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# United States Senate

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August 6, 2010

The Honorable Mary L. Schapiro  
Chairwoman  
United States Securities and Exchange Commission  
100 F Street, NW  
Washington, DC 20549

Dear Chairwoman Schapiro:

The financial crisis has taught us a great deal, and we are very pleased that the Dodd-Frank Wall Street reform bill incorporates much of this new wisdom. It will go a long way toward reducing the frequency and severity of future financial crises.

As you set out to implement this new law, we write to address one area that we believe needs particular attention: how completely and accurately companies disclose their financial information. Without such disclosure, it is almost impossible for regulators to set appropriate capital and leverage requirements and for investors and counterparties to make wise decisions about where to put their money.

This, unfortunately, is a lesson that we should have learned from Enron and the corporate accounting scandals that led to the passage of the Sarbanes-Oxley Act of 2002. Enron reportedly maintained 3,500 off-balance sheet partnerships on which the company built an elaborate fiction of earnings statements. The Sarbanes-Oxley Act gave the Securities and Exchange Commission (SEC) the power to require reporting of off-balance sheet activities.

While the SEC did issue rules on off-balance sheet activity pursuant to Sarbanes-Oxley, we are troubled that despite these rules, widespread off-balance sheet accounting arrangements allowed large financial firms to hide trillions of dollars in obligations from investors, creditors, and regulators. As Frank Partnoy and Lynn E. Turner wrote in a recent report, "Abusive off-balance sheet accounting was a major cause of the financial crisis. These abuses triggered a daisy chain of dysfunctional decision-making by removing transparency from investors, markets, and regulators. Off-balance sheet accounting facilitated the spread of the bad loans, securitizations, and derivative transactions that brought the financial system to the brink of collapse."<sup>1</sup>

For example, Citigroup reportedly kept \$1.1 trillion worth of assets off its books in various financing vehicles and trusts that were used to handle mortgage-backed securities and issue short-term debt.<sup>2</sup> State Street shareholders saw their investment value drop by 60% in a single day when hidden off-balance sheet conduits sustained heavy losses under credit turmoil in

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<sup>1</sup> Frank Partnoy and Lynn E. Turner, "Bring Transparency to Off-Balance Sheet Accounting," in *Make Markets Be Markets*, The Roosevelt Institute, March 3, 2010, [http://www.makemarketsbemarkets.org/modals/report\\_off.php](http://www.makemarketsbemarkets.org/modals/report_off.php)  
<sup>2</sup> Bradley Keoun, "Citigroup's \$1.1 Trillion of Mysterious Assets Shadows Earnings," *Bloomberg News*, July 14, 2008

January 2009.<sup>3</sup> Neither of these companies adequately disclosed the risks posed by their off-balance sheet activities to investors. Had they done so, investors and creditors might have made better decisions.

For these reasons, we urge the SEC to use its existing authority under Sarbanes-Oxley to require that companies write detailed descriptions of all their off-balance sheet activities in their annual 10K reports (not just those that are “reasonably likely” to affect the firm’s financial condition, as the regulations currently state). Companies should also explicitly justify why they have not brought those liabilities onto the balance sheet. Complete disclosure of all off-balance sheet activities is particularly crucial for the largest and most interconnected companies, including both banks and non-banks. Additionally, we also urge the SEC to encourage the Financial Accounting Standards Board (FASB) to improve financial reporting rules for all types of off-balance sheet activities and to monitor FASB’s efforts to prohibit off-balance sheet financing.

We urge the SEC to pay particular attention to the large market for repurchase agreements. We are concerned by both the risks of using short-term funding for longer-term holdings and that firms may be engaging in these transactions *with the intent* to hide their true debt and risk levels. For example, the Lehman Brothers use of the “Repo 105” transaction is particularly troubling. According to the Lehman Brothers Examiner’s Report conducted by Anton Valukas, Lehman took advantage of accounting rules to temporarily book a loan as a sale, and by carefully timing this transaction just before the release of its quarterly financial report, Lehman was able to deceive the public and regulators into thinking it was much better capitalized than it actually was.

Moreover, this may not be limited to Lehman. According to the *Wall Street Journal*, “A group of 18 banks—which includes Goldman Sachs Group Inc., Morgan Stanley, J.P. Morgan Chase & Co., Bank of America Corp., and Citigroup Inc.—understated the debt levels used to fund securities trades by lowering them an average of 42% at the end of each of the past five quarterly periods, the data show. The banks, which publicly release debt data each quarter, then boosted the debt levels in the middle of successive quarters.”<sup>4</sup>

Those who engaged in fraud in the past must be held accountable under our existing securities fraud statutes. But we must also look forward. In order to prevent this from happening in the future, we urge the SEC to require disclosure of period end and daily average leverage ratios in quarterly and annual reports. This would provide useful information to investors and creditors to assist their decision-making processes. Rather than relying on carefully-staged quarterly and annual snapshots, investors and creditors should have access to a complete real-life picture of a company’s financial situation.

The SEC was founded on the premise that when investors and creditors have full and accurate information about companies’ finances, they can allocate capital effectively. But when companies use accounting gimmicks to mislead investors and creditors, capital markets

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<sup>3</sup> Jim Spence, “State Street shares lose more than half their value,” *Marketwatch*, Jan. 20, 2009

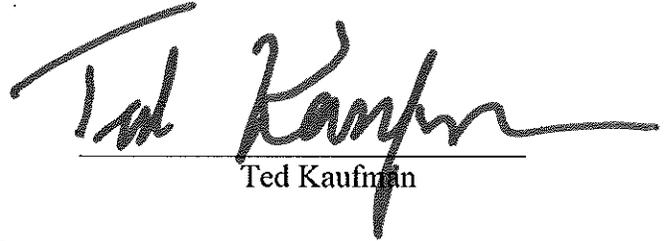
<sup>4</sup> Kate Kelly, Tom McGinty, and Dan Fitzpatrick, “Big Banks Mask Risk Levels,” *Wall Street Journal*, April 9, 2010

malfunction. As we attempt to recover from the latest meltdown, we hope that, in addition to aggressively investigating and prosecuting past misconduct, you will put in place these new rules that will make it harder for companies to mislead investors and creditors in the future.

Sincerely,



Robert Menendez



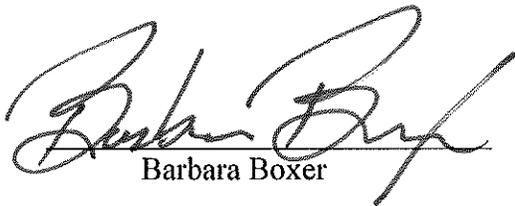
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Carl Levin



Dianne Feinstein



Barbara Boxer



Sherrod Brown