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LEGAL OPINION RE: MAIDEN LANE II AND MAIDEN LANE III LOANS

Issue: Whether the Federal Reserve Board and New York Federal Reserve Bank loans to Maiden Lane II LLC and Maiden Lane III LLC violated 12 USC § 343

I

SUMMARY

This legal opinion concludes that the Federal Reserve Board (Federal Reserve) and New York Federal Reserve Bank (New York Fed) made up to $52.5 billion of loans to Maiden Lane II LLC (Maiden Lane II) and Maiden Lane III LLC (Maiden Lane III) in violation of 12 USC § 343.[1] The residential mortgage backed securities (RMBS) and the collateralized debt obligations (CDOs) pledged to secure the loans were not qualified collateral under 12 USC § 343 and 12 C.F.R. § 201.4.[2]

The Maiden Lane loans were made purportedly to facilitate American International Group's (AIG) restructuring.[3] In fact, the loans helped to get losses off of AIG's financial statement -- losses incurred as part of an alleged fraudulent financial products scheme.[4]

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[1] "Is there any reason why the American people should be taxed to guarantee the debts of banks, any more than they should be taxed to guarantee the debts of other institutions, including the merchants, the industries, and the mills of the country?" Senator Carter Glass (1933); see also Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.

[2] Maiden Lane II Annual Financial Statement for year ended 31 December 2008; Maiden Lane III Annual Financial Statement for year ended 31 December 2008; http://www.newyorkfed.org/markets/maidenlane2.html; http://www.newyorkfed.org/markets/maidenlane3.html.

[3] http://www.newyorkfed.org/markets/maidenlane2.html; http://www.newyorkfed.org/markets/maidenlane3.html.

[4] AIG had a record of 3 SEC fraud injunctions and 2 criminal fraud deferred prosecutions. AIG bought RMBS and acquired the CDO pledged in connection with fraudulent conduct alleged in detail in *Harris v. AIG*, Superior Court of California, County of Los Angeles, Case No. BC 414205; see Second Amended Complaint *Harris v. AIG*.

This legal opinion concludes that the Federal Reserve Board and New York Fed made the Maiden Lane II and III loans in violation of 12 USC § 343 because the RMBS and CDO collateral pledged to secure the loans was not of the value and type required under 12 USC § 343 and the 12 C.F.R. § 201.4.

II.

MAIDEN LANE LOANS

A. Maiden Lane II

Maiden Lane II was formed in the fourth quarter of 2008. On 12 December 2008 Maiden Lane II purchased RMBS with a purported estimated fair value of approximately $20.8 billion as of 31 October 2008. Maiden Lane II financed this purchase of AIG's RMBS with $19.5 billion borrowed from the New York Fed.[5] The loan was for a term of 6 years; the interest rate on the loan is one-month LIBOR plus 100 basis points. As of 31 October 2008 the RMBS had a purported par value of approximately $39.3 billion. BlackRock Financial Management Inc. (BlackRock) was retained by the New York Fed to manage Maiden Lane II's RMBS under a no-bid multi-year contract.

The RMBS delivered to the New York Fed in connection with the Maiden Lane II loans were not AAA-rated and did not satisfy the New York Fed's established collateral requirements for loans to depository institutions. The New York Fed maintains it was not required to follow its collateral quality criteria because of the necessity of the financial crisis of 2008.

AIG caused over $75 billion in RMBS to be purchased with cash borrowed in loans from banks secured by AIG life insurance company bonds. The borrowing of cash using AIG insurance company bonds as collateral to buy RMBS formed AIG's securities lending program.

5 Statement of Financial Accounting Standards 157 defines "fair value" as the "price that would be received to sell an asset ... in an orderly transaction between market participants at the measurement date."

AIG is alleged to have engaged in fraud in connection with the securities lending program.[6] The RMBS Maiden Lane II purchased were a product of the alleged fraud.[7]

B. Maiden Lane III

Maiden Lane III was formed in the fourth quarter of 2008. Maiden Lane III borrowed approximately $24.3 billion from the New York Fed. The loan proceeds were used to purchase from third-party counterparties of AIG Financial Products Corp. (AIGFP) CDOs with a purported estimated fair value as of 31 October 2008 of approximately $29.6 billion. Each of the AIGFP counterparties agreed to terminate the related credit derivative contracts between such counterparty and AIGFP.

Maiden Lane III purchased the CDOs in two stages. The first purchase was on 25 November 2008; the second on 18 December 2008.[8] As of 31 October 2008 the CDO Portfolio had a purported par value of approximately $62.1 billion. The term of the Maiden Lane III loan was for six years; the interest rate is one-month LIBOR plus 100 basis points. BlackRock was also retained by the New York Fed to manage Maiden Lane III's RMBS under a no-bid multi-year contract.

The CDOs delivered to the New York Fed in connection with the Maiden Lane III loans were not AAA-rated and did not satisfy the New York Fed's established collateral requirements for loans to depository institutions. The New York Fed maintains it was not required to follow its collateral quality criteria because of the necessity of the financial crisis of 2008.

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[6] See Second Amended Complaint, *Harris v. AIG*.
[7] See Second Amended Complaint, *Harris v. AIG*.
[8] http://www.newyorkfed.org/markets/maidenlane3.html.

AIG wrote credit default swap (CDS) protection for more than $537 billion of CDOs, $379 billion of which was written by AIG to help banks circumvent their bank regulatory capital requirements. AIG is alleged to have engaged in fraud in connection with its writing of $537 billion of CDS in connection with CDOs.[9] The CDOs Maiden Lane III purchased were a product of the alleged fraud.[10]

C. Valuing the RMBS and CDO held by Maiden Lane II, III

BlackRock manages, under a multi-year contract, the RMBS in Maiden Lane II and the CDOs in Maiden Lane III.[11] The fact the RMBS and CDOs held by Maiden Lane II and III have to be "managed" by a major investment manager like BlackRock under a multi-year contract underscores the fact that the loans were not the type permitted under the emergency lending provisions of 12 USC § 343.

The Maiden Lane II and III "net portfolio holdings" of RMBS and CDOs are reported at "fair value" in the weekly Federal Reserve Statistical Release Factors Affecting Reserve Balances H.4.1 (Fed Reserve Balance Report).[12] The Fed Reserve Balance Report states that "fair value" reflects an "estimate of the price that would be received upon selling an asset if the transaction were to be conducted in an orderly market on the measurement date."[13] It is assumed the Federal Reserve uses the valuation BlackRock made of the RMBS and CDOs. It is also assumed the Maiden Lane II and III audits used BlackRock's valuation of the RMBS and CDOs.

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[9] See Second Amended Complaint, *Harris v. AIG*.
[10] See Second Amended Complaint, *Harris v. AIG*.
[11] Maiden Lane II Annual Financial Statement for year ended 31 December 2008 p.9; Maiden Lane III Annual Financial Statement for year ended 31 December 2008 p. 9.
[12] FEDERAL RESERVE statistical release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks; http://www.federalreserve.gov/Releases/H41/.
[13] FEDERAL RESERVE statistical release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks; http://www.federalreserve.gov/Releases/H41/.

The Maiden Lane audits[14] represent that the RMBS and CDOs are recorded at fair values determined by reference to Statement of Financial Accounting Standards 157 (SFAS 157). The auditors reason that each limited liability company (Maiden Lane II,[15] Maiden Lane III[16]) qualifies as a non-registered investment company under the provisions of the American Institute of Certified Public Accountants' Audit and Accounting Guide for Investment Companies, and therefore, all investments are recorded at fair value in accordance with SFAS 157.[17] In essence, the audit reports treat the New York Fed as an unregistered investment company that made an investment in RMBS and CDOs, rather than a Federal Reserve Bank making a secured loan based upon fully secured collateral under 12 USC § 343.

Under SFAS 157, Maiden Lane II values its "investments" on the basis of last available bid prices or current market quotations provided by dealers or pricing services selected under the supervision of BlackRock, according to the 2008 audit.[18] Again, the New York Fed was not making an "investment;" the New York Fed was making a fully secured loan under 12 USC § 343.

Moreover, the auditors claim the RMBS "do not have a readily available fair value" and the represented fair value "may differ materially from the values that may ultimately be realized and paid."[19] The use of the RMBS as 12 USC § 343 collateral is further undermined by

[14] Maiden Lane audits were performed by Deloitte & Touche LLP.
[15] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 p.11 which provides: "The [Maiden Lane II] LLC qualifies as a non-registered investment company under the provisions of the American Institute of Certified Public Accountants' *Audit and Accounting Guide for Investment Companies* and therefore all investments are recorded at fair value in accordance with Statement of Financial Accounting Standards 157, "Fair Value Measurements" ("SFAS 157"); http://www.newyorkfed.org/markets/maidenlane2.html.
[16] See Maiden Lane III Annual Financial Statement for year ended 31 December 2008 p. 8 which provides: "The [Maiden Lane III] LLC qualifies as a non-registered investment company under the provisions of the American Institute of Certified Public Accountants' *Audit and Accounting Guide for Investment Companies* and therefore all investments are recorded at fair value in accordance with [SFAS 157]", http://www.newyorkfed.org/markets/maidenlane3.html.
[17] See immediately preceding footnotes.
[18] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 p. 8; http://www.newyorkfed.org/markets/maidenlane2.html.
[19] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.

the admission the value ultimately realized from the RMBS may differ materially from its represented value.[20]

The Maiden Lane II audit makes general reference to valuation methods used under SFAS 157 but does not state precisely how Maiden Lane II's RMBS were valued.

> **Determination of Fair Value**
> The LLC values its investments on the basis of last available bid prices or current market quotations provided by dealers or pricing services selected under the supervision of the Investment Manager. To determine the value of a particular investment, pricing services may use certain information with respect to transactions in such investments, quotations from dealers, pricing metrics, market transactions in comparable investments, various relationships observed in the market between investments, and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.[21]

The Maiden Lane II auditors admit "proprietary valuation models" can be used to determine the RMBS values if the Investment Manager (BlackRock) determines "current market quotations do not reflect fair value of a security:"[22]

> Market quotations may not represent fair value in certain circumstances in which the Investment Manager and the LLC believe that facts and circumstances applicable to an issuer, a seller, or a purchaser, or the market for a particular security, cause current market quotations to not reflect the fair value of a security. In such cases, the Investment Manager applies proprietary valuation models that use collateral performance scenarios and pricing metrics derived from the reported performance of the universe of bonds with similar characteristics as well as observable market data to determine fair value.[23]

The 2008 audit does not identify when and if BlackRock used its "proprietary valuation models." Moreover, using "collateral performance scenarios and pricing metrics derived from the reported performance of the universe of bonds with similar characteristics" can confuse the

[20] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.
[21] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.
[22] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.
[23] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.

performance of the market on a macro basis with the idiosyncratic performance of the RMBS acquired by AIG in connection with its unique securities lending program.

Further, the auditors admit that the RMBS were valued using "projected collateral performance scenarios" and "pricing metrics derived from the **reported** performance of the universe of bonds" and "observations and estimates of market data."[24]

Maiden Lane II's 2008 audit reports states certain of Maiden Lane II's RMBS were valued under the "Level 3" method. A Level 3 valuation is one of the three methods used to value assets under SFAS 157. As stated in the quote below, Level 3 is used for assets where there is limited activity or transparency:

> **Valuation Methodologies for Level 3 Assets and Liabilities**
> In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy.
>
> For instance, in valuing certain RMBS the determination of fair value is based on projected collateral performance scenarios. These valuations also incorporate pricing metrics derived from the reported performance of the universe of bonds as well as observations and estimates of market data. Because external price information is not available, market-based models are used to value these securities. Key inputs to the model may include market spread data for each credit rating, collateral type, and other relevant contractual features.[25]

The auditors claimed there is not a readily available fair value for the CDOs and the represented fair value of the CDOs "may differ significantly from the values that may ultimately be realized."[26] Again, there is a readily available fair value for the CDOs as with the RMBS. However, putting the CDOs on the market would have resulted in realized losses which the loans to Maiden Lane II and III are masking.

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[24] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.

[25] See Maiden Lane II Annual Financial Statement for year ended 31 December 2008 pp. 11-13; http://www.newyorkfed.org/markets/maidenlane2.html.

[26] See Maiden Lane III Annual Financial Statement for year ended 31 December 2008 pp. 8, 12-13; http://www.newyorkfed.org/markets/maidenlane3.html.

The auditors represented the Maiden Lane III CDOs were valued as "investments," not collateral for a loan. Again, the auditors refer to general pricing methods used under SFAS 157 but do not reveal how they were used to value the specific CDOs held by Maiden Lane III:

> **Determination of Fair Value**
> The LLC values its investments on the basis of last available bid prices or current market quotations provided by dealers or pricing services selected under the supervision of the Investment Manager. To determine the value of a particular investment, pricing services may use certain information with respect to transactions in such investments, quotations from dealers, pricing metrics, market transactions in comparable investments, various relationships observed in the market between investments, and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.

Again, as with the RMBS held by Maiden Lane II, BlackRock retains the power to apply "proprietary valuation models" and use "pricing metrics derived reported performance of the universe of bonds with similar characteristics:"

> Market quotations may not represent fair value in certain circumstances in which the Investment Manager and the LLC believe that facts and circumstances applicable to an issuer, a seller or a purchaser, or the market for a particular security cause current market quotations to not reflect the fair value of a security. In such cases, the Investment Manager applies proprietary valuation models that use collateral performance scenarios and pricing metrics derived from the reported performance of the universe of bonds with similar characteristics as well as observable market data to determine fair value.

Again, as with the RMBS in Maiden Lane II, BlackRock used "projected collateral performance scenarios" to determine the value of CDOs submitted as collateral to the New York Fed for the Maiden Lane III $24.3 billion loan.

Maiden Lane III's 2008 audit report states certain of Maiden Lane III's CDO were valued under the "Level 3" method.[27] The reference to "Level 3" relates to one of the three methods used to value assets under SFAS 157. As stated in the quote below, Level 3 is used for asset valuation where there is limited activity or transparency:

[27] Notably as set forth in Table 1 herein, a Level 2 valuation was done for some, but not all, RMBS in the Maiden Lane II portfolio. Level 2 – Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Valuation Methodologies for Level 3 Assets and Liabilities
In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within level 3 of the valuation hierarchy.

For instance, in valuing certain ABS CDOs the determination of fair value is based on projected collateral performance scenarios. These valuations also incorporate pricing metrics derived from the reported performance of the universe of bonds as well as observations and estimates of market data. Because external price information is not available, market-based models are used to value these securities. Key inputs to the model may include market spread data for each credit rating, collateral type, and other relevant contractual features. [28]

Table 1 presents the RMBS and CDOs recorded in the 2008 audits of Maiden Lane II and Maiden Lane III:

Table 1 Assets (in thousands)	**Level 1**	**Level 2**	**Level 3**	**Total**
RMBS (ML II)		$7,406,039	$11,433,000	$18,839,039
CDOs (ML III)			$26,664,828	$26,664,828

The Fed Reserve Balance Reports for the values of the RMBS, CDOs and the related collateral values are shown on Table 2:[29]

Table 2 ($$ Billions)	**Start**	**Dec 2008**	**March 2009**	**June 2009**	**Sept 2009**	**Dec 2009**	**Feb 2010**
Maiden Lane II Net Portfolio holdings	20.800	20.049	18.449	15.961	14.662	15.697	15.498
Maiden Lane II Outstanding Loan Principal	19.500	19.494	18.543	17.553	16.587	15.739	15.479
Maiden Lane III Net Portfolio holdings	29.600	28.181	27.645	20.159	20.554	22.660	22.554
Maiden Lane III Outstanding Loan Principal	24.300	24.339	24. 036	22.400	19.574	18.159	17.743

[28] See Maiden Lane III Annual Financial Statement for year ended 31 December 2008 pp. 8, 12-13; http://www.newyorkfed.org/markets/maidenlane3.html.
[29] FEDERAL RESERVE statistical release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks; http://www.federalreserve.gov/Releases/H41/.

III.

LAW RESTRICTING COLLATERAL FEDERAL RESERVE BANKS CAN ACCEPT FOR EMERGENCY LOANS TO NONBANKS

Whether the New York Fed had authority under 12 USC § 343 to make the Maiden Lane II and III loans based on the RMBS and CDOs pledged as security is a question of statutory interpretation. See Kelso, Randall R., *Statutory Interpretation Doctrine on the Modern Supreme Court and Four Doctrinal Approaches to Judicial Decision-making*, 25 Pepp. L. Rev. 37 (1997); Breyer, Stephen G., *On the Uses of Legislative History in Interpreting Statutes*, 65 S. Cal. L. Rev. 845 (1992).

The meaning of the statutory language of 12 USC § 343, the bare meaning of its words, its placement and purpose 12 USC § 343 in the overall statutory scheme of the Federal Reserve System, and its legislative history compel the conclusion that Federal Reserve Banks are limited to lending to nonbanks based on collateral required when Federal Banks lend to depository institutions. As discussed below, the legislative intent of 12 USC § 343 (as amended) provides Federal Reserve Banks with the authority to make emergency loans to nonbanks secured by collateral as with depository institutions.[30]

In summary, the loans to nonbanks must be limited to the periods determined by the Fed Board. The rates must be established in accordance with the provisions of 12 USC § 357. The discounts for nonbanks must be indorsed or otherwise secured to the satisfaction of the Federal

[30] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*. Walker F. Todd is a former assistant general counsel and research officer at the Federal Reserve Bank of Cleveland. Helpful comments and suggestions were provided by Melvin Burstein, Joseph Haubrich, Owen Humpage, William Osterberg, Robin Ratliff, Mark Sniderman, James Thomson, and two anonymous referees.

Reserve Bank. The Federal Reserve Bank making the loan is required to obtain evidence that such nonbank is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Federal Reserve Board.[31]

Specifically, 12 USC § 343 [Federal Reserve Act §13(3)] provides that in unusual and exigent circumstances, a minimum of 5 members of the Federal Reserve Board may authorize any Federal Reserve Bank "to discount" for any nonbank "notes, drafts, and bills of exchange" when "indorsed or otherwise secured to the satisfaction of the Federal reserve bank."[32]

The Federal Reserve Bank making the loan is required to "obtain evidence" that the nonbank "is unable to secure adequate credit accommodations" from other banks. Such discounts are subject to such limitations, restrictions, and regulations, as the Federal Reserve Board may prescribe. Five members of the Fed Board must authorize the loan.[33]

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) mandated limitations on Reserve Banks' advances to undercapitalized banks.[34] FDICIA limited Reserve Banks' loans to undercapitalized depository institutions and made it more difficult for the Federal Reserve to treat an institution as too big to fail.[35]

In the final stages of the congressional debate in November 1991 an amendment to FDICIA (§ 473) was introduced by Senator Christopher J. Dodd (D-Conn.). The amendment proposed to give Federal Reserve Banks authority to lend to nonbanks in emergencies using the same type of collateral in depository institution loans. The amendment was enacted.

[31] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[32] 12 USC § 343 [Federal Reserve Act §13]; Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[33] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[34] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[35] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.

The 1991 legislation, authored by Sen. Dodd, was requested by Goldman Sachs and other Wall Street firms in the wake of the 1987 market crisis, and it would save some of them a generation later.[36] Sen. Dodd, at the time of the legislation, said it would give "greater flexibility to respond in instances in which the overall financial system threatens to collapse."[37]

The 1991 amendment has been read by some to provide the Fed Board and the New York Fed with more authority to lend to nonbanks than banks.[38] They argue Congress in adopting § 473 "vastly expanded the emergency powers of the Federal Reserve" and "[a]llmost no one noticed."[39] They then argue that the 1991 amendment removed "a long standing prohibition on loans that supported financial speculation."[40]

This "sea change" reading is not supported by the legislative history of the 1991 amendment, and is internally inconsistent. On the one hand the argument is made that the 1991 amendment was enacted the day before Thanksgiving, suggesting little attention was being paid to the change. However, proponents of the sea change interpretation claim Congress transformed the Federal Reserve from bank lender to a protector of Wall Street speculators.[41]

Interpreting the legislative history of the Dodd amendment to support the bold proposition that Congress intended to give the Federal Reserve more authority to lend to

36 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.
37 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.
38 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.
39 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.
40 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.
41 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.

nonbanks than banks is further undermined by the drafting ambiguity of the Dodd amendment, as stated in the notes to 12 USC § 343:

> 1991. Act Dec. 19, 1991 purported to amend the **third** paragraph, by deleting "of the kinds and maturities made eligible for discount for member banks under other provisions of this Act" preceding "when such notes"; however, there **being no third paragraph**, the amendment was executed to the second paragraph in order to effectuate the probable intent of Congress.

The legislative record and standard cannons of interpretation do not support the "sea change" interpretation. Congress did not show a legislative intent to convert the Federal Reserve into a bank for bailing out failed speculators. In fact, as noted in this opinion, the FDICIA mother legislation into which the 1991 Amendment (§ 473) was written, was aimed at curtailing, not expanding, the Federal Reserve's involvement in troubled depository institutions.[42]

The fact that the supposed authority for bailing out derivative speculators "sat unused for more than 16 years" cuts against the argument that the law was designed to finance Wall Street speculators by empowering Federal Reserve Banks make loans like Maiden Lane II and III.

Federal Reserve General Counsel Scott Alvarez claims there is legal support for making the loans, however he has not issued a public legal opinion supporting his views quoted here:

> This provision was designed as a last resort to make sure credit flows when times are tough and credit isn't being extended," said Scott Alvarez, the Fed's general counsel. "That's exactly what it's being used for today."[43]

Ernest T. Patrikis, former general counsel at the Federal Reserve Bank of New York,[44] had referenced cases in which Federal Reserve lawyers conducted legal research into Federal

[42] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[43] 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.

Bank options under 12 USC § 343. It would be helpful if the Federal Reserve would release this research.[45] Statements made after passage of the legislation are given little weight especially when made outside of the formal legislative process. *Consumer Prod. Safety Commission v. Gte Sylvania, Inc.* (1980) 447 U.S. 102, 118.

FDICIA § 473 changed 12 USC § 343 [Federal Reserve Act §13 (3)] to allow Federal Reserve Banks to loan to nonbanks using what is known as Federal Reserve Act §10B collateral. Under § 10B the Federal Reserve Banks can make "advances secured to the satisfaction of ... the Federal Reserve Bank," or "any satisfactory assets." The § 473 amendment gave Federal Reserve Banks the authority to use the "satisfactory security" collateral test to make loans under 12 USC § 343 to nonbanks.

During the limited Senate floor debate on § 473, Senator Chris Dodd, § 473's author, represented that loans to nonbanks under his amendment could only be made if "fully secured:"

> [FDICIA] also includes a provision offered to give the Federal Reserve greater flexibility to respond in instances in which the overall financial system threatens to collapse. My provision allows the Fed more power to provide liquidity by enabling it to make fully secured loans to securities firms in instances similar to the 1987 stock market crash.[46]

Thus, 12 USC § 343 [Federal Reserve Act §13(3)] was amended to permit nonbank firms to borrow at the Fed Reserve discount window for emergency purposes but only **under the same collateral terms afforded to banks**. FDICIA § 473 *did not* give Federal Reserve Banks the power to make loans to nonbanks that the Federal Reserve Banks could not make to depository institutions.

Interpreting § 473 to permit loans to nonbanks based on collateral that could not be accepted from depository institutions would contradict the purpose of FDICIA which was

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[44] Mr. Patrikis is now a partner at White & Case, a Washington D.C. based firm that regularly represents major banks and insurance companies.

[45] 30 May 2009 Saturday Washington Post, *Congress's Afterthought, Wall Street's Trillion Dollars; Fed's Bailout Authority Sat Unused Since 1991*.

[46] See *Congressional Record* (1991), p. S18619; Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.

intended both to limit Reserve Banks' loans to undercapitalized depository institutions and to make it more difficult for the Federal Reserve to treat an institution as too big to fail. Congress adopted the revisions of Section13 (3) in § 473 of FDICIA without extensive discussion or debate, leaving a rather scant legislative history for this statute. Finally, there was no explicit statement made during congressional deliberations on FDICIA suggesting the proposed change to the nonbank borrowing collateral requirement under §13 (3) could be used to shift a portion of the risk of loss previously borne by the nonbanks' creditors onto the Reserve Banks and, thus, indirectly onto the taxpayer.[47]

In 2007 the Fed Board adopted a regulation (12 C.F.R. § 201.4) implementing the emergency lending authority of Fed banks under 12 USC § 343. Under the regulation, a Federal Bank can make loans to nonbanks only in unusual and exigent circumstances and after consultation with the Board of Governors. The Federal Reserve Bank has to conclude that credit is not available from other sources and **failure to obtain such credit would adversely affect the economy.**

If the collateral used to secure the emergency loan is not issued or guaranteed by the United States government, then the collateral must be in the form of a discount and 5 Board of Governors members must vote to authorize the discount prior to the extension of the credit:

> **If the collateral used to secure emergency credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof**, **credit must be in the form of a discount and five or more members of the Board of Governors must affirmatively vote to authorize the discount prior to the extension of credit**. Emergency credit will be extended at a rate above the highest rate in effect for advances to depository institutions.[48]

The Federal Reserve Board has adopted various collateral requirements imposed in connection with loans made under Federal Reserve Act §§ 10B and § 13 (3) (12 USC § 343).

[47] Todd, Walker F., *FDICIA's Emergency Liquidity Provisions*.
[48] 12 C.F.R. § 201.4, Availability and terms of credit (12 C.F.R. 201 as amended effective December 12, 2007). Authority: 12 USC §§ 248(i)-(j), 343 et seq., 347a, 347b, 347c, 348 et seq., 357, 374, 374a, and 461.

The Federal Reserve requires collateral to meet regulatory standards for sound asset quality to be accepted as security for loans.[49] In its "Discount Window & Payment System Risk, Acceptance Criteria for Commonly Pledged Asset Types, Acceptance Criteria Applicable to All Securities" (New York Fed Pledged Asset Acceptance Criteria), the NY Fed has specified its requirements as to the form and category of the acceptable collateral.[50]

The New York Fed Pledged Asset Acceptance Criteria requires residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs), like those pledged in connection with the Maiden Lane II and III loans, to be AAA- rated.[51]

While necessity brought about by economic emergencies triggers a Federal Reserve Bank's authority to make loans to nonbanks, it does not appear to provide an excuse for lowering collateral requirements. Loans made to nonbanks even in emergencies must be secured with collateral required of depository institutions. In other words, Federal Reserve Banks have the *same*, but *not more*, authority to lend based on pledged collateral to nonbanks as to depository institutions.

Federal officials have sounded a constant drumbeat that they accepted RMBS and CDOs in connection with the Maiden Lane II and III loans because "our economy stood at the brink," our financial system was "at risk in ways few had ever experienced," and we were "threatened like at no time since the Great Depression."

Whether the New York Fed loans to Maiden Lane II and Maiden Lane III were lawful does not turn only on whether they were necessary in the subjective view of federal officials.

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[49] http://www.frbdiscountwindow.org/cfaq.cfm?hdrID=21&dtlID=#a1

[50] The New York Fed Pledged Asset Acceptance Criteria includes this disclaimer: "This document is for informational purposes only, is subject to change without notice, and is not binding on the Federal Reserve System in any particular transaction." While the New York Fed reserves the right to change the Acceptance Criteria form it does not appear it did so for the Maiden Lane II and III loans. Whether it is binding on the New York Fed is a legal issue that would have to be resolved by a Court.

[51] http://www.frbdiscountwindow.org/cfaq.cfm?hdrID=21&dtlID=#a1

Those loans were required to be made in conformity with 12 USC § 343. Established legal procedures had to be, but were not, followed.

The claim that necessity justified disregarding the legal restrictions on Federal Bank loans to nonbanks cannot stand. Necessity has been repeatedly rejected by the Supreme Court for disregarding proper legal procedures. For example, President Lincoln used the excuse of necessity of national security during the civil war to cancel the right of Habeas Corpus, an act the Supreme Court later found to be unconstitutional. *Ex parte Milligan* (1866) 71 U.S. 2.

V.

CONCLUSION

The Federal Reserve Board and New York Federal Reserve Bank (New York Fed) made up to $52.5 billion of loans to Maiden Lane II and Maiden Lane III in violation of 12 USC § 343. The borrowers did not qualify for the loans, the loans were made for improper purposes, and the collateralized debt obligations (CDOs) and residential mortgage backed securities (RMBS) pledged to secure the loans were not qualified collateral under 12 USC § 343 and 12 C.F.R. § 201.4.[52] The Maiden Lane loans were made purportedly to facilitate American International Group's (AIG) restructuring. In fact, the loans appear to have been made to fund losses of those engaged in a financial product fraud.

This legal opinion concludes that funding transactions to cover losses of those engaged in fraudulent financial transactions is an authority not yet given to the Fed Board. Such authority would require the suspension of the False Claims Act to such transactions and would likely be found to have traversed constitutional limits on use of federal funds.

52 Maiden Lane II Annual Financial Statement for year ended 31 December 2008; Maiden Lane III Annual Financial Statement for year ended 31 December 2008; http://www.ny.frb.org/markets/maidenlane2.html; http://www.ny.frb.org/markets/maidenlane3.html.