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The Role of Investment Banks in the Mortgage Meltdown: Did Investors Slip Through the Holes in SOX?

Elisa C. Clark
eclark14@slu.edu

THE ROLE OF INVESTMENT BANKS IN THE MORTGAGE MELTDOWN: DID INVESTORS SLIP THROUGH THE HOLES IN SOX?

I. INTRODUCTION

When President Bush signed the Sarbanes-Oxley Act of 2002, he announced "with a tough new law we will act against those who have shaken confidence in our markets, using the full authority of government to expose corruption, punish wrongdoers and defend the rights and interests of American workers and investors."[1] As the effects of the current economic downturn reverberate throughout the United States and around the world, consumers and investors look forward for signs that the crisis has reached its bottom point. Identifying the factors that contributed to the crisis is of similar importance because then policymakers can take steps to mitigate the risk of recurrence and identify whether market participants were exposed to disproportionate risk.

The burst of the housing bubble and the rapid decline in the value of mortgage-backed securities have been identified as a trigger of the current economic crisis.[2] Economic indicators in the mortgage industry have declined tremendously from the record number of homes that have entered foreclosure,[3] investment banks have recorded staggering losses and reduced their workforces in response to the decline,[4] and home prices have declined nationwide.[5] However, the impact of the mortgage meltdown extends beyond the mortgage industry. By January 2009, over 2.5 million people lost their

1. MICHAEL F. HOLT, THE SARBANES-OXLEY ACT: COSTS, BENEFITS AND BUSINESS IMPACT 5 (2008).

2. *See* discussion *infra* Part III.

3. *See* Vikas Bajaj, *Foreclosures Rose as Delinquencies Eased in Quarter,* N.Y. TIMES, Sept. 6, 2008, at B8 (showing that in June 2008, 2.75 percent or approximately 1.75 million homes were in foreclosure, the highest rate recorded since such data began being recorded in 1979).

4. *See* Press Release, Citigroup Inc, Citi Reports Third Quarter Net Loss of $2.8 Billion, Loss Per Share of $0.60, (Oct. 16, 2008), *available at* www.citigroup.com/citi/press/2008/081016a.htm (explaining Citigroup recognized a loss of $2.8 billion for the 3rd quarter of 2008 and reduced its head count by 23,000 during the first nine months of 2008).

5. *See* Michael M. Grynbaum, *House Sales Rise, But the Prices Are Lower,* N.Y. TIMES, Aug. 26, 2008, at C1, *available at* http://www.nytimes.com/2008/08/26/business/26econ.html (explaining that in July 2008 home prices fell 7.1% from July 2007. Though the number of homes sold in July 2008 increased, the increase was the result of depressed prices triggered by foreclosures and owners forced to sell at bargain prices because of the lack of selling opportunities (i.e. "distress sales"), the sales contributed to continued declining home prices).

jobs across various industries since the United States entered a recession in 2007.[6] As a result of this job-loss, the lives of many Americans and people across the world have been affected.[7]

The billions of dollars in financial statement write-downs taken by investment banks and the resulting investor shock and market decline conjure memories of the corporate scandals and economic downturn the United States faced at the beginning of the twenty-first century. These scandals motivated President Bush to sign the Sarbanes-Oxley Act of 2002 ("SOX") into law.[8] SOX was intended to improve investor confidence in the market by increasing the quality of disclosures made to investors and enhancing management's responsibility for financial statements.[9] SOX has remained exceedingly controversial due to the staggering costs it places on businesses subject to the regulation.[10]

Subprime lending by investment banks contributed to the mortgage meltdown that has sent the economy into a downward spiral.[11] The question arises whether there was an opportunity for SOX to mitigate the risk posed by the mortgage-related activities of investment banks or whether the events precipitating the current crisis were beyond the scope of SOX. This paper will first explore the events that motivated the passage of SOX, Enron's activities leading to its collapse in 2001, and the resulting reforms SOX instituted. The current economic crisis will be investigated next, and finally the role of SOX and investment banks within the mortgage crisis will be considered.

This paper finds SOX was applicable to the investment bank's financial reporting of its mortgage-related activities. The financial statement accounts reflecting the investment bank's mortgage-related activity should have been identified as "significant," triggering extensive SOX requirements concerning management's responsibility for establishing and assessing internal controls to address valuation and disclosure in financial statements.

II. INVESTOR OUTRAGE RESULTS IN SARBANES-OXLEY ACT OF 2002

Several factors led to the rapid and overwhelming congressional support of SOX in 2002. President Bush referred to SOX as "the most far-reaching

6. Jack Healy, *62,000 Jobs Are Cut by U.S. and Foreign Companies*, N.Y. TIMES, Jan. 26, 2009, *available at* http://www.nytimes.com/2009/01/27/business/economy/27jobcuts.html.

7. *See* Matthew Saltmarsh, *Britain and Spain Show More Signs of a Slowdown*, N.Y. TIMES, Jan. 24, 2009, at B2 (stating that in January 2009, Britain entered into recession, and Spain had its highest unemployment rate in more than 8 years).

8. *See* discussion *infra* Part II.

9. *See* discussion *infra* Part II.C.

10. Large multinational companies can spend between $1 and $10 million and smaller companies can spend between $250,000 and $500,000 for SOX compliance. HOLT, *supra* note 1, at 13.

11. *See* discussion *infra* Part III.

reform of American business practices since the time of Franklin Delano Roosevelt."[12] SOX was preceded by a stock market tumble that began in 2001. Prior to this decline, investor confidence followed the market's consistent upward trend.[13] As various corporate scandals became public,[14] and both the dot-com and telecom "bubbles" burst, market and investor confidence sharply declined in 2001.[15] As 2001 closed, the three major U.S. indices had each lost significant value for the year as the Dow Jones Industrial Average declined 7.1 percent, the Standard & Poor's 500 Index lost 13 percent, and the Nasdaq Composite fell 21.1 percent.[16] This resulted in a congressional "regulatory panic"[17] aimed at restoring the very low investor confidence triggered by corporate scandals and the declining stock market.[18]

A. Corporate Scandals and Dot-Com and Telecom Bubbles Burst

Prior to the passage of SOX, corporate scandals adversely affected the stock market and battered investors as corporations restated earnings and wrote-down assets in stunning amounts.[19] The scandals that preceded SOX included Enron, which took a $500 million accounting loss, reduced shareholder equity by $1.2 billion as the result of off-balance sheet debt, and ultimately declared bankruptcy in 2001.[20] WorldCom also announced in 2002 it had overstated earnings by $3.8 billion through improperly capitalized expenses and recognized $3 billion of revenue it should have expensed.[21]

Concurrent with the fallout from Enron, the dot-com bubble burst after the tremendous growth of internet-based businesses in the 1980s and 1990s spurred by venture capital firms.[22] Most of these dot-com companies ultimately went out of business in what became an intensely competitive

12. HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 9 (2006).

13. *See* Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 6 (2003) (describing the corporate governance issues that came to light from November 2001 through November 2002).

14. SANJAY ANAND, ESSENTIALS OF SARBANES-OXLEY 3–5 (2007).

15. Hamilton, *supra* note 13, at 7–8.

16. Floyd Norris, *The Markets: Stocks and Bonds; After Two-Year Drop in Markets, Calendar Turns on Note of Hope*, N.Y. TIMES, Jan. 1, 2002, at A1, *available at* http://www.nytimes.com/2002/01/01/business/markets-stocks-bonds-after-two-year-drop-markets-calendar-turns-note-hope.html?scp=1&sq=Drop+in+Markets&st=nyt.

17. BUTLER & RIBSTEIN, *supra* note 12, at 7.

18. *Id.* at 30.

19. *See* Thomas G. Bost, *The Sarbanes-Oxley Act of 2002: A Summary*, 7 PERSP. ON LEGIS., REG., & LITIG. 1, 2–4 (2003).

20. Hamilton, *supra* note13, at 10–11.

21. *Id.* at 21.

22. *Id.* at 13.

market.[23] The telecommunications industry also grew rapidly during the 1990s, as companies installed fiber-optic networks for what was expected to be tremendous growth in electronic communication.[24] The telecom bubble burst as demand failed to keep pace with the tremendous capacity created, causing investment interests to dry up, billions of dollars to be lost and many companies to restate earnings.[25]

As these circumstances drove both market and investor confidence down, Congress was motivated to quickly pass the sweeping regulations known as the Sarbanes-Oxley Act of 2002. In April 2002, several months after Enron's bankruptcy,[26] Congressman Michael Oxley introduced the Corporate and Auditing Accountability, Responsibility, and Transparency Act while Senator Paul Sarbanes introduced Senate Bill 2673.[27] Because Congressman Oxley's proposed Act was "more moderate," Senator Sarbanes' more expansive proposal gained support as WorldCom announced its first earnings restatement of $3.85 billion.[28] What started as two proposals in April 2002 was passed though the House of Representatives with a vote of 423 in favor versus three opposed, and was unanimously approved by the Senate. President Bush signed Sarbanes-Oxley into law on July 30, 2002.[29]

Corporate fraud triggered outrage by the public, investors, and regulators, and ultimately resulted in resounding support for the passage of SOX. The overwhelming support was also the result of Congress' belief that serious economic consequences could result if investor confidence was not improved.[30] The concern loomed that, as investor trust in the market and publically traded companies declined, investors would become less willing to invest in the U.S. markets, resulting in heightened risks of market seizure and potential recession.[31] It was in this panicked environment that SOX became law.

B. Enron Debacle Provides Reference Point for Analyzing the Mortgage Meltdown

Enron has emerged as an infamous example of the accounting and financial scandals that marked the tumultuous economic downturn in the early part of the twenty-first century. A review of the events leading to Enron's

23. *Id.* at 14.
24. *Id.* at 13–14.
25. Hamilton, *supra* note 13, at 16–17.
26. GREGORY J. JENKINS, THE ENRON COLLAPSE 8 (2003).
27. ANAND, *supra* note 14, at 9–10.
28. Bost, *supra* note 19, at 5.
29. ANAND, *supra* note 14, at 10.
30. *Id.* at 5.
31. *Id.*

collapse facilitates understanding the aim of SOX and provides a reference point for analyzing the current market downturn and investor outrage.

Enron began operating in 1985 with an initial focus on the transportation of natural gas.[32] As Enron spent billions of dollars to expand worldwide, it shifted from merely operating a gas utility toward activity in the unregulated energy trading markets.[33] Enron predicted this trading activity would be more profitable than engaging in a more traditional business model and owning physical assets.[34] Before becoming the quintessential example of corporate governance failure, Enron's business methods appeared to be successful. It became the seventh largest company in the United States[35] and was repeatedly ranked by Fortune as the most innovative company in America.[36] The company went from reporting revenues of approximately $9 billion dollars in 1995 to $101 billion in 2000, and the stock price grew from approximately $20 in 1997 to almost $90 in 2000.[37] However, the basis for its stock price was unfounded. Inflated asset values and understated liabilities drove its stock price up, while, in reality, the company was moving toward bankruptcy.[38] Enron was holding $1.2 billion in recourse debt that was invisible to investors because it was not consolidated onto Enron's balance sheet and was otherwise undisclosed in the financial statements.[39]

One significant tactic Enron used to mislead investors was its aggressive and deceptive use of special purpose entities ("SPEs").[40] An SPE allows a company to create a "separate, independently controlled entity, with a portion of the ownership separate from the main company's ownership," resulting in the risk exposure of the SPE being carried separate from the main company.[41] When properly structured, an SPE allows a company to pursue potentially risky projects without requiring the main company to consolidate the SPE onto the balance sheet of the main company.[42]

32. Jeffrey D. Van Niel, *Enron—The Primer, in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 3, 11 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

33. *Id.*

34. *Id.* (activities included "buying and selling financial contracts linked to the value of energy assets.").

35. ANAND, *supra* note 14, at 4.

36. BUTLER & RIBSTEIN, *supra* note 12, at 8.

37. JENKINS, *supra* note 26, at 4–5.

38. Edward J. Janger, *Brandeis, Business Ethics, and Enron, in* ENRON, CORPORATE FIASCOS, AND THEIR IMPLICATIONS 63, 64 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

39. *Id.* at 66.

40. Van Niel, *supra* note 32, at 13–14 (explaining how these accounting practices themselves are commonly used and their deceptive potential comes from how businesses choose to utilize them).

41. *Id.* at 14.

42. *Id.*

Enron's accounting treatment of its SPEs was improper because, while it did not consolidate its SPEs onto its balance sheet, Enron failed to qualify for this preferential accounting treatment. Many of Enron's SPEs did not maintain the requisite 3% of independent ownership, and Enron was exposed to substantial risk from the SPE's operations because Enron made guarantees related to the SPE's obligations.[43] As a result, although Enron should have consolidated the associated debt onto its consolidated balance sheet,[44] it failed to do so.[45] Enron announced on October 16, 2001 that in order to revise its accounting for SPEs, it was taking a half a billion-dollar charge against its earnings and reducing its equity by $1.2 billion.[46] Less than two weeks following Enron's earnings announcement, its stock declined in value by more than 54%.[47] Enron also announced that it would have to make astronomical restatements of its earnings and significantly increase its consolidated debt from 1997 through the first two quarters of 2001 because of previously unconsolidated entities.[48] Prior to Enron, Generally Accepted Accounting Principles ("GAAP") required disclosures concerning related-party transactions, but Enron failed to disclose to investors in sufficient detail the structure of its SPEs.[49] This left investors in the dark on Enron's risk exposure until the SPE deals soured and triggered Enron's responsibility for the SPE's obligations.[50] Enron filed for bankruptcy on December 2, 2001.[51]

There was an even more startling aspect of the Enron saga beyond the extent of fraud perpetrated. Enron's Board of Directors owed a fiduciary duty to Enron's shareholders.[52] Enron's lawyers owed a duty to the corporation.[53] Enron's public accountants owed a duty to the public.[54] All failed to either detect the fraud or blow the whistle.[55] As discussed below, SOX attempted to respond to the triggers of the financial debacles of the time, including Enron.

43. *Id.* (stating that in many cases Enron's Chief Financial Officer controlled the partnerships comprising the 3% of independent ownership).

44. *Id.*

45. Van Niel, *supra* note 32, at 14.

46. BUTLER & RIBSTEIN, *supra* note 12, at 7.

47. JENKINS, *supra* note 26, at 7.

48. Reductions to net income were equivalent to "reductions in reported earnings of 91% in 1997, 16% in 1998, 28% in 1999 and 13% in 2000." *Id.* at 7–8.

49. Van Niel, *supra* note 32, at 15.

50. Bethany McLean, *Enron All Over Again,* FORTUNE, Nov. 26, 2007, at 76, *available at* money.cnn.com/magazines/fortune/fortune_archive/2007/11/26/101232905/index.htm.

51. JENKINS, *supra* note 26, at 8.

52. Janger, *supra* note 38, at 66.

53. *Id.*

54. *Id.*

55. *Id.*

C. Sarbanes-Oxley Act of 2002 Provisions

The self-proclaimed purpose of SOX is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures."[56] SOX attempted to establish comprehensive reform measures by establishing the Public Company Accounting Oversight Board ("PCAOB"), addressed auditor independence, corporate responsibility, and enhanced financial disclosures.[57] SOX is applicable to companies that are registered with the Securities and Exchange Commission, and it amended several established laws and also established new regulations.[58]

SOX established the PCAOB to vest an organization with responsibility to oversee the audit of public companies, protect investors and address the preparation of audit reports.[59] The PCAOB's authority includes setting quality control and independence standards,[60] conducting compliance inspections of registered public accounting firms,[61] and pronouncing audit standards.[62] The creation of the PCAOB subjected the previously self-regulated public accounting industry to an independent regulatory body.[63] SOX attempted to increase auditor independence from the client by mandating audit partner rotation[64] and requiring periodic reports by the auditor to the audit committee of the company's board of directors.[65] Auditor independence was further

56. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

57. § 1, 116 Stat. at 745–46. Other areas addressed by SOX include restrictions based on analyst conflicts of interest, mandating the conduction of various studies and reports, and addressing penalties for corporate and criminal fraud.

58. GUY LANDER, WHAT IS SARBANES OXLEY? 1–2 (2004).

59. § 101(a), 116 Stat. at 750. The Public Company Accounting Oversight Board states the following as its mission: "The PCAOB is a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." Pub. Co. Accounting Oversight Bd., PCAOB Oversees the Auditors of Public Companies to Protect Investors, http://pcaob.org/ (last visited Feb. 15, 2010).

60. § 103, 116 Stat. 745, 755–57.

61. § 104, 116 Stat. at 757–59.

62. § 103, 116 Stat. at 755–57. For example, the PCAOB pronounced *Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*. PUB. CO. ACCOUNTING OVERSIGHT BD., BYLAWS AND RULES OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD 434 (2010), *available at* http://pcaobus.org/Rules/PCAOBRules/Documents/All.pdf.

63. *See* JENKINS, *supra* note 26, at 18. SOX made it unlawful for any person who is not registered with the PCAOB to issue an audit report for an issuer. § 102, 116 Stat. at 753.

64. § 203, 116 Stat. at 773.

65. § 204, 116 Stat. at 773.

addressed by specifying non-audit services that a registered public accounting firm is prohibited from providing to audit clients.[66]

SOX also addressed the role of the audit committee by stipulating that the committee is "directly responsible for the appointment, compensation and oversight of the work" of the company's auditor.[67] The company's audit committee members are to be independent of the company, and the only compensation members may receive is based on participation on the audit committee.[68] This committee is also vested with the responsibility for establishing procedures to receive and address complaints concerning the company's accounting, internal control, and auditing activities.[69] The audit committee is also empowered to hire independent counsel and advisors as necessary to assist in carrying out its responsibilities.[70]

SOX attempted to increase management's responsibility for financial statements and how information consolidated into financial statements is identified and reported. Both the "principal" executive and financial officers are required to make certifications concerning how the company's condition is presented in the annual and quarterly reports.[71] Both officers are required to attest to reviewing the annual or quarterly report, that "based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements . . . not misleading," and that the reports "fairly present in all material respects the financial condition and results of operations . . . ."[72] Requiring the officer's certification (based upon the officer's knowledge) holds both officers personally responsible for the annual and quarterly reports to prevent delegation of responsibility for financial statements.[73]

The "principal" executive and financial officers are also charged with responsibility concerning the company's internal control environment. Each annual and quarterly report must include an acknowledgement by the "principal" executive and financial officers' of their responsibility for designing controls to ensure that the company's material information is known to the officers.[74] Management is also required to make an assessment of the

66. § 201, 116 Stat. at 771–72. Prohibited non-audit services include bookkeeping, "financial information systems design and implementation," appraisals, actuarial services, internal audit, management or human resources, investment advisor, legal services and other services found by the Board of Directors to be impermissible.

67. § 301, 116 Stat. at 777.

68. § 301, 116 Stat. at 776.

69. *Id*.

70. *Id.*

71. § 302, 116 Stat. at 777.

72. *Id.*

73. Bost, *supra* note 19, at 32.

74. § 302, 116 Stat. at 777.

internal controls and include a report on the assessment in the company's annual and quarterly reports.[75] The report includes management's statement of responsibility to establish and maintain "an adequate internal control structure and procedures for financial reporting" and an assessment of the "effectiveness of the internal control structure and procedures" for financial reporting.[76] SOX also requires these officers to report to both the auditor and audit committee all significant internal control deficiencies that could adversely affect the company's ability to report financial data and detect management fraud.[77]

The criminal penalties for failure to comply with SOX indicate the seriousness of Congress' message in passing SOX. Penalties for a certified report's failure to comply with SOX can include 10 years imprisonment, fines of up to $1 million, or both.[78] A certifying officer who willfully certifies a statement knowing the statement does not comply with SOX can be penalized with up to 20 years imprisonment, fines of up to $5 million, or both.[79]

SOX attempted to improve financial statement disclosures by several mechanisms. SOX requires disclosure of material "off-balance sheet transactions, arrangements, and obligations" and other relationships with unconsolidated entities or persons that may have a "material current or future effect" on the company's financial condition.[80] SOX also requires that pro forma financial information be presented free from untrue material facts and free from omissions of material facts necessary to ensure the pro forma data are not misleading.[81] SOX also enhanced the role of the auditor by explicitly requiring the financial statements to reflect "all material correcting adjustments" identified by the external auditor.[82]

SOX furthermore addressed disclosures concerning the company's corporate governance structure. A company must disclose whether it has adopted a code of ethics for senior financial officers and, if not, must explain why no such code has been adopted.[83] Finally, a company is directed to disclose whether the audit committee includes at least one member who is a "financial expert" and, if not, explain the reason for the absence.[84]

75. § 404, 116 Stat. at 789.

76. *Id.* SOX increases the spotlight placed on internal controls and information publically available by also requiring the external auditor to express an opinion on management's assessment of the company's internal controls. *Id.*

77. § 302, 116 Stat. at 777.

78. § 906, 116 Stat. at 806.

79. *Id*.

80. § 401, 116 Stat. at 785–87.

81. § 401, 116 Stat. at 786.

82. *Id.*

83. § 406, 116 Stat. at 789.

84. § 407, 116 Stat. at 790. In determining whether one is a "financial expert," factors considered include education and work experience (including roles such as public accountant, auditor and principal financial officer), an understanding of generally accepted accounting

The overriding goals of SOX include improving information provided to investors by enhancing the integrity, accuracy, and accountability of financial statements.[85] These goals are aimed at improving and maintaining the trust of investors by increasing the standards in both a moral and professional capacity.[86] The integrity and accuracy of financial statements are addressed in SOX through its requirements concerning the establishment, maintenance and assessment of a company's internal control structure.[87] The integrity of financial statements is to be improved by installing internal control requirements geared to ensure all relevant financial information is presented, while stripping the financial statements of fraudulent reporting.[88] The accuracy of financial statements is to be improved by imposing an internal control system that is capable of preventing and detecting misleading business practices.[89] These provisions can be linked to Enron's financial statements, which lacked integrity and accuracy since they did not adequately disclose the nature of its relationship with SPEs and failed to consolidate SPE debt onto its balance sheet.[90] Enron's use of pro form reports also contributed to its misrepresentation by characterizing various billion dollar charges as "non-recurring," allowing it to present pro forma financial data as if the charges had not been incurred.[91] Investigations into Enron's corporate governance system identified weakness or absence of internal controls as a source of its failure.[92]

SOX attempted to improve the accountability of corporate executives for financial statements by removing the "faceless corporation" as a refuge for inadequate financial reporting.[93] SOX expressly communicates, to both the company and the public, which executives are responsible for information presented in financial statements.[94] With Enron, there was not a single individual or a group who could officially be designated as responsible for assuring implementation of internal controls over financial reporting.[95] SOX addressed this opportunity for blame shifting by requiring a specific person be identified who is accountable for shortcomings of the financial statements.

principles and financial statements, experience in preparing or auditing financial statements, experience with accounting for estimates, accruals, and reserves, internal controls experience and an understanding of the audit committee functions.

85. ANAND, *supra* note 14, at 28.
86. *Id.* at 23.
87. *Id.* at 29.
88. *See id.* at 23–24.
89. *Id.* at 24–25.
90. Janger, *supra* note 38, at 66.
91. *See* Van Niel, *supra* note 32, at 15.
92. JENKINS, *supra* note 26, at 18.
93. ANAND, *supra* note 14, at 24–25.
94. *Id.*
95. JENKINS, *supra* note 26, at 19.

SOX provisions changed the requirements for corporate governance. The responsibilities of executive officers, the board of directors, and accounting firms were revised and enhanced.[96] Commentators have questioned whether SOX was the best response to prevent the repetition of the corporate fraud that plagued the beginning of the twenty-first century.[97] The current economic crisis and the role of the investment banks within the crisis provide an opportunity to assess whether SOX was an effective response.

III. SUBPRIME LENDING LEADS TO ECONOMIC CRISIS

Many factors have contributed to the recession the United States entered in December 2007. Since entering the recession, the United States has sustained a staggering amount of job losses,[98] the stock market has wildly fluctuated and lost value,[99] a substantial number of mortgages have gone into foreclosure,[100] and investment banks have taken billions of dollars in losses.[101] Though the understanding of the causes underlying the economic downturn continues to be refined, it is clear that losses on mortgages and mortgage-backed securities played a pivotal role in the credit crisis that has exacerbated the situation.[102] The following discussion of the role of mortgage-related activities in the economic downturn introduces the evolution of the complex mortgage industry, the events which precipitated the current mortgage meltdown, and how the housing decline triggered substantial investment bank losses.

A. Evolution of the Complex Mortgage Industry

The mortgage industry has evolved into a very complex market that ultimately contributed to the difficulty of assessing the risk of mortgage-backed securities. Traditionally, the issuance of a home mortgage was a transaction that occurred primarily between the borrower and a local lender who recorded the loan on the lender's books.[103] The industry began to grow more complex during the 1970s, when government-sponsored entities began

96. LANDER, *supra* note 58, at 1.

97. *See generally* Postings of Larry E. Ribstein to Ideoblog: Sarbanes-Oxley, http://busmovie.typepad.com/ideoblog/sarbanesoxley/.

98. Healy, *supra* note 6.

99. Andrew Ross Sorkin, *Lehman Files Bankruptcy; Merrill Is Sold,* N.Y. TIMES, Sept. 15, 2008, at A1.

100. Thomas Killian, *Surviving the 2007 Financial Crisis*, U.S. BANKER, Mar. 2008, at 40.

101. Sorkin, *supra* note 99.

102. *See generally* Michael Krimminger, *"It's Alive!"—Mortgage Risk Reborn: Issues and Possible Solutions*, 17 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 259 (2008); Sally Pittman, *ARMS, But No Legs to Stand On: "Subprime" Solutions Plague the Subprime Mortgage Crisis*, 40 Tex. Tech L. Rev. 1089 (2008); Nomi Prins, *The Risk Fallacy,* FORTUNE, Nov. 10, 2008, at 112.

103. Prins, *supra* note 102, at 114.

purchasing mortgages from local lenders, removing the loans from the lenders' books and clustering them into "mortgage-backed securities."[104] The arrival of mortgage-backed securities resulted in a fundamental shift in the operation of the mortgage market because the local lender no longer bore the risk of mortgage default as the lender shifted the default risk to the holders of mortgage-backed securities.[105]

The variety of mortgage products available has also evolved over time, becoming more complex, and making it more difficult to predict the risk of borrower default.[106] The two primary kinds of mortgages are a fixed-rate mortgage ("FRM") and adjustable-rate mortgage ("ARM").[107] The interest rate and payment amount of a FRM are fixed and do not fluctuate over time.[108] In contrast, the interest rate and payments of an ARM vary and can fluctuate greatly because payment is determined by reference to an index.[109]

Subprime borrowers are individuals with "a high debt-to-income ratio, an impaired or minimal credit history," or have other characteristics suggesting a higher probability of default than a prime borrower.[110] Subprime mortgages are typically offered an interest rate higher than a prime mortgage rate.[111] Many subprime mortgages begin with a starter rate that resets after twenty-four or thirty-six months.[112] Once the subprime mortgage's low initial fixed rate expires, the rate becomes variable and monthly payments are likely to increase.[113]

B. *Popularity of Subprime Lending Increases Due to Reduced Interest Rates and Securitization of Mortgages*

The subprime lending market has operated since the early 1980s but experienced an increased rate of growth during the mid-1990s and grew exponentially during the early part of the twenty-first century.[114] For example, $120 billion of subprime loans were originated during 2001, while over $600

104. *Id.*

105. *Id.*

106. *Id.* New mortgages introduced included balloon mortgages, adjustable rate mortgages, and floating rate mortgages.

107. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer*, *in* THE SUBPRIME MORTGAGE MELTDOWN: WHO, WHAT, WHERE AND WHY … INVESTIGATIONS & LITIGATION 89, 93 (Keith W. Miller ed., 2007).

108. *Id.*

109. *Id.* ARM payments can adjust monthly, semiannually, or annually.

110. *Id.* at 92. Prime mortgages are typically the mortgages offered to borrowers with good credit.

111. *Id.*

112. Krimminger, *supra* note 102, at 261.

113. *Id.*

114. Sabry & Schopflocher, *supra* note 107, at 91.

billion in subprime loans were originated during 2006.[115] This growth was spurred by several factors, including the reduction of interest rates during 2001 and 2002 and mortgage securitization.[116]

1. Reduced Interest Rates Lead to Increased Subprime Lending

The market decline in 2001 and 2002 triggered the significant reduction in interest rates and resulted in the prime mortgage market becoming highly saturated.[117] As a result of the market saturation, lenders sought to issue more mortgages and turned to riskier subprime borrowers.[118] Lenders were motivated to continue issuing mortgages by the opportunities to generate profits through mortgage securitization.[119] The growth in the subprime market was further enhanced by the questionable underwriting practices of some lenders. Such practices included issuing mortgages based solely on the borrower's stated income, requiring little or no documentation.[120] Some lenders offered hybrid mortgages and approved borrowers based on their ability to pay the minimum mortgage payments, without consideration of the borrower's ability to pay the higher payments required once the mortgage transitioned into an ARM.[121] The liquidity available to lenders through the securitization process provided an incentive for lenders to issue riskier mortgages without the tempering effect of the lender bearing the risk of default.[122]

2. Mortgage Securitization Further Increases the Popularity of Subprime Lending

The mechanisms and parties involved with securitizing mortgages are complex, and as such, the following is intended to present an overview of the process to assist in understanding the current crisis and role of investment banks. The securitization process begins with the lender issuing a loan to a borrower. In many cases, the lender will then sell its rights to collect the mortgage payments to a trust or special purpose entity (SPE)[123] that the lender has created.[124] The SPE effectively becomes the owner of the loans and

115. *Id.* at 93.

116. Pittman, *supra* note 102, at 1097 (discussing the events causing the expansion of subprime lending).

117. Prins, *supra* note 102, at 116.

118. *Id.*

119. *See* Mara Der Hovanesian, *Sex, Lies, and Mortgage Deals*, BUS. WK., Nov. 28, 2008, at 70.

120. Krimminger, *supra* note 102, at 262.

121. *See id.* at 262–63.

122. *Id.* at 263.

123. Van Niel, *supra* note 32, at 71.

124. Sabry & Schopflocher, *supra* note 107, at 95–96.

underwrites the mortgage-backed securities.[125] Mortgage-backed securities are created by grouping subprime mortgages and other assets together and then dividing the group into sections, or "tranches," based upon the likelihood of default.[126] After the securities have been underwritten, either the underwriter or an investment bank purchases the securities from the trust and then conveys the securities to investors.[127]

Repurchase agreements are one source of bankruptcy risk for lenders. Lenders often enter into repurchase agreements with the mortgage purchasers, stipulating that the lender will repurchase the subprime loans if default rates of the underlying loans reach a specified threshold.[128] Lenders are to fund reserves to service these potential repurchases.[129] Bankruptcy can result when lenders do not properly reserve for their repurchase requirements.[130]

The securitization of subprime loans significantly increased in 2003. Investment banks were the catalyst for the growth of subprime mortgages as they purchased and securitized tremendous numbers of loans.[131] In 2006, the top ten investment banks sold mortgage-backed securities worth $1.5 trillion, a dramatic increase from the $245 billion of mortgage-backed securities sold in 2000.[132] Investment banks further increased their participation by purchasing mortgage wholesaling firms, extending billions of dollars in credit to subprime lenders, and even purchasing subprime lenders.[133]

Mortgage securitization was considered a risk reducing activity because the risk of default would be widely spread across many investors.[134] However, as banks also created more complex mortgages and new, increasingly complex securities, it became more difficult for investors to assess the risk of default for the underlying assets.[135] Meanwhile, the potentially crippling economic impact that could result from the widespread default of subprime mortgages was compounded by several other factors. Financial institutions used mortgage-backed securities as collateral to borrow more money, which further extended the reach of subprime mortgage-backed securities into the economy.[136] Additionally, beginning in 2004, the Securities and Exchange

125. *Id.* at 96.

126. Prins, *supra* note 102, at 114.

127. Sabry & Schopflocher, *supra* note 107, at 96.

128. *Id.* at 97.

129. *Id.*

130. *Id.*

131. Der Hovanesian, *supra* note 119, at 70.

132. *Id.*

133. *Id.*

134. Prins, *supra* note 102, at 114.

135. *Id.* Rating agencies assigned grades to different tranches based on computer models that many believe did not accurately assess the risk of the securities, resulting in high ratings to securities that in fact carried a high degree of risk.

136. *Id.* at 116.

Commission permitted investment banks to carry $30 in debt for each $1 in equity.[137] This degree of leverage became unmanageable when the market was no longer willing to buy the mortgage-backed securities that provided the collateral for the debt.[138]

The purchasers of mortgage-backed securities further extended the risk underlying subprime mortgages into the greater economy as investors in mortgage-backed securities came to include "individuals, hedge funds and companies."[139] The extension of this risk to the greater economy had rippling effects that extended beyond defaulting homeowners and purchasers of mortgage-backed securities, and ultimately triggered significant losses for investment banks and the loss of jobs in many industries.

C. The Housing Decline Triggers Investment Bank Losses

Though the housing bubble led to tremendous opportunities for subprime borrowers to achieve home ownership, the bubble's burst had staggering effects on those same subprime borrowers and ultimately the economy at large. Home values consistently increased until 2006, when prices began to fall.[140] During the period of soaring home values (and increasing subprime lending), borrowers facing an ARM resetting to a higher payment could avoid delinquency by either refinancing their mortgage or selling their house.[141] When the housing market turned, subprime borrowers facing adjusting ARM payments found that home values were falling and existing home sales were declining.[142] Those who were unable to refinance their mortgage or sell their home were left with little alternative to default.[143] These defaults negatively impacted investors in mortgage-backed securities as the securities lost value in response to increasing defaults.[144]

Mortgage loan deficiencies approached 10-year highs in 2007, and for the first time since the Great Depression, median home prices declined across the nation.[145] Once losses in subprime mortgage-backed securities started to occur, investors retracted from mortgage-backed securities and other types of complex securitized products, including investments that had traditionally been

137. *Id.*
138. *Id.*
139. Pittman, *supra* note 102, at 1102.
140. Krimminger, *supra* note 102, at 263.
141. Sabry & Schopflocher, *supra* note 107, at 99.
142. *Id.*
143. *Id.*
144. Pittman, *supra* note 102, at 1102.
145. Killian, *supra* note 100, at 40.

considered safe, such as asset-backed commercial paper.[146] The availability of credit was severely curtailed and offered only to those with the highest of credit ratings.[147] The impact of this credit crunch extended to everyday businesses struggling to finance their operations in an environment of reduced credit.[148] Businesses could no longer rely on credit to bridge the timing differences between receiving payments and incurring the costs necessary to operate.[149]

Investment banks struggled to survive after sustaining hundreds of billions of dollars in losses from mortgage-related activities during 2008.[150] Unprecedented events for many investment companies occurred during September 2008, including companies that had previously seemed impervious to trouble. For example, Lehman Brothers was unable to continue treading water and ultimately filed for bankruptcy, and Bank of America purchased Merrill Lynch for $50 billion.[151] The economic hardship was not confined to investment banks as the overall economy suffered staggering job losses in 2008, a trend that continued into 2009. For example, November 2008 saw the loss of over five hundred thousand jobs, and over sixty-five thousand jobs were lost on a single day: January 26, 2009.[152]

In light of the severity of the economic downturn, the question arises whether SOX, the controversial legislative response to the last bout of corporate scandal, functioned adequately to protect investors and the public. Were the tremendous costs incurred by companies to be in compliance with SOX in vain, or did SOX minimize the losses the investment banks incurred?[153]

III. THE ROLE OF SOX AND INVESTMENT BANKS IN THE MORTGAGE CRISIS

SOX focused on the creation of financial statements free from material misstatement, increased management's responsibility for financial statements, and implemented internal controls related to financial reporting. The following

146. Steven L. Schwarcz, *Markets, System Risk, and the Subprime Mortgage Crisis*, 61 SMU L. REV. 209, 211–12 (2008) (discussing the reaction of investors to decline in value of mortgage-backed securities).

147. CBO, ADDRESSING THE ONGOING CRISIS IN THE HOUSING AND FINANCIAL MARKETS (2009) (statement of Director Doughlas W. Elmendorf to the Comm. on the Budget, U.S. Senate).

148. *Id.*

149. *Id.*

150. Sorkin, *supra* note 99, at A1.

151. *Id.*

152. Louis Uchitelle et al., *533,000 Are Cut: Biggest Drop Since '74 as the Recession Accelerates*, N.Y. TIMES, Dec. 6, 2008, at A1; Healy, *supra* note 6.

153. HOLT, *supra* note 1, at 13. Large multinational companies can spend between $1 and $10 million and smaller companies can spend between $250,000 and $500,000 for SOX compliance.

discussion considers the application of SOX to investment banks in the events leading to the economic downturn. This section will consider whether investment banks appropriately identified mortgage-related accounts as requiring internal controls for financial reporting, whether the mortgage-related accounts were properly valued in the financial statements, and whether the financial statement disclosures regarding investment bank's mortgage-related activity complied with the SOX mandated disclosures.[154]

The massive asset write-downs taken by investment banks since 2007 demonstrate that mortgage-related activity had the potential to greatly impact financial statements.[155] As part of the focus on financial reporting and auditing, SOX requires that both management and the company's external auditor assess the company's internal controls over financial reporting.[156] SOX also charged the PCAOB with responsibility for promulgating standards for the audit of financial statements.[157] Thus, the PCAOB pronouncement addressing the audit of internal controls over financial reporting provides valuable insight into what SOX intended for management to consider when establishing and assessing its internal control over financial reporting.[158] The current PCAOB pronouncement for the audit of internal controls over financial reporting is Auditing Standard No. 5 ("AS 5") and will be used here to help identify areas where SOX may have been applicable and therefore play a role in the financial reporting of investment banks leading up to the mortgage meltdown.[159]

The requirement for management to assess its internal controls is provided for in SOX to afford "reasonable assurance" of the "reliability of financial

154. Some commentators have pinpointed a failure of risk management by investment banks as a source of the mortgage meltdown and call for disclosure of such practices. *See* Betty Simkins & Steven A. Ramirez, *Enterprise Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571, 572–73 (2008); Joe Nocera, *Risk Mismanagement: What Led to the Financial Meltdown*, N.Y. TIMES MAG., Jan. 4, 2009, at 26–27.

155. For example, Citibank reported a net loss of $9.83 billion for the fourth quarter of 2007 citing "write-downs on sub-prime related direct exposures" as a catalyst of the net loss. Press Release, Citigroup Inc., Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99 (Jan. 15, 2008), http://www.citigroup.com/citi/fin/data/qer074.pdf.

156. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified in scattered sections of 15 U.S.C.).

157. § 101, 116 Stat. at 750.

158. *See* § 101, 116 Stat. at 750–51.

159. This pronouncement supersedes Auditing Standard No. 2 and is applicable for audits conducting under Section 404(b) of SOX. PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 5: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS ¶ 1 (2007), a*vailable at* http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx [hereinafter AUDITING STANDARD NO. 5].

reporting and preparation of financial statements."[160] AS 5 indicates the assessment should address the internal controls that concern accounts and disclosures that are "significant."[161] Thus, the internal controls of the accounts and disclosures considered "significant" to the investment bank should have been assessed by both management and the company's external auditor. AS 5 also sets out financial statement "assertions" that should be considered when identifying significant accounts and disclosures.[162] The most applicable types of assertions relative to the discussion here of the mortgage crisis are "valuation" and "presentation and disclosure."[163] The success of SOX in this area depends on the identification of the correct "significant" accounts and disclosures, implementing proper internal controls to address the financial reporting of these accounts and disclosures, and management properly assessing the effectiveness of the internal controls.[164]

A. Accounts Reflecting Mortgage Activity Trigger the Need for Internal Controls

Auditing Standard No. 5 identifies several factors to consider in identifying significant accounts. These factors include the:

> Size and composition of account; volume of activity; complexity and homogeneity of the individual transactions processed through the account; nature of the account; accounting and reporting complexities associated with the account; exposure to losses in the account; and possibility of significant contingent liabilities arising from the activities reflected in the account.[165]

Considering these risk factors it seems that the accounts reflecting the mortgage activities of investment banks should be deemed "significant," triggering the requirement for internal controls concerning these accounts. There was a tremendous volume of subprime lending, as loan originations reached approximately $625 billion in 2005.[166] There were also a remarkable number of mortgage-backed securities transactions by investment banks,

160. Auditors are also to consider any control deficiencies they identify when conducting the financial statement audit. *Id.* ¶ 15.

161. This is to direct attention to the accounts, disclosures and assertions that "present a reasonable possiblity of material misstatement to the financial statements and related disclosures." *Id.* ¶ 21.

162. *Id.* ¶ 28.

163. The other financial statement assertions include "existence or occurrence, completeness, and rights and obligations." *Id.*

164. *See* AUDITING STANDARD NO. 5, *supra* note 159, ¶ 2; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified in scattered sections of 15 U.S.C.).

165. AUDITING STANDARD NO. 5, *supra* note 159, ¶ 29.

166. Sabry & Schopflocher, *supra* note 107, at 93. The 2005 figure shows the tremendous growth in subprime loan origination as 2001 had only approximately $120 billion of subprime loan origination.

evidenced by the $1.5 trillion worth of mortgage-backed securities the top 10 investment banks sold during 2006.[167] The variety of mortgages and securitization schemes underlying these accounts also became increasingly complex.[168] Additionally, the sale of mortgages by investment banks to SPEs triggered the application of complicated accounting standards and the need to fund reserves for repurchase agreements in order to stave off the risk of bankruptcy.[169] Further, there was obviously a significant risk of loss associated with mortgage-related activities, as hundreds of billions in losses have been triggered by these activities.[170] These accounts, therefore, likely should be been identified as "significant."

Since mortgage-related accounts should have been identified "significant," investment banks should have concluded that these accounts required internal controls addressing their valuation and disclosure in the financial statements. Citigroup will be used as an example to illustrate the potential applications of these aspects of SOX to the role of investment banks in the mortgage meltdown.[171]

B. Internal Control over Valuation

The "valuation" financial statement assertion addresses whether elements of the financial statement have been appraised or "valued" appropriately.[172] Assets recorded in financial statements at fair value have been affected by the housing and mortgage markets, triggering the need to increase credit losses for mortgage and mortgage-backed securities.[173] The internal controls addressing the valuation of the accounts that reflect this activity should address the method of valuation, whether the method's underlying assumptions are

167. Der Hovanesian, *supra* note 119, at 70.

168. Prins, *supra* note 102, at 114.

169. *See* Sabry & Schopflocher, *supra* note 107, at 95–97.

170. Sorkin, *supra* note 99, at A1.

171. Citigroup has participated widely in the mortgage business and is one of the largest issuers of subprime mortgages. *See* Eric Dash, *Citigroup Combining Mortgage Operations Into One Unit*, N.Y. Times, Jan. 9, 2008, at C2, *available at* www.nytimes.com/2008/01/09/business/09citi.html?scp=1&sq=citigroup%20combining%20mortgage%20operations%20into%20one%20unit&st=cse.

172. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AICPA PROFESSIONAL STANDARDS AU § 326.07 (2006) ("Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that property is recorded at historical cost and that such cost is systematically allocated to appropriate accounting periods. Similarly, management asserts that trade accounts receivable included in the balance sheet are stated at net realizable value.").

173. PUB. CO. ACCOUNTING OVERSIGHT BD., STAFF AUDIT PRACTICE ALERT NO. 2, 1 n.1 (2007), http://pcaobus.org/Standards/QandA/12-10-2007_APA_2.pdf.

reasonable, and if the method should be altered due to market conditions.[174] This could be an area of success or failure for SOX, primarily turning on whether the internal controls concerning valuation triggered investment banks to take their mortgage-related write-downs at the proper time. If the write-down of an asset should have been taken earlier than when it was actually reflected in the financial statements, it would indicate that the prior financial statements were improperly overvalued.

SOX may not have enhanced investor protection during the mortgage crisis if investment banks failed to identify the accounts reflecting mortgage activity as "significant" and, thus, failed to conclude the accounts required internal controls to address proper valuation.[175] If the correct accounts are not identified as requiring internal controls to address how the activity is recorded in the financial statements, investors are not provided with information superior to the information available pre-SOX.

Sox may not have provided increased investor protection if investment banks correctly implemented the internal controls but incorrectly assessed the controls as effective.[176] For example, one of Citigroup's write-downs in its Securities and Banking division for the fourth quarter of 2008 included $4.6 billion for direct subprime related exposure.[177] In the fourth quarter of 2007, Citigroup wrote down $17.4 billion for the same exposure.[178] If it is found in the future that the 2008 write-down should have occurred in 2007 or sooner, then both the 2008 financial statements and the prior period's financial statements would have been improperly valued. This could be considered an area where SOX was not effective if it is found that though management conducted the required assessment and determined that the internal controls were effective, when in actuality the adjustments should have been recorded in a different period. This would suggest that merely complying with SOX assessment requirements was not sufficient to provide additional protection to investors.[179]

Conversely, SOX may be deemed a success concerning account valuation if it is determined that the mortgage-related accounts were properly valued and the write-downs that occurred in 2007 and 2008 were taken in the proper

174. *Id.* at 4–5.

175. *See* AUDITING STANDARD NO. 5, *supra* note 159, ¶ 21.

176. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified in scattered sections of 15 U.S.C.).

177. Press Release, Citigroup Inc., Citi Reports Fourth Quarter Net Loss of $8.29 Billion, Loss Per Share of $1.72 (Jan. 16, 2009), http://www.citigroup.com/citi/fin/data/qer084.pdf.

178. Press Release, Citigroup Inc., Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99 (Jan. 15, 2008), http://www.citigroup.com/citi/fin/data/qer074.pdf.

179. The purpose of SOX is "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . . ." Sarbanes-Oxley Act, 116 Stat. at 745.

period.[180] This would constitute a SOX success because proper valuation would be indicative of management's implementation of internal controls that facilitated the bank's identification of the write-downs' proper timing and application of accounting standards.[181]

As further investigation into the mortgage crisis is conducted, it will be possible to more definitively assess whether the SOX provisions addressing internal controls and their application to valuation were successful. It is, however, possible at this time to identify that there were opportunities for the application of SOX concerning the valuation of mortgage-related activities.

C. SOX Disclosure Requirements

Section 401 though Section 409 of SOX are dedicated to "enhanced financial disclosures" and include specific guidelines that address the disclosure of off-balance sheet transactions, management's assessment of internal controls, pro forma information, the use of a code of ethics, and the presence of a financial expert on the Audit Committee.[182] Additionally, via AS 5, there should be a component of the internal control framework tailored to address the disclosures comprising the financial statements and whether they are "properly classified, described, and disclosed."[183]

1. Investment Bank's Use of Off-Balance Sheet Transactions Trigger SOX Provisions

As mentioned in Part III.A.2, an SPE is a type of off-balance sheet arrangement that can be used by lenders as part of the mortgage securitization process.[184] Section 401 requires a company to disclose material "off-balance sheet transactions"[185] in the Management Discussion and Analysis of the annual and quarterly reports.[186] The disclosure is intended to provide investors with enhanced transparency by including discussion to address the nature of the relationship, the importance of the transactions to liquidity, the nature of

180. *See* AUDITING STANDARD NO. 5, *supra* note 159, ¶ 28; AM. INST. OF CERTIFIED PUB; ACCOUNTANTS, *supra* note 172, at AU § 326.07.

181. AUDITING STANDARD NO. 5, *supra* note 159, ¶ 28.

182. §§ 401–09, 116 Stat. at 785–91; AUDITING STANDARD NO. 5, *supra* note 159, ¶ 28.

183. AUDITING STANDARD NO. 5, *supra* note 159, at ¶ 28. Examples of the application of the disclosure assertion include "management asserts that obligations classified as long-term liabilities in the balance sheet will not mature within one year. Similarly, management asserts that amounts presented as extraordinary items in the income statement are properly classified and described." AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 172, at AU § 326.08.

184. Sabry & Schopflocher, *supra* note 107, at 96.

185. § 401,116 Stat. at 786.

186. Bost, *supra* note 19, at 37.

any interests retained by the company, and any known events of uncertainty that are likely to reduce the benefit of the SPE to the company.[187]

While it is to be expected that the 2008 annual reports of investment banks will include significant disclosures related to the off-balance sheet arrangements that contributed to the losses recorded during 2008, one might also expect for there to have been similar disclosures *prior* to the losses that were ultimately recorded. SPE transactions were one of the principal triggers of Enron's downfall, and its investors were not properly or sufficiently informed of the degree of risk Enron was exposed to by them.[188] The spirit of SOX would seem to call for providing investors with disclosure *before* the investor suffers declining share value from losses stemming from these risks.

Investment banks began writing-down assets related to mortgage activities in October 2007.[189] This renders the 2006 annual report of an investment bank of particular interest to the analysis here. Comparison of Citigroup's 2006 and 2007 annual reports will therefore be used to highlight the application of SOX to the mortgage meltdown.

In 2006, Citigroup allocated two pages of its annual report discussion under the heading "Off-Balance Sheet Arrangements."[190] The discussion stated that Citigroup was involved with various off-balance sheet arrangements that included SPEs, some of which were variable interest entities ("VIEs") requiring financial support from third parties.[191] Citigroup stated that it did not consolidate most of these VIEs into its financial statements because Citigroup was not the primary beneficiary of the VIEs.[192] Citigroup did note that some of these arrangements concerned the securitization of assets, including mortgage loan securitizations, and that those arrangements had previously been recorded on its consolidated balance sheet.[193] Additionally, Citigroup noted that it securitized a wide range of mortgage products to reduce credit exposure "effectively transferring the risk of future credit losses to the purchasers of the securities issued."[194]

There is also a reference within the off-balance sheet discussion directing readers to an additional note for further discussion. This note included a table

187. *Id.*

188. Van Niel, *supra* note 32, at 14–15.

189. For example, Citigroup announced for the first time in October that its net income would decline for the third quarter of 2007 from "dislocations in the mortgage-backed securities and credit markets." Press Release, Citigroup Inc., Citi Expects Substantial Decline in Third Quarter Net Income (Oct. 1, 2007), http://www.citigroup.com/citi/press/2007/071001a.pdf.

190. Citigroup Inc., Annual Report (Form 10-K), at 92–93 (Feb. 23, 2007).

191. *Id.* at 92. Citigroup defines a VIE as "type of SPE that does not have sufficient equity to finance its activities without additional subordinated financial support from third parties."

192. *Id.*

193. *Id.* The discussion includes a reference to another footnote for further discussion of cash flows received and paid in relation to the securitizations.

194. *Id.* at 93.

describing the assets of unconsolidated VIEs and company's expectation that actual losses related to unconsolidated VIEs will not be material, with an estimated maximum exposure from unconsolidated VIEs of $109 billion for 2006.[195] Though there was discussion of the company's estimated maximum exposure, arguably investors would have had to search for the information, as it was not included in the discussion under the heading "Off-Balance Sheet Arrangements." Readers had to refer to a separate note, and the information was presented several pages into the referenced note.

Citigroup significantly increased the number of pages and discussion under the heading "Off-Balance Sheet Arrangements" in 2007. The pages increased to twelve and increased the discussion of Citigroup's VIE exposures and the difficulties surrounding the decision whether to consolidate them in the financial statements.[196] The expanded discussion included the standard for determining whether a VIE is reported on a consolidated basis in the financial statements, "based on expected loss and residual returns" from those scenarios most likely to occur.[197] Citigroup commented on the difficulty in ascertaining whether the extent of its involvement with the VIEs rendered it a primary beneficiary (based on "significant involvement") and the factors to consider in making the assessment.[198]

Citigroup made a significant adjustment in its disclosure in 2007 by altering its definition of "significant involvement" to include all variable interests, including those interests where the likelihood of loss was considered small.[199] This triggered VIEs previously considered insignificant to be reclassified to significant.[200] Citigroup's rationale for the expanded designation of significant VIEs was to provide "more meaningful and consistent information regarding its involvement in various VIE structures and . . . more data for an independent assessment of the potential risks the Company's involvement in various VIEs and asset classes."[201]

This reclassification had a tremendous impact of the 2006 unconsolidated "significant" VIEs, which increased from $227.8 billion in 2006[202] to $388.3 billion when reclassified in 2007.[203] Another potential source of surprise for investors in 2007 was the $58.5 billion dollars of additional liability reported on the consolidated balance sheet in 2007 after Citigroup became the primary

195. Citigroup Inc., Annual Report (Form 10-K), at 147 (Feb. 23, 2007).
196. *See* Citigroup Inc., Annual Report (Form 10-K), at 85–96 (Feb. 22, 2008).
197. *Id.* at 85.
198. *Id.* at 85–86.
199. *Id.* at 86.
200. *Id.*
201. Citigroup Inc., Annual Report (Form 10-K), at 86 (Feb. 22, 2008).
202. Citigroup Inc., Annual Report (Form 10-K), at 147 (Feb. 23, 2007).
203. Citigroup Inc., Annual Report (Form 10-K), at 87 (Feb. 22, 2008).

beneficiary of its structured investment vehicles (SIVs), a type of SPE.[204] The only specific reference to SIVs in Citigroup's 2006 Annual Report was embedded as a line item within a table presenting SPE assets and was not included under the heading "Off Balance Sheet Arrangements".[205]

As SOX specifically addressed off-balance sheet relationships in its provisions, it certainly had a role to play in the period leading up to the current economic turmoil because much of the losses sustained by the investment banks were triggered by off-balance sheet relationships.[206] Whether the disclosures concerning the investment bank's off-balance sheet arrangements were SOX compliant will likely be addressed in the future through shareholder litigation.

Presumably, investment bank investors should have been in a better position than Enron investors to assess the risk posed by off-balance sheet arrangements since SOX attempted to enhance these disclosures in response to the outrage of Enron's investors to its hidden off-balance sheet risk exposure.[207] However, similar to the shock felt by Enron investors when the risks of its off-balance sheet relationships were revealed, investors of investment banks are currently expressing shock at the magnitude of risk investment banks undertook and ultimately passed on to its investors.[208] With Enron, the disclosure of the extent of its risky off-balance sheet relationships was revealed after the damage to the company had already been inflicted.[209] Here, while there was increased disclosure in 2007 preceding the tremendous write-downs during 2008, there was minimal disclosure of off-balance sheet risk exposure prior to the write-downs taken during 2007. This may be found to have denied investors the opportunity to adequately assess the risk investment banks faced from off-balance sheet arrangements and, thus, could be considered a failure of SOX.

If the disclosures are found to be lacking, this may also indicate a failure of the internal controls intended to address the adequacy of financial statement disclosures. Future investigations will likely shed further light on whether the investment banks' disclosure of off-balance sheet arrangements was inadequate, whether investors gave inadequate attention to the disclosures that were presented, or a combination of both.

204. *Id.* at 94. In 2007 Citigroup became a primary beneficiary of structured investment vehicles, by committing to support the SIVs senior debt rating. The rating of the debt had been downgraded and continued liquidity issues prompted Citigroup to make the commitment, resulting in consolidation of the SIV on Citigroup's balance sheet.

205. Citigroup Inc., Annual Report (Form 10-K), at 146 (Feb. 23, 2007).

206. McLean, *supra* note 50, at 76.

207. *See supra* Part II.B.

208. *See supra* Part II.B.

209. *See supra* Part II.B.

2. Investment Bank's Use of Pro Forma Data Regarding Capital Requirements Trigger SOX Provisions

SOX also addressed the presentation of disclosures related to pro forma data. Section 401 calls for pro forma data to be presented in a manner that is free from untrue material facts and free from omissions of material facts necessary to make the pro forma data not misleading.[210] While in 2006, Citigroup did not present pro forma mortgage-related data,[211] its 2007 Annual Report presented pro forma capital ratios incorporating the effect of Citigroup's actions to increase its capital base during the fourth quarter of 2007 and beginning of 2008.[212] SOX calls for assessing whether this presentation of pro forma capital ratios was free from untrue material facts and whether any material facts necessary to make them not misleading were omitted when Citigroup indicated that the pro forma capital ratios would have exceeded management's targets.[213] The discussion presented did not directly discuss any perceived concerns about future needs to further increase Citigroup's capital base.[214]

The absence of discussion of future capital needs may be considered a violation of SOX if the absence constituted a failure to include material facts necessary to prevent the data from being misleading. This is a possibility considering the extensive strides Citigroup took to raise capital during 2008. Citigroup made a $4.5 billion common stock offer on April 30, 2008, with the intent of "improving the balance sheet."[215] More notably, Citigroup issued $25 billion of perpetual preferred stock to the U.S. Treasury as part of the TARP Capital Purchase Program on December 31, 2008.[216] These actions could be considered indicative of the serious problem capital requirements posed for Citigroup during 2008. Further investigation will likely reveal whether Citigroup should have known of this potential problem at the time it made its pro forma disclosures in the 2007 Annual Report.

210. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401, 116 Stat. 745, 785–87 (codified in scattered sections of 15 U.S.C.).

211. Citigroup Inc., Annual Report (Form 10-K), at 115 (Feb. 23, 2007).

212. Citigroup Inc., Annual Report (Form 10-K), at 76 (Feb. 22, 2008). The Company raised over $30 billion to increase its capital base and on a pro forma basis would have increased several of its capital ratios.

213. § 401, 116 Stat. at 785–87; Citigroup Inc., Annual Report (Form 10-K), at 76 (Feb. 22, 2008).

214. *See* Citigroup Inc., Annual Report (Form 10-K), at 76–77 (Feb. 22, 2008).

215. Press Release, Citigroup Inc., Citi Prices $4.5 Billion Common Stock Offering (Apr. 30, 2008), *available at* http://www.citigroup.com/citi/press/2008/080430a.htm.

216. Citigroup released its first progress report of the use of its TARP funds in February 2009. Press Release, Citigroup Inc. Citi Issues First Quarterly Progress Report on Its Use of TARP Capital (Feb. 3, 2009), *available at* http://www.citigroup.com/citi/press/2009/090203a.htm.

3. Disclosure of Code of Ethics and Audit Committee Financial Expert Did Not Prevent Losses

SOX also required the company to disclose whether it has a code of ethics and whether the audit committee has a financial expert.[217] While these enhanced disclosure requirements arguably provide investors with important information concerning general corporate governance, these likely played less of a role in the context of the mortgage-related risks. Citigroup indicated in both its 2006 and 2007 Annual Reports that it has a company-wide Code of Conduct that is supplemented by a Code of Ethics for Financial Professionals.[218] Citigroup also directed readers to its website for additional information concerning its corporate governance. The Audit and Risk Management Committee Charter indicated that its membership included at least one member that qualified as an audit committee financial expert.[219]

While these additional disclosure requirements provide some insight into a company's corporate governance practices, the generality of these disclosures likely did little to shed light for investors on the tremendous mortgage-related risks the investment banks were facing. In the context of these disclosures, investors may be more informed by the *absence* of a code of ethics or financial expert on the audit committee. A company's failure to maintain a code of ethics or include a financial expert on its audit committee would provide a warning to a potential investor about the company's corporate governance when deciding whether to invest. In the context of Citigroup, compliance with these SOX requirements did not prevent staggering losses, but perhaps their utilization indirectly mitigated the degree of losses sustained.

V. CONCLUSION

The United States entered a recession in 2007, millions of people lost their jobs, many homes entered foreclosure, and investment banks took billions of dollars in losses.[220] Investment banks played a significant role in the popularization of subprime lending and growth in mortgage securitization. The losses incurred by investment banks refresh the public's memory of Enron's collapse that propelled the Sarbanes-Oxley Act into law. As SOX focused on protecting investors through reliable and accurate financial

217. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 406–07, 116 Stat. at 789–790.

218. Citigroup Inc., Annual Report (Form 10-K), at 96 (Feb. 23, 2007). Financial professionals include positions concerning "finance, accounting, treasury, tax and investor relations." Citigroup Inc., Annual Report (Form 10-K), at 97 (Feb. 23, 2007).

219. Citigroup Inc., Audit and Risk Management Committee Charter, at 1 (Jan. 20, 2010), *available at* http://www.citigroup.com/citi/corporategovernance/data/auditriskcharter.pdf?ieNocache=809.

220. *See* discussion *supra* Part I.

disclosures, the question arises whether SOX had a role to play in protecting investors of investment banks from the current crisis.

It is clear there are SOX provisions applicable to the mortgage-related activity of investment banks. SOX charged management of investment banks with responsibility for establishing internal control systems to address financial reporting for "significant" accounts.[221] Given the tremendous volume and complexity of investment banks mortgage-related transactions, these accounts should likely be considered "significant."[222] As a result, investment banks should have instituted controls to address the valuation and disclosure of mortgage-related activity in the financial statements.[223] Of particular concern is whether the disclosure of off-balance sheet relationships used by investment banks for mortgage activities were sufficiently disclosed prior to investment banks' recorded losses.[224] A further concern is whether disclosure of pro forma data for capital requirements made prior to the significant capital raising activities during 2008 were sufficient to not be misleading.[225] While SOX triggered disclosures regarding the existence of a code of ethics and the presence of financial experts on the audit committee, these disclosures likely did not provide information sufficiently specific to alert investors to the mortgage-related risks investment banks incurred.[226]

Further investigation is necessary to assess whether the investment bank's financial statements violated SOX. If investment banks were compliant, this may suggest that SOX is not effectively carrying out its purpose of enhancing protection for investors. As the broad reach of the economic recession has demonstrated, answering these questions is imperative to ascertain what reform measures should be taken to protect not only investors, but the general public as well.

ELISA C. CLARK∗

221. *See* discussion *supra* Part III.
222. *See* discussion *supra* Part III.A.
223. See discussion supra Part III.A.
224. *See* discussion *supra* Part III. B.
225. *See* discussion *supra* Part III.C.2.
226. *See* discussion *supra* Part III.C.3.

∗ J.D. Candidate, May 2010, Saint Louis University School of Law. I would like to extend my appreciation to Professor Matthew Bodie for his guidance in writing this comment.