Opening Statement
of
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Chairman, Domestic Policy Subcommittee
Oversight and Government Reform Committee
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On December 5, 2008, the shareholders of Bank of America voted to approve a merger with Merrill Lynch. Only twelve days later, Ken Lewis, CEO of Bank of America, made a call to then-Secretary of Treasury Hank Paulson, initiating a process that led to a $20 billion bailout of the merger and a promise of government insurance for losses of up to $118 billion. The chronology of events strained belief. Was it true that the financial situation at Merrill Lynch shifted so dramatically in that short amount of time, as Ken Lewis said? Or did top management know, or should they have known, about the deteriorating situation at Merrill Lynch much earlier? Did they fail to make necessary disclosures to the shareholders?

In the course of this investigation, we discovered that top officials at the Federal Reserve had come to the conclusion that Bank of America knew or should have known in mid-November about the mounting losses that ultimately led them to appeal to the U.S. Government for a rescue. In fact, the top lawyer at the Fed speculated in email to Chairman Bernanke that Bank of America may be liable for securities law violations as a result of not disclosing that information to shareholders.

After reviewing over 400,000 pages of documents and interviewing the key players at Bank of America, Merrill Lynch and the law firm of Wachtell, Lipton, Rosen & Katz, we have found evidence of possible securities law violations at Bank of America:

- Bank of America relied on the November 12 forecast for Fourth Quarter '08, created by Merrill Lynch, that, <u>omitted any forecast</u> of how collateralized debt obligations, subprime mortgage backed securities, credit default swaps – would perform in the quarter.

- The former Merrill CFO admitted to staff that the November 12 forecast was not, in fact, a valid forecast.

- Bank of America knew at the time that the November 12 forecast was of "questionable validity."

- However, Bank of America did not do any actual financial analysis to make up for the Merrill omissions. Instead, Bank of America merely pulled a number out of thin air on November 13, which was recorded on the forecast document as the "gut" feeling of Neil Cotty, Bank of America's Chief Accounting Officer. Bank of America simply created an assumption that Merrill Lynch' illiquid assets would almost break even for November, thereby spreading October's bad results over two months.

- The attorneys at Bank of America and at Wachtell, Lipton did not question the financial information they were given, in spite of the glaring and obvious omission and the explicit reference to a "gut" feeling. They advised Bank of America not to make further disclosures to its shareholders in advance of the merger vote, based on the information in the deficient forecast and a "gut" feeling.

Within only weeks, however, reality crowded out wishful thinking. Merrill Lynch's exotic investments continued to lose large amounts of money, causing Merrill to lose over $21 billion in just the Fourth Quarter. Bank of America went running to the U.S. Government for a rescue.

When I asked Ken Lewis, Bank of America's CEO, about why he had not disclosed the mounting losses to shareholders before the shareholder vote, he told this Committee that he relied on the advice of counsel. Protecting shareholders is often, in the final instance, the practical responsibility of corporate General Counsels and their outside counsel. The Subcommittee's investigative findings demand the question, "Where were the lawyers?" The glaring omissions and inaccurate financial data in the critical November 12 Forecast make Bank of America's decision not to disclose to shareholders unsupportable. Furthermore, the flaws in the forecast document were so obvious that they should have alerted the attorneys to the necessity of a reasonable investigation before making a decision on Bank of America's legal duties to disclose. The apparent fact that they did not mount such an investigation makes the decision not to disclose Merrill's losses to shareholders an egregious violation of securities laws.

As a law enforcement matter, the Subcommittee's findings form the basis of three possible legal violations.

First, a violation of Section 11 of the 1933 Securities Act, which creates private civil liabilities for false registration statements. Here, the question is, did Ken Lewis, Joe Price, Tim Mayopoulous and the Wachtell, Lipton attorneys *reasonably* rely upon the Neil Cotty guesswork and the deficient Merrill Lynch forecast?

Second, a violation of Rule 14a-9 of the 1934 Exchange Act. Rule 14a-9 prohibits false or misleading proxy solicitations. Here the question is, were Lewis, Price, and Mayopoulos *negligent,* and were the attorneys at Wachtell, Lipton *reckless*, in relying upon Merrill Lynch's deficient forecast and Cotty's guesswork?

Third, a violation of Rule 10b-5 of the 1934 Act, which makes it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Here the question is, were Bank of America and their attorneys

reckless, i.e., did their conduct constitute an extreme departure from, or disregard for ordinary care?

The broader question before the SEC is, Will they allow corporate management to rely upon the advice of counsel defense, and then allow the counsel to avoid liability for their advice? This question, in the context of whether a securities fraud was perpetrated when Bank of America failed to disclose information relating to mounting losses at Merrill Lynch before the shareholder vote on the merger, should be central to SEC's enforcement action against Bank of America.

The stage for these possible violations was set by former SEC Chairman Christopher Cox. Bank of America's conduct, potentially illegal conduct, was the culminating corporate reaction to the years of regulatory retrenchment and serious and substantial weakening of enforcement and deterrence at SEC under Chairman Cox.

In 2006, Chairman Cox initiated a policy, known as the corporate penalty Pilot Program, that required enforcement staff to pre-clear proposed corporate penalties with the Commission. The resulting delays, and the concerted action of the Commission to reduce proposed penalties, had the effect of reducing significantly the amount of penalties ordered by SEC. GAO recently found that the tumble in penalties accelerated 39 percent in 2006, another 48 percent in 2007, and then 49 percent in 2008. So at exactly the time that CDOs, CDS, and other exotic investments proliferated in financial markets, Cox's SEC was reducing investigations and penalties for financial fraud. It might as well have been financial regulation according to Cole Porter's 1936 song, "Anything Goes." "The world has gone mad today/ And good's bad today/ And black's white today/ And day's night today." Under Cox's watch, according to GAO, "it became more difficult [for SEC enforcement staff] to obtain 'formal orders of investigation,' which allow issuance of subpoenas to compel testimony and produce books, records, and other documents. Since fiscal year 2005, the number of formal orders approved by the Commission has decreased 14 percent."[1]

Against that record of scandalous performance, current Chairman Schapiro's efforts signal an important turn around. For instance, Chairman Schapiro rescinded the Cox policy of discouraging penalties and formal orders for investigation upon taking office. Chairman Shapiro appointed Robert Khuzami to reinvigorate enforcement at SEC. Nevertheless, Judge Jed Rakoff was unimpressed. In September of this year, he struck down a settlement of charges that Bank of America made false and misleading statements to shareholders regarding $5.8 billion in bonuses awarded by Merrill Lynch after the shareholder vote. Though SEC is now litigating, I am concerned that a pernicious aspect of the Cox legacy may have survived: The unwillingness to pursue, as GAO wrote, "more complicated cases, those based on novel legal reasoning, or those with industry

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[1] Government Accountability Office, "Securities and Exchange Commission: Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement," GAO-09-358 at 7 (Mar. 2009).

wide implications, in favor of those seen as more routine."[2] While I applaud the SEC for enforcing the law in the case of the non-disclosure of the Merrill bonuses, Bank of America's failure to disclose accelerating losses at Merrill Lynch to shareholders before their vote on December 5 is more significant. Indeed, the magnitude of the undisclosed losses dwarfs the undisclosed bonuses on which the SEC has thus far focused.

Over the many months of this investigation, we have provided our findings to SEC. The investing public, and now this Congressman, want to know, where is the SEC in pursuing egregious disclosure violations involving billions of rapidly growing trading losses?

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[2] *Id*. at 42.