

July 12, 2004

Personal and Confidential

The Honorable William H. Donaldson, Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Bill:

I am writing to bring to your attention a company that is deserving of substantial SEC scrutiny that to date has appeared to escape the SEC's normally careful review process.

I am an investor in a hedge fund called Gotham Partners that received significant publicity in early 2003 in connection with critical research reports it wrote on two companies it had sold short: Farmer Mac, a government-sponsored enterprise, and MBIA Inc., the largest guarantor of municipal and corporate obligations in the world (over \$1 trillion of guarantees at last count). These reports were written by one of the two principals of Gotham, William Ackman, who was one of my students at Harvard and is a close personal friend. We also share many charitable interests.

Ackman's reports on Farmer Mac ultimately led to a GAO investigation of Farmer Mac at the request of the Senate Agriculture Committee. In October, the GAO published a highly critical 123-page report that confirmed most if not all of Ackman's allegations and made numerous recommendations to Congress and Farmer Mac's regulator in an attempt to enhance Farmer Mac's inadequate liquidity, reduce its off-balance sheet risk, and ultimately protect the U.S. taxpayer from loss. The GAO report recently led to a June 2, 2004 Congressional hearing on Farmer Mac at which the Treasury, the GAO, and the Farm Credit Administration testified. A number of the GAO's recommendations are in the process of being implemented. Substantial taxpayer funds are likely to have been saved by Mr. Ackman's critical reports on Farmer Mac and the thorough work of the GAO.

Rather than encouraging any regulatory focus on the company, Ackman's report on MBIA served only to bring scrutiny on Gotham Partners. Ackman was privately threatened by the CEO of MBIA prior to Gotham's release of its report. After the report

was released, at the request of MBIA, Gotham Partners was investigated by the New York Attorney General. The NYAG investigation of Gotham received enormous MBIA-generated publicity, but after six months of intensive investigation, the AG found no evidence of wrongdoing by Gotham or Ackman. The SEC, in an investigation led by Walton Kinsey, also examined Gotham in connection with the release of its research reports, with again no finding of wrongdoing.

After Ackman completed his testimony to the SEC, he requested the opportunity to explain why he believed the SEC should investigate MBIA's accounting and business practices. The SEC apparently welcomed the opportunity for Ackman to express his views.

MBIA is worthy of the SEC's attention because it is indirectly one of the largest issuers in the capital markets. It has guarantees outstanding on more than one trillion dollars of obligations supported by only \$6.5 billion of shareholders equity. It issues approximately \$100 billion of additional financial guarantees annually which allow \$100 billion of Aaa-rated newly issued securities to be syndicated to investors. These investors are seeking the lowest possible risk investments and receive only a limited return above risk-free investments. MBIA-guaranteed securities are held by numerous mutual funds, institutional investors, retail investors and many regulated institutions such as banks, brokers, and insurance companies. If Ackman's research on MBIA proves correct, the collapse of Enron will look like a corner grocery business by comparison.

In order to eliminate any potential concern about the quality, accuracy, and/or potential for conflicts of Ackman's work on MBIA, Ackman hired Kroll Zolfo Cooper's forensic accounting practice to perform its own analysis on MBIA. You may be familiar with KZC's forensic accounting practice since Lynn Turner, the former Chief Accountant of the SEC, is a Managing Director and Senior Adviser of the Kroll division. In addition, KZC was engaged at the behest of the SEC in connection with the Independent Examiner's Report of Spiegel, Inc., that was completed as part of Spiegel's settlement with the SEC.

After the completion of Kroll's analysis, Ackman with the assistance of the Kroll representatives prepared a 33-page letter to the SEC which amplified Gotham's original concerns raised in its earlier research with additional issues identified by KZC.

The issues outlined in the January 9, 2004 letter include:

- Kroll estimates that MBIA's reserves for losses on its guarantee portfolio are understated by approximately \$6.0 billion. The materiality of this reserve inadequacy can be seen in comparison to MBIA's shareholders equity of \$6.5 billion. MBIA is effectively insolvent in Kroll's (and Ackman's) opinion.
- MBIA entered into a retroactive reinsurance transaction that served to erase \$170 million in one year (boosting MBIA's earnings that year by 47%) and spread those losses out over the next six years in direct contravention to GAAP

accounting rules. In economic substance, this transaction was simply a loan disguised as a reinsurance transaction. The reinsurers—Zurich Re, Munich Re, and Axa Re—were complicit in assisting MBIA in covering up the accounting for this transaction. The reinsurers assumed and paid a \$170 million loss that had already occurred in exchange for only \$2.85 million of disclosed premium payments according to the reinsurance agreements filed with the SEC. MBIA agreed to pay back the reinsurers for their \$170 million loss in an undisclosed side agreement that was not filed with the SEC. Last year, the SEC fined AIG and Brightpoint Inc. in connection with a similar but less material transaction.

- MBIA has reclassified insurance premiums (which it is required to defer over the life of a bond issue which can be 30 years or more) as advisory fees recognized immediately, a practice that has served to materially boost MBIA's reported net income.
- Not until Enron filed for bankruptcy did MBIA disclose over \$8.0 billion of debt (\$3.0 billion of which is commercial paper) held in off-balance sheet special-purpose vehicles capitalized with only \$125,000 of equity. GAAP accounting would have required MBIA to consolidate these debts beginning in 1998. Under cover of new accounting rules (FIN 46), MBIA consolidated these debts in 2003, but continues to do so inappropriately with inadequate disclosures. MBIA consolidates these debts primarily with its holding company, whereas GAAP accounting requires these debts to be consolidated with MBIA's highly rating-sensitive, Aaa-rated insurance subsidiary, MBIA Insurance Corp.
- MBIA entered into \$360 million of undisclosed credit-linked note transactions similar to those completed by Parmalat for the apparent purpose of tightening the spreads on MBIA's bonds during the offering periods for billions of dollars of MBIA newly issued bonds. Ackman compares this practice to an issuer who covertly steps into the market to buy back and prop up its stock during a secondary offering, a practice that for obvious reasons is illegal.

After Ackman sent the letter to the SEC, he was asked to come to Washington and make a more detailed presentation of these findings. On February 3rd, 2004 Roger Siefert and David Brain, the representatives of Kroll Zolfo Cooper who completed the MBIA analysis; David Martin, the former head of the SEC Division of Corporate Finance and one of Ackman's lawyers engaged to assist in the MBIA analysis and SEC presentation; and Ackman and other Gotham personnel and legal representatives attended a meeting at SEC headquarters.

The meeting with the SEC included the following members of your staff: Walton Kinsey, Susan Markel, David Estabrook, Kelley Kilroy, Jeffrey Riedler, James Rosenberg, Oscar Young, Steven Walker, Eric Schuppenhauer, and Gregory Faucette.

The meeting took place over five hours during which Ackman, Siefert, Brain, Martin and others from Gotham's team participated. I am told that the members of your staff asked very probing questions and appeared to take the matter seriously.

In addition to the issues raised in the letter, at the meeting Gotham provided additional supporting documentation and for the first time discussed conflicts it has identified on MBIA's board of directors and in particular on its audit committee. For example, Ms. Freda Johnson—the Chairman of MBIA's audit committee for all years for which Ackman and Kroll question MBIA's accounting—owns a company formed shortly after she joined the board of MBIA in 1990, which has been paid large fees as an "advisor" in connection with billions of dollars of transactions in which MBIA has served as financial guarantor. There is no disclosure of this fact or the fees that have been paid to Ms. Johnson's company in any of MBIA's public filings.

While Ackman and the other members of Gotham's accounting and legal team have offered to provide additional assistance to the SEC in connection with the matter, it has been nearly five months since the meeting and there has not been one request from the SEC for supporting documentation or follow up of any kind. While Mr. Kinsey after the meeting indicated to Mr. Ackman's counsel that the SEC may have additional questions, none have been forthcoming. On the basis of the feedback it has received from the SEC since the February 3rd meeting, it is Mr. Ackman's counsel's view that the SEC has not pursued Mr. Ackman's and Kroll's allegations seriously, and may have dropped the matter entirely.

Shortly after Ackman's meeting with the SEC, Mr. Joseph Brown, the CEO of MBIA, has had approximately \$35 million of incentive compensation vest as a result of the MBIA stock trading intra-day above \$60.00 per share for ten consecutive trading days in the first quarter of the year. While the stock has not traded above \$60 since, Mr. Brown can now walk away with an additional \$35 million of compensation.

Several weeks after the vesting of Mr. Brown's incentive compensation, in a surprise announcement on March 12th, the board of MBIA announced Mr. Brown's resignation as CEO. On the same day, Mr. Ned Budnick, the CFO during the entire period of questionable accounting, announced that he would be stepping down to become President of a non-public subsidiary.

There has been a flurry of additional high-level resignations at MBIA this year. On January 12, 2004, Richard Weil, one of MBIA's vice chairmen, announced his resignation. On June 10, 2004, Vice Chairman Jack Caouette announced that he would be retiring after a brief transition period. On June 21, 2004, Mr. W. Thacher Brown, President of MBIA Asset Management, MBIA's largest non-insurance subsidiary, stepped down.

MBIA's audit committee members during the period in question have also left or indicated that they will leave the company. In this year's proxy, two of the four members of the committee, Ms. Johnson and Mr. James Lebenthal (another conflicted member of

the committee as his family's business is one of the largest manager/issuers of MBIA-guaranteed municipal bonds), have indicated that they will leave the board at year-end 2004. Just three weeks after Gotham's original report on MBIA was published in December 2002, Mr. William Gray, a third member of the committee, resigned "unexpectedly" according to the 2003 proxy.

While there may be many reasons for these executives and audit committee members leaving the company, Ackman believes that their resignations relate to their desire to exit MBIA before it collapses under its tremendous leverage and accounting shenanigans.

I believe that it behooves the SEC to take whistleblowers seriously, even when the whistleblowers are short sellers and have something to gain if their analysis proves correct. In my experience, the shorts tend to do much better work than the longs, and Gotham's work on MBIA is, in my opinion, a paradigm of the model.

Now when a short seller's analysis is backed up by credible independent legal and accounting professionals, particularly advisors who include respected and senior former staff members of the SEC, I cannot understand why the SEC would stand by while investors are misled. Bill, I hope you didn't think it presumptuous for me to suggest that this calls for your attention.

As Mr. Ackman points out in his letter to the Commission, MBIA shares the distinction of being one of the top five financial institutions in the U.S. as ranked by credit exposure along with Citigroup, Bank of America, Fannie Mae and Freddie Mac, yet it is the only one of the five not principally regulated by a federal agency, and the only institution not overseen by a regulator with the financial expertise to accurately assess the company's risk and business practices.

It behooves the SEC to investigate MBIA's accounting and business practices with a great degree of alacrity. Not to do so could allow grievous and growing harm to visit the capital markets and the investing public, at considerable embarrassment and reputational cost to the SEC.

If you want a "one-up" on Bill Ackman, you could always ask Professor Michael Porter at The Harvard Business School. But I caution you: he is even more of a fan of Bill's than I am.

Very best wishes,

Martin Peretz