Government Taps Bailout Contractors With Conflicts of Interest

Firms With Ties to Banks Can Work Both Sides of Rescue

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As the Wall Street bailout nears its first anniversary, the controversy over giving public money to private banks has become public knowledge. But an equally risky aspect of the financial rescue has flown largely under the radar: the government's reliance on private contractors – many with potentially significant conflicts of interest – to help revive the stalled economy.

The Treasury Department knows that the law firms and investment managers hired to aid its salvage effort could be influenced by their ties to bailed-out banks; in fact, the department released a rule in January aiming to mitigate the problem.

That rule, however, has raised questions from watchdogs by asking contractors to identify and police their own conflicts of interest. And a careful review of bailout hiring agreements reveals an inconsistent set of rules applied to the types of private deals that contractors can make while serving as agents of the U.S. government.

"It's just a wonderfully closed circle," Simon Johnson, former chief economist at the International Monetary Fund and leading critic of the bailout, said in a recent interview.

"They'll sell you on this line that there's a scarcity of talent," so contractors must be plucked from Wall Street and remain part of its culture, Johnson continued. "It's the same argument they're using to explain why they're appointing a Goldman Sachs lobbyist as [Treasury Secretary Tim] Geithner's chief of staff. That's part of how the club thinks."

Can these contractors guide the bailout with the public interest in mind while simultaneously courting bailout-related business for themselves? It's tough to say, but imposing greater transparency requirements is crucial, according to more than a dozen financial and legal experts interviewed for this story.

Right now, even as more of these lawyers and financiers are helping with the financial rescue, less is being disclosed about their handling of taxpayer-owned assets. Investment managers are setting values for securities that their companies may also hold privately, while law firms are approving government aid for companies they still represent in certain cases – but the public remains almost completely in the dark.

The Investment Managers

Consider the case of AllianceBernstein. Like many investment management firms, Alliance

did not have a good 2008. Assets dropped by more than 40 percent, net income fell by one-third and the company was forced into its first layoffs in 35 years.

Yet things were looking up by late April, thanks to the Treasury. Alliance was one of three firms the department chose to monitor the assets and debt of banks receiving bailout. Its contract involves Alliance in highly sensitive issues, from executive pay limits to the execution of government stock warrants.

“We expect this to be an attractive proposition from a profitability point of view,” CEO Peter Kraus told analysts as he announced the news.

But Alliance executives also told analysts that the firm plans to apply for the Treasury’s Public-Private Investment Program, which could allow the firm to leverage its look at banks’ balance sheets into profits down the road.

If Alliance joins the PPIP, the company could partner with private investors to purchase the same types of mortgage-backed securities that it’s also handling for the government – thus earning a double windfall when the market value of those mortgage-backed securities increases.

Neil Barofsky, the special inspector general for the Troubled Assets Relief Program warned of this potential conflict in his most recent report to Congress: “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 [public-private program] manager who is making the investment decisions…”

Under the Treasury’s conflict-of-interest rule, Alliance and its fellow contractors (FSI Group and Piedmont Investment Advisors) are only required to step aside from managing assets owned by a bailed-out bank if that bank’s assets provided more than 5 percent of the firm’s most recent annual revenue.

The contracts signed by Alliance, FSI and Piedmont, posted on the Treasury’s website, acknowledge six potential conflicts of interest and suggest how each can be worked around. Yet Treasury did not reveal which banks’ assets were given to which contractor, or even whether the investment managers are doing anything with the securities they’re being paid to watch.

An Alliance spokesman declined to comment when asked how the firm is working out any conflict-of-interest risks it may face.

“The whole idiocy of this,” Chris Whalen, co-founder of the banking risk-management firm Institutional Risk Analytics, said during a recent conversation, “is that the administration would even have these firms pretending to manage this stuff, giving them subsidized deals.”

Alliance is now poised to value assets once held by Merrill Lynch – the same company that paid Alliance CEO Kraus a $25-million bonus for three months of work. Kraus’ bonus, distributed just before Merrill was sold to Bank of America, was part of a $3.6 billion pot that is now under investigation by the New York attorney general and the Securities and Exchange Commission.

A Treasury spokesman did not respond to several requests for comment on conflicts of interest, but did point to its January regulation as evidence of the government's action on the issue and awareness of possible problems.

The Law Firms

The risk of conflicts of interest is not limited to asset managers sitting on toxic mortgage-backed assets. Simpson Thacher & Bartlett, the prominent New York law firm chosen in October to be the chief legal adviser to the TARP, has a long history of shepherding mergers and acquisitions in the banking industry, particularly during the housing bubble's halcyon days.

Before the bailout began, Simpson Thacher had advised Washington Mutual on avoiding insolvency and the board of AIG on winning help from the Federal Reserve. Come the crash, however, the law firm was put in charge of setting terms for the government's investment in major banks – on the opposite side of the table from the banks it once helped make mighty.

Simpson Thacher's original contract, signed in October, did not mention the need to work around or waive conflicts. When the law firm agreed to expand its bailout work in February, however, that pact stated that Treasury "HAS NOT WAIVED any potential conflicts of interest" – giving the government room to make case-by-case decisions if problems arose.

Yet the law firm's contract, however, appears to allow an inherent conflict of interest: The Treasury cleared Simpson Thacher to continue representing private clients participating in "other programs in support of the [bailout]" – non-TARP initiatives such as the PPIP or the Term Asset-Backed Securities Loan Facility.

In fact, Simpson Thacher senior partner Lee Meyerson, whose pivotal role in the TARP made him American Lawyer's No. 4 "Dealmaker of the Year," continued to advise private-equity clients on how to snap up failing banks while he worked on the bailout. When Florida's BankUnited collapsed last month, costing the government $4.9 billion, three private equity firms represented by Meyerson swooped in to take over the property.

Simpson Thacher did not respond to repeated requests for comment about the language in its Treasury contract and on its internal mechanisms to prevent conflicts of interest.
"These firms are making up the rules [of the bailout] and advising private clients about the rules," Yale Law School professor Jonathan Macey, a banking specialist and author, said in a recent interview.

"The problem is, No. 1, this means we lose the appearance of fairness," he continued. "And, No. 2, there's a very strong inclination for the people making up the rules to be sympathetic to their own clients as opposed to other people's clients when they're writing the rules."

Davis Polk & Wardwell, another law firm turned Treasury contractor, was so closely involved in drafting Geithner's proposal for "resolution authority" to wind down non-bank institutions that when members of Congress received the Obama administration's draft proposal on the topic, it still bore Davis Polk's computer signature. Ironically, Davis Polk turned down a chance to apply for Simpson Thacher's first bailout contract – citing the risk of conflicts of interest.

At the Federal Reserve

The Treasury is not the only bailout administrator that has come to lean on contractors.

BlackRock, which manages a $1.3 trillion asset portfolio that ranks largest in the world, was hired for three no-bid deals in October by now-Treasury Secretary Geithner, then president of the Federal Reserve Bank of New York.

Geithner assigned BlackRock to supervise toxic assets once held by Bear Stearns, as well as those held by AIG – deals worth at least $71.3 million over three years. Yet BlackRock, like Alliance, plans to participate in the Treasury's PPIP, again offering the firm the possibility of benefits based on its knowledge of AIG and Bear's exposure.

Lawmakers in both parties have raised concerns about BlackRock's conflicts, as The New York Times reported earlier this month. But Charles Hallac, a founding partner of BlackRock and the head of its risk-advisory arm, BlackRock Solutions, said such concerns are unfounded.

No BlackRock analyst managing the AIG and Bear holdings will take part in the PPIP, or "any kind of program where they're using government funds to make money for clients, Hallac explained in a telephone interview.

BlackRock was selected because of its expertise in separating its investment business from its risk-advisory business, Hallac added. "We didn't want to show this to anybody who was going to try to make money in the markets with this information. So we created a separate team within BlackRock Solutions to just manage the Fed portfolio."

However, he said some employees in line to work on the PPIP have helped with a separate Fed program that involves buying up mortgage-backed securities.

The financial world often uses the anachronistic phrase "Chinese wall" – a phrase that came into wide use after the 1929 stock market crash – to describe an investment firm's internal efforts to isolate compromising information.

To a certain extent, then, the debate over conflicts of interest at BlackRock and other firms depends on whether you believe Chinese walls can survive in the age of BlackBerries and blogs.

"Let's be honest, it's bullshit. They don't exist," Barry Ritholtz, the CEO of the independent research firm Fusion IQ and the creator of the Big Picture financial blog, said in an interview. "They're a theoretical, abstract legal construct that looks and sounds good when you're developing legal constructs."

One hedge fund manager, who requested anonymity in order to speak candidly, said he is more concerned bailout contractors' access to Geithner and Federal Reserve Chairman Ben Bernanke.

"The public-private cooperation that's going on – not just in the PPIP – ought to be very unsettling to people," the hedge-fund manager said. "These guys are on the phone with Geithner, Bernanke, with everybody who matters and is setting policy in Washington. And at the same time, they're trading their own books."

While bias among these government contractors is undeniably problematic, some experts asserted that it is also unavoidable. As this argument goes, if the government ruled out

firms that did significant business with a bailed-out bank, there would be no one left to hire.

"Because Treasury doesn't have the in-house expertise, it's inevitable that they would have to contract out," said Campbell Harvey, a professor of international business at Duke University. "It's also inevitable that there will be conflicts of interest. If you're qualified, then almost by definition, there's a conflict of interest."

William Seidman, former chairman of the Resolution Trust Corporation (RTC), which led the recovery effort after the 1990s savings-and-loan crisis, offered a sharp contrast to Treasury's current opaque bailout contracts.

Seidman said he racked up large auditing bills to ensure that his contractors were complying with conflict-of-interest rules. "Occasionally we had transactions that we didn't make public for some sort of public-policy reason, but … most we had to report to Congress," he said in an interview shortly before his death on May 13.

"It was expensive," Seidman added, "but the program had so much potential for fraud or conflict that we thought it was essential."

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