworn in.

DAVID WESSEL: Greenspan had a very clear ideology about regulation.

HENRY KAUFMAN, Dir., Lehman Brothers, 1995-'08: His philosophy was in the form of what was called Libertarianism. And that meant those who do well prosper, those who do poorly fail, and the market clears the transactions.

Pres. RONALD REAGAN: that I will faithfully execute the office of president of the United States.

NARRATOR: It was a philosophy made to order for Ronald Reagan.

Pres. RONALD REAGAN: Government is not the solution to our problem, government is the problem.

NARRATOR: In 1987, Reagan made Greenspan the most powerful banker in the world, the chairman of the Federal Reserve.

JOSEPH STIGLITZ, Sr. Clinton economic Adviser, 1993-'97: Greenspan was a believer in Ayn Rand, a believer in free market. A little bit curious for a central banker, because what is central banking? It's a massive intervention in the market, setting interest rates.

NARRATOR: Greenspan worried about this contradiction in his autobiography.

[Alan Greenspan,*The Age of Turbulence*: "I knew I would have to pledge to uphold not only the Constitution but also the laws of the land, many of which I thought were wrong."]

Pres. RONALD REAGAN: And now the vice president will swear Alan Greenspan in as the 13th chairman of the Federal Reserve.

NARRATOR: He swore the oath and took the job.

[Alan Greenspan,*The Age of Turbulence*: "I had long since decided to engage in efforts to advance free-market capitalism as an insider, rather than as a critical pamphleteer."]

DAVID WESSEL: He understood that there were laws he had to enforce that he personally would not have passed. But he intended to do as little as he could on regulation, and he proceeded to do just that.

NARRATOR: And by the time Bill Clinton took the White House, the anti-government rhetoric had become so fashionable that even some Democrats embraced it.

DAVID WESSEL: Ronald Reagan had won. Government was seen as the problem. And even though Bill Clinton was someone who believed in government and wanted to use it, he was kind of forced into that Reaganesque ideology because that was what people wanted to hear.

NARRATOR: From the beginning, Clinton aimed to reassure powerful forces on Wall Street, and he did so with a key appointment.

Pres. BILL CLINTON: I have asked Robert Rubin to serve as assistant to the president for economic policy.

JOE NOCERA: Rubin is the best known financier in the country, at that point, because he had run the legendary Goldman Sachs.

TIMOTHY O'BRIEN: Bob Rubin was Bill Clinton's emissary to Wall Street. Clinton placed great trust in Bob Rubin and Bob Rubin's view of financial markets and financial regulation.

DAVID WESSEL: He had an enormous amount of credibility because he was a business success, and Democratic administrations always seem to worship people who can excel at business.

NARRATOR: At the White House, and as Treasury secretary, Rubin found an unlikely ally. Clinton had asked Alan Greenspan to stay on.

TIMOTHY O'BRIEN: Bob Rubin and Alan Greenspan were very much in lockstep. They had very similar views on Wall Street. It boiled down to the less regulation, the better.

NARRATOR: And Rubin populated the Clinton administration with a network of free market true believers.

JOE NOCERA: It wasn't just Rubin and Greenspan who were these free market acolytes. That thinking pervaded the Treasury and the White House.

NARRATOR: Among Rubin's acolytes, 35-year-old Timothy Geithner and Rubin's top deputy, the outspoken Harvard economist Larry Summers.

ROGER LOWENSTEIN: Summers was tough. Summers is very blunt-spoken, doesn't suffer fools lightly, or anyone else, as the saying goes.

TIMOTHY O'BRIEN: Bob Rubin is not a guy who likes confrontation. He's confrontation-averse. But he understands that you need someone in there who can swing a heavy axe, and that person was Larry Summers. He was the enforcer.

NARRATOR: Together, Greenspan, Rubin and Summers formed their own pro-business, anti-regulation support group.

RON SUSKIND: They're the committee to save the world, according to the Time magazine cover. These are the people that we turned to at that moment who together, all three in a way, who say "Trust us."

JOE NOCERA: They seemed to have things under control. You know, the world trusted Rubin and Greenspan, so why wouldn't Clinton, you know? And the market was doing great and the country seemed to be doing great.

NEWSCASTER: Big day on Wall Street, as stock prices return to territory not seen since December.

NEWSCASTER: NASDAQ joining the party on Wall Street today, posting a triple-digit gain, along with

NEWSCASTER: Stock trading at five times its

NEWSCASTER: the active volume, 55 million shares changing hands

NARRATOR: These were the euphoric, go-go '90s.

TIMOTHY O'BRIEN: Well, you know, the mid to the late 1990s were a very ripe boom period. It was the most robust portion of the tech boom.

NEWSCASTER: Internet fever has not subsided.

NEWSCASTER: On the money tonight, Internet fever again.

NEWSCASTER: EBay up 700 percent since September.

TIMOTHY O'BRIEN: The financial markets were zooming.

NEWSCASTER: Priceline.com is the latest beneficiary of the Internet stock craze.

JOE NOCERA: The market was rocking and rolling.

NEWSCASTER: Shares of the Web technology company soared more than 350 percent

NEWSCASTER: The Dow Jones industrial average gained 91 points today

NEWSCASTER: three hundred dollars a share!

NEWSCASTER: Santa Claus arrives early on Wall Street.

NARRATOR: But in Washington, there was one agency that looked at the bull market with some skepticism, buried deep in the bureaucracy, the Commodities Futures Trading commission, CFTC.

DANIEL WALDMAN, CFTC General Counsel, 1996-'99: It was a small fish in an otherwise a pretty big pond. It was always viewed as kind of a sleepy, small, not terribly significant agency.

NARRATOR: The agency was authorized to regulate agriculture futures and to oversee arcane, complex financial instruments known as derivatives.

RON SUSKIND: You know, they're one of these little afterthought agencies that kind of get in the way of the big guys.

NARRATOR: The CFTC started "getting in the way" in 1996 when a new chairperson, Brooksley Born, took over.

BROOKSLEY BORN, CFTC Chair, 1996-'99: My law practice was in the derivatives area. I'd practiced derivatives law for more than 20 years.

JOE NOCERA: Brooksley Born is a long-time securities lawyer. She has a stellar reputation. She's been around the block. She knows her stuff.

NARRATOR: Born was 55, a veteran of the gender wars that had influenced many women of her age group. In Born's case, the struggle had started early. Born went to Stanford in the early 1960s. Most women in her class got married, Brooksley went to law school.

NANCY DUFF CAMPBELL, Washington Attorney: There were very few women in law school at the time. This was during the Vietnam War, and a lot of men in the class saying, "What are you doing here? You're taking the place of somebody, a man who could be here and not have to go to the war." The way she approached this was, "Well, I've got to show them I can do it."

NARRATOR: She did top of her class, the first female president of The Stanford Law Review.

MANUEL ROIG-FRANZIA, *The Washington Post*: You would think this would be a moment of triumph for Brooksley Born. Instead, she gets a phone call from one of the deans. And he says, "Brooksley, I just want to let you know that the faculty stands ready to step in if you're not able to pull this off." It goes on like that, on and on and on, at each step of Brooksley Born's life and career.

NARRATOR: In Washington, she became a partner in a prestigious law firm, built an international reputation, formed alliances with other powerful female attorneys, including one who happened to be the wife of Arkansas's governor.

MICHAEL GREENBERGER, CFTC Director, 1997-'99: She had developed a very close relationship with Hillary Clinton when Hillary Clinton was a very prominent lawyer in Little Rock, Arkansas.

NARRATOR: And then Bill Clinton won the presidency.

MANUEL ROIG-FRANZIA: Born found herself invited down to Arkansas during the transition for a meeting with him to discuss possibly being the attorney general of the United States.

NANCY DUFF CAMPBELL: She's very self-effacing. You know, she's flattered. But she's going to see if it happens.

NEWSCASTER: Week seven of the Clinton transition. NBC's Andrea Mitchell tonight.

NEWSCASTER: For attorney general, Clinton is considering Washington lawyer Brooksley Born. But he may have

MICHAEL GREENBERGER: Brooksley went in for an interview with Clinton. The story that comes back was that Clinton found her boring and that she was it never went anywhere.

MANUEL ROIG-FRANZIA: It didn't happen. Janet Reno was chosen.

NARRATOR: And that's how Brooksley Born ended up running the obscure CFTC.

MICHAEL GREENBERGER: I think to some extent, you could view this as a consolation prize. To the general world, people who knew Brooksley, the circle she traveled, the American Bar Association, the DC Bar, all the prestigious boards she served on, people were probably scratching their heads.

NARRATOR: An experienced financial litigator who'd seen the worst of the markets, Born was a believer in government regulation. Given the political climate in Washington at the time, clashes with Greenspan, Rubin and Summers were inevitable. Almost right away, she had one. It began after she received an invitation to lunch at the Federal Reserve with the chairman himself.

MANUEL ROIG-FRANZIA: How could you not have a little bit of butterflies in your stomach when you're going to see Alan Greenspan at that moment in time?

NARRATOR: It didn't take long for Born to learn that she and the chairman were not going to see eye to eye.

JOE NOCERA: He said something to the effect that, "Well, Brooksley, we're never going to agree on fraud." And she said, "Well, what do you mean?" And he said, "`You probably think there should be rules against it." And she said, "Well, yes, I do." He said, you know, "I think the market will figure it out and take care of the fraudsters."

INTERVIEWER: The Alan Greenspan lunch did it actually happen? Where he says

BROOKSLEY BORN: I'm not going to talk about it. I'm not going to talk about it on camera.

NARRATOR: Born is reluctant to speak about her meetings with Greenspan or others in the Clinton administration. Greenspan refused to speak to FRONTLINE at all. But Born's advisers did.

MICHAEL GREENBERGER: Greenspan didn't believe that fraud was something that needed to be enforced, and he assumed she probably did. And of course, she did. I've never met a financial regulator who didn't feel that fraud was part of their mission.

MANUEL ROIG-FRANZIA: And this is an absolute stunner for the new head of this tiny agency who is charged with making sure people don't commit fraud.

NANCY DUFF CAMPBELL: Well, I think she was taken aback about how far he would go towards deregulation, that even the notion that we should police fraudulent activity he didn't think was something that was a given.

MICHAEL GREENBERGER: That was her introduction to Alan Greenspan.

NARRATOR: The clash with Greenspan didn't intimidate Born. She was determined that her agency would investigate fraud at the first opportunity. One are that caught her attention was a new and highly lucrative market, over-the-counter derivatives.

JOE NOCERA: She starts to realize that there's this whole world out there of what are called over-the-counter derivatives that are essentially unregulated. It's not even that they're unregulated, it's that the government doesn't even know what's going on.

BROOKSLEY BORN: My staff began to say how big this was and how little information they had about it.

NARRATOR: On Wall Street, they described it as a "black box" only the parties involved in a deal knew what was happening.

KELLY HOLLAND, *BusinessWeek*, 1992-'99: The derivatives market was a market that was not well understood, was growing rapidly, that had a few really smart, aggressive innovative players.

NARRATOR: Derivatives, swaps, basically bets between companies and banks , laying off risk.

TIMOTHY O'BRIEN, *The New York Times*: Derivatives, in essence, are insurance policies that various players on Wall Street enter into to protect themselves from unforeseen calamities.

NARRATOR: It was a $27 trillion-market happening out of sight, inside a black box.

BROOKSLEY BORN: We didn't truly know the dangers in the market because it was a dark market. There was no transparency.

KELLY HOLLAND: The conditions were very favorable for things to go wrong.

NARRATOR: As Born's investigators learned, there was also plenty of room for old-fashioned fraud.

MICHAEL GREENBERGER: There's this major scandal at Bankers Trust, where they have taken two of their customers, Procter & Gamble and Gibson Greeting Cards, to the cleaners with these complex over-the-counter derivative products.

NEWSCASTER: fraudulent dealings in derivatives sold by Bankers Trust.

NEWSCASTER: Procter & Gamble claim they've lost millions of dollars from derivative deals arranges by Bankers Trust.

NARRATOR: In 1993, Bankers Trust, one of the largest banks in the country at the time, had sold derivatives to Procter & Gamble.

JOE NOCERA: Procter & Gamble sued Bankers Trust, claiming that they had been sold products that they didn't really understand and that blew up in their face.

NARRATOR: The lawsuit set the stage for a stunning revelation. Bankers Trust employees took advantage of the fact that derivatives were too complicated to understand.

TIMOTHY O'BRIEN: It opened a window onto what was really going on in the derivatives market.

NARRATOR: As part of the case, Procter & Gamble discovered secret audiotape recordings of telephone calls among Bankers Trust brokers.

KELLY HOLLAND: There was one employee who described the business as a "wet dream." A Bankers Trust employee said, "We set them up."

TIMOTHY O'BRIEN: They had taped phone calls from people inside Bankers Trust who were sort of chuckling, saying, "Ha, ha, these idiots really think that this is in their best interests, but ha, ha, it's not. We're probably going to end up cleaning their clocks on these contracts."

NARRATOR: It had all happened in secret. Even this blatant scam might never have been discovered by the government.

BROOKSLEY BORN: The only way the CFTC found out about the Bankers Trust fraud was because Procter & Gamble and others filed suit.

NARRATOR: Looking inside Wall Street's black box was impossible for Born, or indeed any other government regulator.

TIMOTHY O'BRIEN: They're unregulated. The contracts aren't traded on exchanges. They're entered into between private parties.

BROOKSLEY BORN: There was no record-keeping requirement imposed on participants in the market. There was no reporting. We had no information.

ADAM DAVIDSON, Planet Money, NPR: There's no way, really, for the government or anyone else to know how many of these are out there, know how big a market it is and know who owns them and who owes who money because it's just a bunch of contracts in file cabinets in the lawyers' offices of banks and hedge funds all over the world.

NARRATOR: And that's what frightened Born more than anything, trillions of dollars and the biggest banks in the country operating in secret. If something went terribly wrong, the high-stakes derivatives market could take down the entire financial system.

MICHAEL GREENBERGER: And that's what everybody's worried about. You have one big institution that fails, it can't pay its obligations, it forces somebody else into dangerous territory who can't pay their obligations, and pretty soon, it's a falling domino effect through the economy.

NARRATOR: As the market grew and morphed, Born felt her agency would have to get involved, but that would mean confronting Greenspan, Rubin and Summers.

MICHAEL GREENBERGER: She used to say she would lay awake at night, turning in her bed, because she could see coming down the road, the crises kept building and building.

NEWSCASTER: Federal Reserve chairman Alan Greenspan told Congress today, the economy is the best he's ever seen.

NARRATOR: By spring of 1998, the idea of tougher regulation seemed out of step with all the good news.

[*www.pbs.org: Video timeline of deregulation*]

ALAN GREENSPAN, Federal Reserve Chairman: Current economic performance is as impressive as any I have witnessed in my near half century.

NEWSCASTER: Those Internet stocks continue their meteoric rise.

NEWSCASTER: Investors are hoping Alan Greenspan will give them another boost by lowering interest rates yet again.

ROGER LOWENSTEIN, Author, When Genius Failed: You have to remember the context. Companies are going public and doubling, and doubling every week of the year.

NEWSCASTER: If you thought the Internet bubble was about to burst, think again.

ROGER LOWENSTEIN: Some weeks, it was happening every day. And you know, the idea of worrying about derivatives was just, you know, so so 20th century.

DAVID WESSEL, The Wall Street Journal: We were on a path towards, "Wow, markets can do great things." Communism was dead. Markets, capitalism was invincible.

NARRATOR: But at Treasury, things were about to change. The carefully calibrated inner tranquility was being disturbed by a small tremor. It quickly made its way up to Robert Rubin. Brooksley Born was contemplating the regulation of OTC derivatives.

JOE NOCERA: The pushback is visceral and immediate, and that's one of the striking things about this.

NARRATOR: This was a job for Larry Summers.

MICHAEL GREENBERGER: I walk into Brooksley's office one day, the blood has drained from her face. She's hanging up the telephone. She says to me, "That was Larry Summers."

RON SUSKIND: Larry basically reads her the riot act. He more or less tells her, my understanding, is that, "You don't get it."

MICHAEL GREENBERGER: He says, "You're going to cause the worst financial crisis since the end of World War II," that he has, my memory is, 13 bankers in his office who informed him of this. Stop right away. No more.

NARRATOR: In Washington, they say, the financial sector has five lobbyists for every congressman.

TIMOTHY O'BRIEN: Brooksley Born is stepping into the maw of the most well oiled and highly financed lobby in the history of Washington, D.C. It's the financial lobby.

ROGER LOWENSTEIN: Bankers just fall over themselves calling Summers and Rubin and Greenspan and everybody, saying, "Get this lady off our backs."

NARRATOR: But the harder they pushed, the more interested Born became.

BROOKSLEY BORN: They were totally opposed to it. That puzzled me. You know, what was it that was in this market that had to be hidden? Why did it have to be a completely dark market? So it made me very suspicious and troubled.

[*www.pbs.org: More of Born's interview*]

NARRATOR: Born's agency was legally independent. She reported to the president. Rubin had no authority over her. To stop her, he would call upon his allies who sat with him on a secretive council known as "the president's working group."

TIMOTHY O'BRIEN: The president's working group was the most influential White House body on financial policy.

MICHAEL GREENBERGER: It was called at the discretion of the secretary of the Treasury.

TIMOTHY O'BRIEN: It was a committee hand-picked by Bob Rubin, and it was a committee that he steered.

NARRATOR: Larry Summers attended. So did Alan Greenspan and the chairman of the SEC, Arthur Levitt.

ARTHUR LEVITT, SEC Chairman, 1993-'01: Alan and Bob and I had known one another and away from government. I think we all liked one another and respected one another.

NARRATOR: By executive order, the head of the CFTC also attended the meetings.

ARTHUR LEVITT: I didn't know Brooksley Born. I was told that she was irascible, difficult, stubborn, unreasonable.

DAVID WESSEL: Rubin, Summers and Greenspan had a great deal of faith in their own intellects. And I think that they were not welcoming of somebody who looked at the world different and was kind of abrasive.

NANCY DUFF CAMPBELL: You know, they were used to dealing mainly with men and with people they knew. And here was someone they didn't really know. They didn't know that much about her. And to boot, she was a woman. So you know, put it all together and you've got somebody that you can kind of flick off with the back of your hand, at least they thought.

NARRATOR: As Rubin was quietly preparing the working group, Born was taking the first steps toward regulating OTC derivatives, designing a document known as a "concept release." In response, Rubin acted, calling an emergency meeting of the working group.

MICHAEL GREENBERGER: We're driven there, and we get out at the entrance of the Treasury, go up to the room. Everybody assembles. The secretary walks in. The meeting is called to order. And the subject of the meeting was to discuss the concept release and the clear mission of it was to convince Brooksley that it shouldn't be issued.

JOE NOCERA: What's amazing is that Rubin and Greenspan said, "No, no, no. You can't do that. We just can't have this." And it got pretty nasty pretty quickly.

NANCY DUFF CAMPBELL: Those on the other side were saying, "Look, this deregulated market is part of what's brought us the boom times. And so we don't we can't we don't want to change that. You know, the market will take care of everything. And we really don't need regulation of these, and in fact, it would be counterproductive."

MICHAEL GREENBERGER: Each of the principals in turn that is to say, Rubin, Greenspan and Levitt take their shot at telling Brooksley that she shouldn't do what she's doing.

JOE NOCERA: Rubin says to her, "You don't have the legal authority to do this."

MICHAEL GREENBERGER: And Brooksley said, "Well, that's interesting. That's the first time I've ever heard that. All my lawyers at the CFTC have assured me that we have the exclusive jurisdiction to do this."

ROGER LOWENSTEIN: Rubin was condescending toward her. He said he would get his lawyer in the department to help her understand the laws better, or something like that.

NARRATOR: SEC chairman Arthur Levitt had been personally lobbied to join the effort to shut Born down.

ARTHUR LEVITT: This tight-knit group persuaded me that we really would face a situation of financial turmoil if we tried to undo these existing contracts.

NARRATOR: And then it was Alan Greenspan's turn.

MICHAEL GREENBERGER: I happened to be sitting behind Brooksley and behind Greenspan. They're sitting next to each other. Greenspan turns to her, she turns to him, his face is red and he's clearly quite upset.

MICHAEL GREENBERGER: He was very adamant that this was a serious, serious mistake, that it would cause untold damages to the financial services market and that she should stop and not do this, that it was unwise and would cause tremendous damage.

ARTHUR LEVITT: In a group of this kind, there will be a disparity in power, and it would take an extraordinarily outspoken, knowledgeable, pugnacious person to fight the losing battle against the titans who led that group.

[*www.pbs.org: More of Levitt's interview*]

TIMOTHY O'BRIEN: It's the education of Brooksley Born. They decided that, "Hey, she's not playing ball. We're going to teach her a lesson. And we're going to get this thing killed because we don't want it to happen."

NARRATOR: But two weeks later, Born told her staff to publish the concept release.

RON SUSKIND: That creates an earthquake. You're talking foundation of the building. And she is literally in the crossfire of an amazing number of bullets.

NARRATOR: The response of the working group was immediate and unprecedented.

MICHAEL GREENBERGER: By the afternoon, Rubin, Greenspan, Levitt put out a statement, saying, "This is a very bad thing and Congress should act with all deliberate speed to block it."

[*"We have grave concerns about this action and its possible consequences. We are prepared to pursue, as appropriate, legislation that would provide greater certainty concerning the legal status of OTC derivatives."*]

TIMOTHY O'BRIEN: The powers that be in Washington put out the word to the media and they put out the word to Capital Hill that her views were not to be trusted, they were not to be taken seriously, that she was running a podunk agency, that this was a power grab, and she didn't have a clear understanding of the products that she was going to regulate and shouldn't be entrusted with that kind of power, and it would be a great mistake if she were.

[*www.pbs.org: Watch this program on line*]

Sen. RICHARD LUGAR (R-IN), Chairman: This hearing of the Senate Agriculture Committee is now called to order.

NARRATOR: Only Congress had the legal authority to stop Born. Rubin, Greenspan, Summers and Levitt lobbied hard.

Sen. RICHARD LUGAR: Today we will receive testimony on over-the-counter derivatives.

NARRATOR: Hearings were held almost immediately in both the House and the Senate.

Rep. JIM LEACH (R), Iowa, 1977-'07: Brooksley is a lady, and the men were gentlemen, but the feelings were quite intense. This was an enormous embarrassment to the executive branch because they couldn't coordinate with each other.

JOE NOCERA: There are a ridiculous number of congressional hearings.

CONGRESSMAN: It is essential that the government not create uncertainty.

CONGRESSMAN: CFTC wants to come into somebody else's yard here.

JOE NOCERA: She just gets pummeled on Capital Hill.

Sen. PHIL GRAMM (R), Texas (1975-'02): I see no evidence whatsoever to suggest that this is a troubled market, that fraud is rampant in this market.

LARRY SUMMERS, Dep. Treasury Secretary: The release has cast a shadow of regulatory uncertainty over a thriving market.

ARTHUR LEVITT: The CFTC's action has and will bring, I believe, significant disruption to this important global market.

ALAN GREENSPAN: Regulation that serves no useful purpose hinders the efficiency of markets to enlarge

JOE NOCERA: All the regulators there testifying, and you know, all of them say, "This is a bad idea. This is a bad idea. This is a bad idea. This is a bad idea.' Then she says, "This is a good idea," and the senators and congressmen just just, you know, beat her over the head.

Sen. PHIL GRAMM: I feel very strongly that we should not have one agency innovate in this area and in doing so create very substantial financial problems.

DAVID WESSEL: Ninety percent of the members of Congress couldn't have told you what a derivative was. So all they knew was that these guys on Wall Street, some of whom make big campaign contributions, many of whom seem very smart, say, "If we do this, it'll screw up the economy."

Rep. SPENCER BACHUS: My question again is what are you trying to protect?

BROOKSLEY BORN: We're trying to protect the money of the American public, which is at risk in these markets.

NARRATOR: That summer of 1998, Born testified four times before hostile congressional committees.

BROOKSLEY BORN: They were hearing from very respectable sources that there was no problem, and they chose to rely on those people. And I think that was understandable. I think it was unfortunate, but I think it was very understandable.

Sen. RICHARD LUGAR (R), Indiana: I thank each one of you for coming and for your testimony.

BROOKSLEY BORN: Thank you, Mr. Chairman.

DAVID WESSEL: The system wasn't set up to allow somebody like Brooksley Born to have a real impact.

JIM LEACH: She was running against the tide of very powerful forces, and powerful forces that were doing exceptionally well.

NARRATOR: As Congress headed for the summer recess, it seemed likely they would not heed Born's warning.

MICHAEL GREENBERGER: She had no support anywhere.

ROGER LOWENSTEIN: She wasn't a member. She had no political capital. She had no chance.

[*six weeks later...*]

NARRATOR: Then Born's warning became a prophecy.

GARY GENSLER, Asst. Secy., Treasury, 1997-'99: I was at home and I got a call, as I would often get a call, from the Treasury operator. And it was Secretary Rubin on a Saturday. And the secretary of the Treasury wants to have a conversation with me about this hedge fund that apparently was about to go under.

NARRATOR: The hedge fund, Long Term Capital Management, was melting down. A quiet panic had begun. It looked exactly like what Brooksley Born had been warning about. Known on the Street as LTCM, it was the trillion-dollar favorite of in-the-know investors.

TIMOTHY O'BRIEN: LTCM's a hedge fund. It's run by John Meriwether, ex-Salomon Brothers. He's considered one of the great geniuses of the bond market. Tons of money flows his way from private investors who would like to make a killing via his smarts.

ROGER LOWENSTEIN: The firm also had the former vice chairman of the Fed, Alan Greenspan's number two.

NARRATOR: David Mullins and John Meriwether operated LTCM outside government regulations.

ROGER LOWENSTEIN: They were the personification or the embodiment of Alan Greenspan's credo. The credo was, "Markets get it right."

NARRATOR: LTCM invented complex mathematical formulas and used derivatives to place their bets.

RON SUSKIND: These guys are the rock stars, the Long Term Capital Management team. They're sort of rock stars for the math clubs of America.

DAVID WESSEL: LTCM is a case study in arrogance, a lot of really, really smart people who thought they had a foolproof money machine, a number of them Nobel Prize winners.

NARRATOR: Neither the government nor investors knew anything about how LTCM worked. It was a completely secret process.

MICHAEL GREENBERGER: If you want to invest in Long Term Capital Management, you've got to walk into a conference room, abandon computers, abandon pencils, abandon yellow pads, no notes, and you're told, "There's a black box. Look at these returns, 46 percent, 40 percent, 20 percent." People are fighting to get in, to invest. People are fighting lend money.

NARRATOR: LTCM did business with 15 of Wall Street's biggest banks, leveraging $5 billion into more than $1 trillion in derivatives.

BROOKSLEY BORN: All these big banks hadn't done their homework. They didn't even know the extent of LTCM's exposures in the market, or the fact that all of the other OTC derivatives dealers had been lending to them, as well.

NARRATOR: Then trouble. LTCM's complicated computer models were failing

NEWSCASTER: In Russia, the financial markets were hit hard today.

NARRATOR: rocked by a financial crisis in Russia.

ROGER LOWENSTEIN: The firm had all sorts of models that said no matter what happened, based on history, they couldn't lose more than $35 million a day.

NEWSCASTER: In Russia today, a grave financial situation grew decidedly worse.

NEWSCASTER: The effects of the Russia crisis were evident everywhere.

ROGER LOWENSTEIN: They started dropping $300 million, $400 million, $500 million every day.

NARRATOR: Word of a pending collapse spread. Many banks had invested in LTCM's derivatives believing they alone were in a deal. They weren't.

TIMOTHY O'BRIEN: When LTCM started to get stressed and these guys said, "I want to collect my collateral," they all discovered that a lot of other parties had the same claims on it.

NARRATOR: With Wall Street's banks in a panic, LTCM was perilously close to collapse. And that's when Washington first heard about the problem. The secretary of the Treasury began to contact members of the president's working group.

BROOKSLEY BORN: I got a call from the Treasury Department. I thought that LTCM was exactly what I had been worried about. None of the regulators had known they were on the verge of collapse. Why? Because we didn't have any information about the market.

NARRATOR: That weekend, the members of the working group were told the entire American economy was hanging in the balance.

GARY GENSLER: Long Term Capital Management had very large positions in the over-the-counter derivatives marketplace. And if it came down, the question is, "How would that affect the American public? How would that reverberate through the system and affect everybody's livelihood in the country?"

TIMOTHY O'BRIEN: The fear is that if it goes down, it would present what they call a "systemic risk," something that could unwind the entire financial system.

NARRATOR: At Treasury, all they could do was watch and wait.

ROGER LOWENSTEIN: It was very scary. Credit markets around the world just shut down. There was a period of real panic. People were very, very frightened. These firms were worried about, in some cases their future, in some cases their survival. It was a real bloodletting.

NARRATOR: After four days, the Fed acted, but not directly. The Wall Street banks were pressured to bail out LTCM themselves.

MICHAEL GREENBERGER: The government said, "It is our belief that your financial stability is in jeopardy. And the way to solve this problem is for you each to pony up $400 million and buy the fund, prevent it from collapsing, and try and work the thing out."

ROGER LOWENSTEIN: Fourteen banks agree to put a few hundred million each, about $3.5 billion total.

NARRATOR: It worked. The crisis passed. In Washington, a collective sigh of relief. And then a call to action.

Rep. JIM LEACH: The committee will come to order.

NARRATOR: Some in Congress began to clamor for regulation.

Rep. JIM LEACH: The United States government is obligated to be on top of the issues.

Rep. RICHARD BAKER (R), Louisiana: When and how did the concept of market self-regulation fail us?

Rep. BERNIE SANDERS (I), Vermont: Americans should be worried about the gambling of Wall Street elites.

Rep. PAUL KANJORSKI (D), Pennsylvania: That puts at risk every American. It puts at risk democracy.

Rep. MAURICE HINCHEY (D), New York: How many more failures do you think we'd have to have before some regulation in this area might be appropriate?

JOSEPH STIGLITZ, Sr. Clinton economic Adviser, 1993-'97: There was a strong sense that we ought to do something about these derivatives, that they really were posing a risk to our national economy and to the global economy.

NARRATOR: But Alan Greenspan had no intention of yielding.

ALAN GREENSPAN: [*October 1, 1998*] I know of no set of supervisory action we can take that would prevent people from making dumb mistakes. I know of no piece of legislation that can be passed by the Congress which would require us to prevent them from making dumb mistakes.

BROOKSLEY BORN: Congress was told that this was an anomaly, this was not indicative of dangers in the market.

ALAN GREENSPAN: I think it's very important for us not to introduce regulation for regulation's sake.

NARRATOR: In the end, Congress agreed with Alan Greenspan. There would be no new regulations of over-the-counter derivatives.

MICHAEL GREENBERGER: So now this is an unregulated market, no transparency, no capital reserve requirements, no prohibition on fraud, no prohibition on manipulation, no regulation of intermediaries. All the fundamental templates that we learned from the Great Depression are needed to have markets function smoothly are gone.

NARRATOR: But within the next few weeks, Congress did decide to do something about Brooksley Born. They stopped her entirely.

TIMOTHY O'BRIEN: Essentially, what you had was a very bald and brutal power play. They defenestrate her entire agency. They say, "Because you haven't played ball, we are now declaring a regulatory freeze on anything you folks can do in this market. Forget it. You're done." And she was.

NARRATOR: Born resigned.

BROOKSLEY BORN: There was not anything effective that was going to happen in the over-the-counter derivatives area. And I felt as though, because of that, I had done what I could to help protect the public and there wasn't much left for me to do.

NARRATOR: With Born out of the way, the last two years of the Clinton administration were a heyday of deregulation. OTC derivatives were off limits. Banks were freed to make riskier investments. Wall Street was largely left to regulate itself.

JOE NOCERA: Again and again during the Clinton administration, you see these examples of the top regulators basically saying, "The market knows better than us, and we're going to let the market do it."

NARRATOR: By 2007, the OTC derivatives market had grown to $595 trillion. That's $595 trillion.

NEWSCASTER: Stocks shot higher, giving the Dow its best day in almost

NARRATOR: The hands-off approach seemed to be working. Wall Street had bet heavily on the real estate boom.

NEWSCASTER: The economy expanded at a robust 4.3 percent annual rate.

NARRATOR: Those derivatives were at the heart of that strategy.

JOE NOCERA: You have derivatives insuring derivatives which are based on derivatives. It's an almost an Alice in Wonderland kind of profitability.

TIMOTHY O'BRIEN: What, in fact, you essentially had was a big, creaking time bomb that needed some sort of event to disrupt all the assumptions everyone had.

NEWSCASTER: The stock market dropped by hundreds of points

NEWSCASTER: Profits in the banking industry are plunging.

NEWSCASTER: The jobless rate in America has now soared to

NEWSCASTER: The Dow tumbled

NARRATOR: The time bomb exploded almost exactly 10 years after the collapse of LTCM.

NEWSCASTER: Investors were shaken by Lehman's bankruptcy filing and what was essentially

TIMOTHY O'BRIEN: You had the most raw panic the economy and the financial markets had seen since the 1930s. It was ugly, it was broad-based, it was bringing huge institutions to their knees. And a lot of that was tied into derivatives.

MICHAEL GREENBERGER: They're hidden like land mines in a battlefield, and nobody wants to give money to anybody else because they don't know.

NEWSCASTER: AIG plunging. At one point, they were down

NEWSCASTER: If AIG can't raise $20 billion, they'll have to announce bankruptcy tonight.

BROOKSLEY BORN: It was my worst nightmare coming true. Nobody really knew what was going on in the market. The toxic assets of many of our biggest banks are over-the-counter derivatives and caused the economic downturn that made us lose our savings, lose our jobs, lose our homes. It was very frightening.

JOSEPH STIGLITZ: I think to understand the crisis, you have to understand that it had many, many factors that contributed to it. But it's absolutely clear to me that if we had restricted the derivatives, some of the major problems would have been avoided.

TIMOTHY O'BRIEN: Had Brooksley Born been enfranchised, had Brooksley Born been listened to, had Brooksley Born been made part of the process, would that have had a different ending for what subsequently happened in the derivatives market? Certainly.

NARRATOR: In the aftermath, one former member of the working group has had a change of heart about Brooksley Born.

ARTHUR LEVITT: I've come to know her as one of the most capable, dedicated, intelligent and committed public servants that I have ever come to know. I wish I knew her better in Washington. I could have done much better. I could have made a difference.

NARRATOR: And the others? Robert Rubin left government to join top management at CitiBank. The taxpayers have pledged more than $100 billion to keep Citi afloat. Rubin's former deputies, Larry Summers and Timothy Geithner, have become President Barack Obama's chief financial advisers.

Neither Rubin nor his former deputy, Larry Summers, would speak with FRONTLINE about what happened to Brooksley Born. And Rubin's other top deputy, Gary Gensler, now holds Brooksley Born's former post at the CFTC. It still lacks authority to regulate OTC derivatives.

Alan Greenspan retired from the Federal Reserve just before the crisis hit in 2006. Last year, he once again appeared before the Congress.

RON SUSKIND: You see Greenspan at the hearing table after the collapse, and you see a crushed man, really.

ROGER LOWENSTEIN: He said that the premise that you could trust the markets to regulate themselves was misplaced.

Rep. HENRY WAXMAN (D), California: [*October 23, 2008*] You have been a staunch advocate for letting markets regulate themselves. And my question for you is simple. Were you wrong?

ALAN GREENSPAN: Yes. I found a flaw, but I've been very distressed by that fact.

Rep. HENRY WAXMAN: You found a flaw in the reality.

ALAN GREENSPAN: Flaw flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak.

Rep. HENRY WAXMAN: In other words, you found that your view of the world, your ideology, was not right.

ALAN GREENSPAN: Precisely. No, that's precisely the reason I was shocked because I've been going for 40 years or more with very considerable evidence that it was working exceptionally well.

JOSEPH STIGLITZ: After almost two decades of public service, he realizes that the economic philosophy that he had pushed so hard, resisting regulation of derivatives he realized that there were some fundamental flaws in that whole philosophy.

JOE NOCERA: It was a pretty incredible moment that after a lifetime of faith in a certain way the world worked, that Greenspan would say, "I was wrong."

ROGER LOWENSTEIN: It struck me as someone admitting that the core belief that had animated, you know, basically, a 20-year, 18-year career as Fed chief was wrong. It's stunning, but it doesn't undo the damage.

NEWSCASTER: President Obama visits New York today to deliver a major address to Wall Street.

NARRATOR: Last month, the president spoke on Wall Street.

Pres. BARACK OBAMA: We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis.

NARRATOR: Right now, he is deciding how hard to push to regulate the OTC derivative market.

Pres. BARACK OBAMA: We've got to close the loopholes that were at the heart of the crisis. Where there were gaps in the rules, regulators lacked the authority to take action.

NARRATOR: The president's point man, Larry Summers, now says he supports strong regulation of over-the counter derivatives, and Treasury has released a proposal outlining some of the same ideas Born had 11 years ago. But the financial lobby is still against those ideas and is lobbying hard at the White House and in Congress. The new regulations are stalled.

JOSEPH STIGLITZ: I was very hopeful that in the aftermath of the crisis, we could see what had gone wrong and said, "Let's fix it." But it may be that we are passing that critical moment. And in that case, the necessary reforms will be just much more difficult to come by.

NARRATOR: As for Brooksley Born, without new regulations, she's offering another warning.

BROOKSLEY BORN: I think we will have continuing danger from these markets and that we will have repeats of the financial crisis. It may differ in details, but there will be significant financial downturns and disasters attributed to this regulatory gap over and over until we learn from experience.

THE WARNING

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ANNOUNCER: There's more in this report at FRONTLINE's Web site, where you can watch the full program again on line, read FRONTLINE's interviews with Brooksley Born and others, explore our video timeline that tracks the deregulation tide over recent decades and those early financial crises that revealed the dangers of derivatives, plus more analysis from experts. And then join the discussion at PBS.org.

Next time on FRONTLINE, in a corner of New York City

WOMAN: The recession just hit.

ANNOUNCER: inside a shop down the street

WOMAN: I sold the Porsche to pay my health insurance.

ANNOUNCER: from people who could live next door

WOMAN: I'm almost 40 years old. Why should my mother have to give me money?

ANNOUNCER: are intimate stories

MAN: I was laid off eight months ago.

ANNOUNCER: that hit

WOMAN: It's the Upper East Side. This isn't supposed to happen here!

ANNOUNCER: Close to Home. Watch FRONTLINE.

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