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Client Alert

Financial Markets Task Force

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For more information, contact:

Carolyn Z. Alford
(404) 572-3551
czalford@kslaw.com

C. William Baxley
(404) 572-3580
bbaxley@kslaw.com

Sarah R. Borders
(404) 572-3596
sborders@kslaw.com

Daniel F. Donovan, III
(202) 661-7815
ddonovan@kslaw.com

Theodore M. Hester
(202) 626-2901
thester@kslaw.com

Eleanor J. Hill
(202) 626-2955
ehill@kslaw.com

W. Todd Holleman
(704) 503-2567
tholleman@kslaw.com

Allison F. Kassir
(202) 626-5600
Akassir@kslaw.com

Christopher A. Ott
(202) 626-8990
cott@kslaw.com

Thomas J. Spulak
(202) 661-7948
tspulak@kslaw.com

Keith M. Townsend
(404) 572-3517
ktownsend@kslaw.com

House Financial Crisis Hearings Probe Lehman Brothers and AIG; Signal Legislative Reforms

Chairman Henry Waxman (D-CA): "This Committee will make recommendations for legislative solutions to the committees of jurisdiction … these hearings are just the beginning of our efforts."

Congressional oversight hearings are scheduled to resume next week, on Wednesday, October 22, regarding the role of credit reporting agencies in the financial crisis. Last week, the House Oversight and Government Reform Committee, chaired by Rep. Henry Waxman (D-CA), held hearings on the causes and effects of the failures at Lehman Brothers and AIG. The first hearings on the financial crisis opened with partisan salvos. On the eve of the Lehman Brothers hearing, Republican members, led by Ranking Member, Tom Davis (R-VA), called for widening the Committee's probes and released a report entitled, "Examining the Causes of the Credit Crisis of 2008." The report prepared by minority staff argued that Fannie Mae and Freddie Mac "contributed greatly to the problem and…their role was a catalyst for others to become involved and eventually fail."[i] For his part, Chairman Waxman used his opening statement to target President Bush's cousin, George H. Walker—a member of Lehman Brothers' executive committee—in an effort to "portray a company in which there was no accountability for failure."[ii] In the current campaign environment, the partisan recriminations leveled at these hearings will continue to escalate.

A. October 6 Hearing: Lehman Brothers

At the outset of the hearing, Chairman Waxman announced his dual goals "of holding those responsible to public account and identifying the reforms we need for the future." The Committee first heard from a panel of industry experts before turning to its interrogation of Lehman Brothers' CEO, Richard Fuld.

Members of the Committee focused their attention throughout the hearing on the many factors leading to the bankruptcy of Lehman Brothers, including, among others:

- excessive executive compensation
- over-leveraging of Lehman Brothers' assets
- loosening credit standards and over-reliance on the subprime mortgage market
- lax regulating by government agencies
- lacking transparency within the securitization of mortgages
- weakening of disclosure rules, and
- conflicting interests between investment banks and credit rating agencies

Selecting key documents from among the thousands of pages of internal communications provided to the Committee, Chairman Waxman sought to establish a record that Mr. Fuld and other Lehman executives were "getting rich … and steering Lehman Brothers and our economy towards a precipice." Likewise, other members used internal communications and presentations to examine Mr. Fuld and to question the accuracy of Lehman Brothers' financial statements. Many members questioned why Lehman Brothers was allowed to fail. Rep. Dennis Kucinich (D-OH) asked Mr. Fuld several pointed questions about Lehman Brothers' negotiations with the Treasury Department over a taxpayer-funded rescue and whether the agency had been forthcoming in its dealings with him. Other Committee members suggested Treasury Secretary Henry M. Paulson had a conflict of interest in bailout negotiations, given his role as the former Chairman of Goldman Sachs. Chairman Waxman's closing remarks, which focused on Mr. Fuld's failure to acknowledge any wrongdoing and his substantial compensation, indicated that executive compensation reform will continue to be a central focus of his oversight hearings.

B. October 7 Hearing: AIG

On the second day of the hearings, the Committee turned its attention to AIG. Responding to Republican criticism, Chairmen Waxman agreed to schedule hearings on the role of Fannie Mae and Freddie Mac in the financial crisis. Following a script certain to play out at future hearings, Chairman Waxman once again sought to draw conclusions from select internal corporate communications and documents provided to the Committee. [iii] In his opening remarks, he raised "three fundamental sets of questions" to be asked at the hearing, including:

1. whether AIG's executive compensation practices were fair and appropriate
2. whether AIG's former CEOs bear responsibility for the collapse of AIG, and
3. whether AIG misled investors and the public about AIG's financial condition

Among the "mistakes and excesses" leading to the government bailout of AIG, hearing witnesses testified that the following factors contributed to the need for a rescue plan for AIG:

- unsound investor business practices, including potentially illegal practices
- mark-to-market accounting rules and the resulting downgrade of AIG's values
- excessive executive compensation and poor governance by the Board of Directors
- lack of transparency within the credit default swaps (CDS) market, including $62 trillion in unregulated derivates, which negatively influenced investor confidence
- inadequate due diligence by investment banks
- cheap debt and tremendous leverage in debt
- lack of SEC resources and regulatory authority
- failure of the Federal Reserve to identify and rectify unsound lending practices
- growth of financial institutions considered "too large to fail," and
- lack of risk management controls so severe that the Office of Thrift Supervision warned AIG

The Committee probed AIG's involvement in the CDS market and the decision-making that led AIG's corporate leaders to enter the CDS market. Members of both parties expressed concern that AIG policy holders were put at risk because AIG's financial-products division focused so heavily on the CDS market. There was also discussion of whether AIG's insurance policy holders, investors, and government regulators were sufficiently aware of the risks associated with CDS and other risky ventures pursued by AIG's financial-products division. Documents released at the hearings raised allegations that top officials at AIG knew of the company's risk exposure and material liabilities and misled its auditors and investors.

In addition to examining the causes of AIG's near-bankruptcy, the Committee sharply criticized the actions of AIG since the bailout. Members of both parties were critical of AIG's executive compensation policies, its use of the majority of the $85 billion federal loan in a very short time period, and the corporate retreat taken by AIG executives a week after its bailout by taxpayers. AIG's actions in the wake of their bailout are likely to intensify Congressional focus on corporate excesses and executive compensation reforms.

C. Committee Members Signal Potential Legislative Solutions

Aside from the oversight hearings scheduled this month, Speaker Pelosi's agenda on the financial crisis also includes forward-looking hearings to be scheduled by Rep. Barney Frank (D-MA), chairman of the House Financial Services Committee and by other committees of jurisdiction. At both oversight hearings last week, Committee members discussed potential solutions to the financial crisis, including:

- limiting executive compensation, including "say on pay proposals," granting shareholders an appointee on corporate Boards, and providing clawback provisions for compensation packages
- reconsidering the SEC's 2005 decision to allow greater leverage of assets
- requiring greater transparency within the securitization of mortgages, especially in the credit default swaps market

- strengthening disclosure rules to better reflect focus on protecting investors
- reviewing potential conflict of interests between investment banks and credit rating agencies
- regulating credit default swaps and other risky, exotic financial products
- repealing the Gramm-Leach-Bliley Act
- restructuring the Federal Reserve and SEC
- strengthening guidelines walling off insurance assets from risky financial products
- reconsidering the McCarran Ferguson Act, including potential federal regulation of insurance, and
- reconsidering the repeal of the Glass-Steagall Act

D. Hearings Scheduled Next Week

Wednesday, October 22: The Breakdown of Credit Rating Agencies

Executives from three credit rating agencies will testify regarding "*the role of the credit rating agencies in the financial excesses on Wall Street*":

Deven Sharma, President, Standard & Poor's
Raymond W. McDaniel, Chairman and Chief Executive Officer, Moody's Corporation
Stephen Joynt, President and Chief Executive Officer, Fitch Ratings

Thursday, October 23: The Role of Federal Regulators

Invited witnesses will testify regarding "*the role and responsibility of federal regulators in the Wall Street financial crisis*":

Alan Greenspan, Former Federal Reserve Chairman
John Snow, former Treasury Secretary
Christopher Cox, current SEC Chairman

[i] http://republicans.oversight.house.gov/media/pdfs/20081006FinancialCrisisReport.pdf
[ii] http://oversight.house.gov/story.asp?ID=2210
[iii] http://online.wsj.com/article/SB122368147261224877.html?mod=googlenews_wsj#