May 19, 2009

Letter sent to the Chair and Ranking Member of:

U.S. Senate Committee on Banking, Housing, and Urban Affairs
U.S. Senate Committee on Finance
U.S. House Committee on Financial Services
U.S. Joint Economic Committee

Dear Chair and Ranking Member:

The Project On Government Oversight (POGO) is writing to you today to raise concerns about the serious potential for conflicts of interest involving firms that are being hired by the Federal Reserve and Treasury Department to manage and provide “independent” advice on the valuation of toxic assets.

POGO is an independent nonprofit that investigates corruption and other misconduct in order to achieve a more effective, accountable, open, and ethical federal government. Although POGO takes no policy position on the strategic merits of the government’s plan to stabilize the nation’s financial system, we believe it is essential that the ongoing expenditure of billions of taxpayer dollars be subjected to extraordinary scrutiny. As such, we encourage Congress to provide greater oversight of the Fed and Treasury’s use of private asset managers, many of which have a direct financial interest in the same types of toxic assets that they are managing and valuating for the government.

The Federal Reserve and Treasury’s Reliance on Private Asset Managers

Private asset managers are now playing a pivotal role in programs managed by both the Fed and Treasury. The Federal Reserve Bank of New York (“New York Fed”) has hired four private firms to manage its $1.25 trillion mortgage-backed securities purchase program: Pacific Investment Management Co. (PIMCO), BlackRock, Inc., Goldman Sachs Asset Management, and Wellington Management Company, LLP. ¹ The New York Fed has also retained BlackRock as an asset manager for all three of its Maiden Lane portfolios: Maiden Lane LLC, which was formed to facilitate JP Morgan’s acquisition of Bear Stearns, as well as Maiden Lane II LLC and Maiden Lane III LLC, both of which were formed to facilitate the restructuring of the New York Fed’s financial support to American International Group (AIG).²

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This week, Treasury is expected to approve five private fund managers for its Legacy Securities Program. These fund managers will be raising equity capital from private investors for joint investment partnerships with Treasury that will invest in commercial and residential mortgage-backed securities.\(^3\)

BlackRock and PIMCO both submitted applications to this program, and are widely expected to be approved.\(^4\) In addition, these same firms could potentially bid for illiquid loans and assets through the Legacy Loans Program, which is being managed by Treasury and the Federal Deposit Insurance Corporation (FDIC). As part of this program, the FDIC will also be hiring a third party valuation firm to help determine the valuation of eligible asset pools.\(^5\)

**Potential Conflicts of Interest**

It’s perfectly understandable that the government is relying on the expertise of these private fund managers to assist with the complex tasks of asset management and valuation. POGO is concerned, however, about the conflicts of interest that could arise if these fund managers are also investing in the same types of assets for their private clients. These conflicts of interest could have a wide range of consequences, including financial losses for the American taxpayer, an unfair competitive advantage for the fund managers, and the continued erosion of public confidence in the government’s ability to stabilize the financial system.

Citing two people with knowledge of the arrangement, Bloomberg News recently reported that PIMCO had been advising the federal government on the value of $118 billion in assets—including securities backed by residential and commercial loans—that were guaranteed in the bailout of Bank of America Corp. But PIMCO had also been investing in these same types of mortgage-backed securities for a wide range of private clients. In fact, as of March 31, 2009, PIMCO was carrying around $967 million in its mortgage-backed securities fund.\(^6\) Bloomberg quotes Representative Scott Garrett (R-NJ) in describing PIMCO’s apparent conflict of interest: “Pimco and others potentially have two masters to serve: the U.S. taxpayer and their own fiduciary obligations to clients.”\(^7\) In the end, Bank of America decided not to go through with this arrangement, but it highlights the type of conflict that POGO is concerned about.

The financial interests of BlackRock may be even more entangled, especially given its multiple existing arrangements and contracts with the government. Another recent article in Bloomberg

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described BlackRock as the “dominant player in evaluating and pricing distressed assets,” with “more contracts from the government, investment banks and insurance companies than other firms.” According to Bloomberg, BlackRock is currently managing $130 billion in toxic assets for the Fed and Treasury, and could soon be purchasing billions more if it is approved as one of the fund managers for the Legacy Securities Program. BlackRock CEO Larry Fink has denied that any conflicts of interest could result from his firm managing and also purchasing toxic assets for the government: “I don’t get any inside information, and it’s a competitive auction pool.” In the meantime, he has declined to share much information about the assets BlackRock is managing for its private clients: “I have to be opaque....It’s hundreds of billions and not necessarily for the U.S. government.”8 In fact, the company’s website boasts that BlackRock Solutions—the subsidiary that is managing $130 billion in assets for the government—provides “services for more than US $7 trillion in securities and derivatives across more than 95 clients, many of whom are among the largest and most sophisticated financial institutions in the world.”9

Additional concerns have been raised about the way in which BlackRock received its government contracts. Although the Fed is not required to follow the same contracting rules and regulations that apply to most government agencies, the Government Accountability Office has reported that the Federal Reserve Board typically follows the “spirit of the federal government contracting rules,” and that the Reserve Banks are supposed to follow internal acquisition guidelines which stipulate that “invitations to bid and requests for proposals should be sent to as many interested suppliers as possible to ensure competition.”10 Yet the New York Fed has awarded BlackRock three no-bid contracts to oversee the bank’s acquisition of troubled assets, according to a recent article in The New York Times. In the case of BlackRock’s contract to facilitate JP Morgan’s acquisition of Bear Stearns (Maiden Lane LLC), fees were not established until after the contract was awarded.11

And while Treasury has yet to name its five fund managers for the Legacy Securities Program, concerns have already been raised about potential conflicts of interest. The most recent report to Congress by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) found that the Legacy Securities Program and Legacy Loans Program are both “inherently vulnerable to fraud, waste, and abuse.” The report warns Congress that conflicts of interest could come into play because “the same entity might buy and sell toxic assets for its own benefit and manage portfolios of toxic assets for others, all while holding or managing equity or debt securities of the banks and other institutions that have large positions in the same toxic assets.” It goes on to describe this potential conflict in some detail:

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By their nature and design, including the availability of significant leverage, the PPIF [Public-Private Investment Fund] transactions in these frozen markets will have a significant impact on how any particular asset is priced in the market. As a result, the increase in the price of such an asset will greatly benefit anyone who owns or manages the same asset, including the PPIF manager who is making the investment decisions.

The incentives [to overpay for an asset] exist, for example, even if the fund manager does not own MBS [mortgage-backed security] X but is merely managing other funds that hold MBS X, as the manager earns fees based on the value of that fund, a value that would, in this example, be significantly overstated (temporarily) as it can increase the value of that fund based on valuing, or “marking” the MBS X at the inflated “market” price that it set. The conflict can even exist if the manager holds or manages equity tied to the value of the banks from which the MBS are being purchased; here, using PPIF funds to overpay for bank assets may increase the bank’s stock price, thus giving a greater profit to the fund manager.12

Although the details of these programs are still being negotiated, it’s worth pointing out that the initial terms of the Legacy Security Program stated that the fund managers would be pre-qualified based on anticipated criteria including “a minimum of $10 billion (market value) of Eligible Assets under management,”13 further underscoring the potential for the types of conflicts highlighted in the SIGTARP report.

Congressional Oversight

We appreciate the initial efforts by Congress to oversee these asset managers and their conflicts of interest, but we hope you will agree that the answers you’ve received so far have been less than satisfactory.

On April 2, 2008, at a hearing before the Joint Economic Committee, Senator Bob Casey (D-PA) asked Fed Chairman Ben Bernanke to explain how the Fed came to hire BlackRock as an asset manager for the Bear Stearns deal, and to disclose how much the firm would be paid. Chairman Bernanke replied that the Fed was “operating under extreme time constraints” and confirmed that the New York Fed “engaged BlackRock on a fee-to-be-determined-later basis,” but did not reveal any more details about the highly unusual deal.14

The next day, at a hearing before the Senate Committee on Banking, Housing, and Urban Affairs, Senator Wayne Allard (R-CO) posed a similar question to then-New York Fed President Timothy Geithner, who explained that he “made the judgment that we should have a world class adviser sitting there with us. And in that period of time—very little time—we made the best

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judgment we could about what firm would have the mix of expertise, knowledge, experience and independence that could best provide that judgment. I think [BlackRock] met that test.\textsuperscript{15}

On January 21, 2009, at a hearing before the Senate Finance Committee to consider Geithner’s nomination as Treasury Secretary, Senator Charles Grassley (R-IA) asked him why BlackRock was “the only firm qualified to value and manage the assets of special purpose vehicles.” Secretary Geithner replied that “they came with a world-class reputation and a set of expertise in doing that, and we thought the interest of the American taxpayer would be best served by having them there on our side as we made those consequential judgments.”\textsuperscript{16}

A few months earlier, Senator Grassley and Senator Max Baucus (D-MT) had sent then-New York Fed President Geithner a list of questions about the Bear Stearns deal. When asked to identify the assets in the Maiden Lane LLC portfolio, Geithner made the curious argument that “public disclosure of individual assets in the collateral pool and of the hedging strategies that are employed to reduce the risk in the portfolio would undermine our ability to best protect the taxpayer against loss on the liquidation of the portfolio,” although he apparently agreed to provide this information to the Finance Committee staff on a confidential basis. When asked how BlackRock was selected as the asset manager, Geithner pointed out that the New York Fed’s acquisition guidelines “recognize that exigent circumstances may require an exception to the normal competitive bidding process,” and explained that BlackRock was selected for its “technical expertise, operational capacity, and track record.” And when asked for a copy of the BlackRock contract, Geithner invited the Committee staff to visit the New York Fed to review the “details of these arrangements on a strictly confidential basis.”\textsuperscript{17}

On February 10, 2009, at a hearing before the House Financial Services Committee, Representative Spencer Bachus (R-AL) asked Chairman Bernanke to describe what the Fed is doing to identify and mitigate any potential conflicts of interest involving the private asset managers. Chairman Bernanke replied that “it’s probably impossible to completely separate, you know, these firms from the other organizations in some sense….But these companies, of course, have to establish credibly that they do have separations between their different activities. Otherwise, nobody would use them because of concerns about conflict of interest.”\textsuperscript{18}

Finally, on April 23, 2009, in response to written questions from Representative Alan Grayson (D-FL), Chairman Bernanke stated that BlackRock employees “assigned to managing the assets of the Maiden Lane entities must be segregated from those personnel who work on BlackRock’s trading and sales activities or any other transactions that could be in conflict with BlackRock’s


role as investment manager.” He also pointed out that BlackRock is prohibited from using the confidential information it receives from the Fed for other transactions. And in response to a question about how BlackRock came to be selected as manager of the Maiden Lane portfolios, Chairman Bernanke explained that New York Fed officials “determined that an exception to the competitive bidding provisions of the Acquisition Guidelines was appropriate,” and that BlackRock was chosen for its “technical expertise, operational capacity, and track record.”

Conflict of Interest Policies

Not surprisingly, the private asset managers have also defended their contracts and arrangements with the government, arguing that the potential for conflicts of interest is greatly deterred by internal firewalls that separate the employees working on the government contracts from the employees working for private clients. PIMCO Managing Director Bill Gross has even claimed that the people working on the government contracts are “housed in a different building.”

It’s clear that the government should be collecting much more information from these asset managers before drawing any conclusions about their conflicts of interest. But it appears that both the Fed and Treasury are mostly relying on the asset managers for self-disclosure. Treasury’s interim conflict of interest rule for the TARP specifically mentions that organizational conflicts of interest could arise if a “retained entity provides services for Treasury relating to the acquisition, valuation, disposition, or management of troubled assets at the same time it provides those services for itself or others.” However, a public comment by the American Bar Association argues that Treasury is relying too much on self-disclosure by the asset managers, and calls for “greater participation by agency personnel in the planning stages in identifying potential OCIs [organizational conflicts of interest], negotiating the neutralization or mitigation of OCIs, and monitoring OCI risks during performance.”

It is imperative that Treasury establish strong conflict of interest policies for the TARP, because while the firms that were awarded TARP procurement contracts also have to follow the conflict of interest rules in the Federal Acquisition Regulation, it appears that other firms are being retained as “financial agents” and would only have to follow the TARP rules. For instance, Treasury has entered into a financial agency agreement with Bank of New York Mellon (BONY)

to serve as the master custodian for the TARP, but BONY also received $3 billion in TARP funds under the Capital Purchase Program. While this has raised obvious concerns about potential conflicts of interest, it appears that BONY would only have to follow the TARP rules, which at the moment give the bank significant leeway to manage its own conflicts.

The Fed also seems to be content to allow its asset managers to handle their own conflicts of interest. In a section of its website dedicated to Frequently Asked Questions about the mortgage-backed security (MBS) purchase program, the New York Fed stipulates that “each investment manager will be required to implement ethical walls that appropriately segregate the investment management team that implements the Federal Reserve’s agency MBS program from other advisory and proprietary trading activities of the firm.” In light of the complex entanglement of firms like BlackRock in the MBS market, this anemic policy is hardly sufficient to manage the conflicts of interest that are likely to arise.

**Additional Opportunities for Oversight**

As Treasury selects its initial fund managers for the Legacy Securities Program, we urge you to take this opportunity to conduct an overall review of the government’s reliance on fund managers for the management and valuation of toxic assets, and to consider alternative approaches that would better protect the government’s interests.

There are several alternatives that Congress might consider. For instance, the Fed and Treasury could prohibit fund managers from both purchasing and valuating the same types of toxic assets. Fund managers could also be required to divest in certain types of toxic assets when managing or valuating these assets for the government. Or, if Congress determines that it would be impossible to adequately mitigate the conflicts of interest involving private asset managers, it could require the Fed and Treasury to turn to more independent accounting firms to assist with asset valuation.

We also urge you to consider whether internal ethical walls and self-disclosure are the best mechanisms for identifying and mitigating conflicts of interest among private fund managers and their employees. Given the sheer quantity of assets involved, and the serious potential for conflicts of interest, Congress should ask the GAO or SIGTARP to immediately review these internal company firewalls to determine their effectiveness.

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Overall, POGO believes that Congress should be demanding that the Fed and Treasury take a more proactive role in protecting the government from the conflicts of interest that are likely to arise from the use of private fund managers for asset management and valuation.

We look forward to working with your Committee on this important issue. If you have any questions or need additional information, please contact me at (202) 347-1122.

Sincerely,

[Signature]

Danielle Brian
Executive Director

cc: Special Inspector General for the Troubled Asset Relief Program Neil Barofsky
Congressional Oversight Panel (COP) Chair Elizabeth Warren and COP Members