DEVELOPMENTS IN BANKING AND FINANCIAL LAW:
2006-2007

I. STOCK OPTION BACKDATING ............................................................. 2
II. SEC EXECUTIVE COMPENSATION DISCLOSURE REQUIREMENTS ................................................................. 12
III. REGULATION OF EXOTIC & NON-TRADITIONAL MORTGAGES ........................................................................ 21
IV. REAL ESTATE ACTIVITIES OF BANKS .................................................. 29
V. DATA SECURITY .................................................................................. 38
VI. MUTUAL FUND INDUSTRY ................................................................. 48
VII. HEDGE FUND REGISTRATION RULE FOLLOWING THE GOLDSTEIN DECISION ............................................. 57
VIII. SEC RULES ON INDEPENDENT DIRECTORS & CHAIRMEN .................................................................. 67
IX. VENTURE CAPITAL AND PRIVATE EQUITY ........................................ 76
X. SECURITIES EXCHANGE MERGER ACTIVITY .............................................................. 855
XI. PATRIOT ACT RENEWAL ................................................................. 100
XII. PENSION PROTECTION ACT OF 2006 ............................................. 109
XIII. WAL-MART BANKING BID ................................................................. 116
XIV. EUROPEAN BANK Mergers & Acquisitions .................................... 129
XV. THRIFT/CREDIT UNION UPDATE .................................................. 138
XVI. BUSINESS BANKRUPTCIES .............................................................. 148
XVII. BANKRUPTCY REFORM IMPLEMENTATION ............................................. 158
XVIII. FHLB CAPITAL REQUIREMENTS & SEC FILINGS ................................................................. 170
XIX. BASEL II ......................................................................................... 179
XX. BANK Secrecy ACT & ANTI-MONEY LAUNDERING REGULATION .................................................................. 186
XXI. FEDERAL INSURANCE CHARTER ....................................................... 196
XXII. FINANCIAL EFFECTS OF DISASTERS .................................................. 203
XXIII. IRS RULES ON ABUSIVE TAX SHELTERS ................................. 212
XXIV. KPMG TAX SHELTER SCANDAL ...................................................... 219
XXV. CORPORATE GOVERNANCE ........................................................... 226
XXVI. REGULATORS AT THE GATE: THE FUTURE OF PRIVATE EQUITY INVESTMENT ........................................... 235
I. STOCK OPTION BACKDATING

The spring of 2006 witnessed the beginning of an unprecedented number of high profile stock option backdating scandals.1 The story burst into the public consciousness on March 18, 2006, when the Wall Street Journal published an article titled The Perfect Payday, which made reference to the Securities & Exchange Commission (“SEC” or “the Commission”) investigations of option backdating and identified companies with improbably advantageous grant dates resulting in executive windfalls.2 Over the course of 2006, the SEC, the Department of Justice, other regulatory agencies and corporations themselves have conducted investigations into possible accounting, tax and disclosure violations.3

A stock option is a form of equity compensation that entitles the holder to purchase a stock in the future at a price fixed in the present, usually at the market price on the date of the grant.4 In general, shareholders of public corporations vote on stock-option plans that include rules for how and when the corporation will grant stock options, and the board of directors’ compensation committee subsequently approves individual option grants.5 The shareholder-approved options plans are filed with the SEC.6

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3 Vanyo & Weisman, supra note 1, at 625.
6 Forelle & Bandler, supra note 2.
A. Background

Throughout the 1980s and 1990s, stock option grants became a significant component of manager compensation. The business community viewed stock options as advantageous for a number of reasons. First, during the internet start-up boom of the 1990s, many fledgling tech companies did not have sufficient cash flow to attract and retain management and stock options represented an attractive alternative to high salaries. Second, stock options purportedly “align[ed] management and shareholders’ interests . . . on the corporation’s long-term productivity” and stock price gains.

Third, 1993 amendments to the Internal Revenue Code (“the Code”) created advantage in favor of performance-based compensation over salary. Generally, under section 162(a) of the Code, businesses may deduct “reasonable allowances for salaries” from their gross income. In 1993, Congress amended section 162(m) of the Code to prohibit the deduction of salary exceeding $1,000,000 per covered employee of a publicly held corporation. However, certain forms of non-salary compensation, such as qualifying stock options, are not subject to the $1,000,000 salary deduction cap, so the corporation may treat them as a tax-deductible expense. The corporation takes the deduction in the year in which the options are exercised, and “[t]he deduction is equal to the difference between the exercise price and the fair market value . . . on

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7 Janice Kay McClendon, Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders’ Interests and Promote Long-Term Productivity, 39 WAKE FOREST L. REV. 971, 972 (Winter 2004).
8 See id. at 977.
10 McClendon, supra note 7, at 978.
11 Id. at 979; see also Christopher Cox, Chairman, Sec. & Exch. Comm’n, Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 6, 2006) (transcript available at http://www.sec.gov/news/testimony/2006/ts090606ecc.htm).
13 McClendon, supra note 7, at 979 (citing I.R.C. § 162(m) (2006) (defining “covered employees” as the chief executive officer and the four highest compensated officers other than the chief executive officer)).
15 See I.R.C. § 162(m)(4)(C) (2006); see also I.R.C. § 83(h) (2006); McClendon, supra note 7, at 979; Cox, supra note 11.
16 I.R.C. § 83(h) (2006); see also McClendon, supra note 7, at 980.
This deduction encourages corporations to limit their managers’ salary compensation and make up the difference in stock options.18

Finally, accounting methods in place prior to 2005 also encouraged at-the-money stock option grants.19 From 1972 until 1995, issuers generally accounted for option grants by using Accounting Principles Board (“APB”) Opinion No. 25’s intrinsic value method.20 Under the intrinsic value method, the expense a corporation records on its balance sheet for an option grant is equal to the difference between the option’s exercise price and its market price on the grant date.21 When an option is granted at-the-money, its exercise price and market price are equal, so the company records no expense.22 In 1995, the Financial Accounting Standards Board (“FASB”) issued Statement 123, permitting corporations to choose to report their option grants using either the intrinsic value method or the fair value method.23 Until recently few corporations used the fair value method, which calculates the expense based on the option’s projected future value.24

B. Potentially Abusive Option Grant Practices

The focus of the recent stock option scandals has been on allegations of backdating.25 Backdating entails retroactively dating an option grant to coincide with an earlier date on which the market price was particularly depressed, thus ensuring a low exercise price while still permitting favorable tax and accounting treatment.26 This is known as granting options “in-the-money” (exercise price is below market price) rather than “at-the-money” (exercise price equals market price) or “out-of-the-money” (exercise price exceeds market price).
A low exercise price creates “an instant paper profit” for the option holder, and allows him to realize greater gains when he exercises the option. Backdating was possible in part because prior to 2002, “officers and directors didn’t have to report their receipt of stock option grants until after the end of the fiscal year” in which the options were received.

A lesser concern is the practice of “spring loading” option grants. Spring loading entails granting stock options either just before the announcement of good news or just after the announcement of bad news, in order to take advantage of the corresponding price surge or dip.

Though issuing stock options at below market value is not per se illegal, there are multiple ways in which corporations that have improperly issued stock options may have incurred liability in doing so. Improper option grants can potentially result in accounting violations, tax code violations, disclosure violations and accusations of fraud.

1. Potential Accounting Violations

When a corporation issues stock options in-the-money but accounts for the options as though they were issued at-the-money, the corporation may understate its expenses on the balance sheet. While it is permissible for accounting purposes to grant options in-the-money, the intrinsic value method dictates that the corporation should recognize the difference between the market price on the grant date and the exercise price as a compensation-related

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28 Vanyo & Weisman, supra note 1, at 625; see also Cox, supra note 11.
29 Cox, supra note 11.
31 See id.
32 See Forelle & Bandler, supra note 2; see also Vanyo & Weisman, supra note 1, at 625.
33 Vanyo & Weisman, supra note 1, at 627; Etter, supra note 9.
34 Vanyo & Weisman, supra note 1, at 630.
expense.\textsuperscript{35} Understating expenses results in overstating net income and profits.\textsuperscript{36}

The Securities Exchange Act of 1934 (the “Exchange Act”) requires issuers to prepare and file periodic financial statements providing current and accurate financial information.\textsuperscript{37} The Exchange Act further requires that all filings conform to Generally Accepted Accounting Principles (“GAAP”) standards.\textsuperscript{38} Materially overstating net income and profits in public financial statements could contravene the above rules and obligate the corporation “to restate its financials.”\textsuperscript{39} “Restatements frequently trigger shareholder lawsuits.”\textsuperscript{40}

2. Potential Tax Violations

An issuer who, for tax purposes, treats options issued in-the-money as though they were issued at-the-money may take an improper tax deduction.\textsuperscript{41} There are two basic types of stock options for tax purposes.\textsuperscript{42} Section 83 of the Code applies to non-forfeitable stock options that have an “ascertainable fair market value” on the grant date.\textsuperscript{43} Section 83 options may qualify for exception to the deduction cap under section 162(m).\textsuperscript{44} The provision under Code section 162(m) that “excepts certain ‘performance-based’ compensation from the $1 million [salary] deduction cap” applies only to qualifying options with exercise prices at or above market value on the grant date, and does not apply to options granted in-the-money.\textsuperscript{45} When a covered employee exercises an option that was granted in-the-money, the profit he receives does not qualify as

\textsuperscript{35} ACCOUNTING FOR STOCK-BASED COMPENSATION, supra note 23, at 4; see also Vanyo & Weisman, supra note 1, at 628-29. \textsuperscript{36} Stock Options “Backdating”: Regulator Investigations and Shareholder Lawsuits Show No Signs of Waning, supra note 2, at 2. 
\textsuperscript{37} See 15 U.S.C. § 78m (a) (2006); see also 17 C.F.R. § 240.12b-20 (2006); 17 C.F.R. § 240.13a-1 (2006); 17 C.F.R. § 240.13a-11 (2006); see also Vanyo & Weisman, supra note 1, at 627-28. 
\textsuperscript{38} Vanyo & Weisman, supra note 1, at 628 (citing 17 C.F.R. § 210.4-01(a)(1) (2006)). 
\textsuperscript{39} Vanyo & Weisman, supra note 1, at 630. 
\textsuperscript{40} Stock Options “Backdating”: Regulator Investigations and Shareholder Lawsuits Show No Signs of Waning, supra note 2, at 2. 
\textsuperscript{41} Cox, supra note 11. 
\textsuperscript{42} Vanyo & Weisman, supra note 1, at 636. 
\textsuperscript{43} CHIRELSTEIN, supra note 14, at 417 (discussing I.R.C. § 83). 
\textsuperscript{44} See I.R.C. § 83(h). 
\textsuperscript{45} Vanyo & Weisman, supra note 1, at 638 (citing I.R.C. § 162(m) (2006)).
“performance-based” compensation. Consequently, the corporation must include the portion of employee compensation realized when the employee exercises the option (the difference between the market price on the exercise date and the exercise price) in the salary subject to the $1,000,000 salary deduction cap. An employer who has failed to do so may have improperly taken deductions in excess of the $1,000,000 deduction cap, and will incur a tax liability as well as possible interest and penalties.

Section 421 applies to a “special class” of “incentive” options, which are subject to various statutory conditions (including the requirement of an exercise price at or above the market price on the grant date). Because backdated stock options are generally in-the-money at the grant date, they do not qualify as section 421 incentive options. An employee is taxed on incentive options only when he sells the stocks he purchased through exercise of the options. When the employee sells the underlying stocks, his profit is taxed as capital gain. The issuer may never deduct section 421 incentive options pursuant to section 162. An executive who improperly treated backdated options as section 421 options may be “liable for unpaid income taxes and withholding that accrued upon exercise of those options.”

3. Potential Disclosure Violations and Fraud

Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder forbid issuers from making any “material false or misleading statement or omission in . . . public disclosures”. Any “[f]inancial statements filed with the Commission which are not prepared in accordance with [GAAP] will be presumed . . . misleading or inaccurate . . . .” Violations of the
securities laws can result in regulatory enforcement actions as well as shareholder suits and derivative actions for fraud.56

Corporations have the legal right to reward their executives in any manner they choose, including the issuance of in-the-money stock options.57 Public corporations generally “grant . . . options under a shareholder-approved [compensation plan] on file with the SEC.”58 “Section 14 of the Exchange Act, and rules promulgated thereunder,” require issuers to “accurately disclose” their compensation plan’s “material features” “whenever shareholder approval is required with respect to a compensation plan.”59 Specifically, Schedule 14A mandates that proxy statements filed pursuant to section 14(a) of the Exchange Act must “accurately disclose the material terms of any option grant, including the grant date, the exercise price and the federal tax consequences . . . .”60 If an option grant violates provisions of the shareholder-approved compensation plan, the issuer may expose itself to liability for misleading public statements and fraud.61

C. Recent Changes in Federal Law Affecting Stock Options

In 2002, Congress passed the Sarbanes-Oxley Act (“Sarbanes-Oxley”).62 Section 403 of Sarbanes-Oxley amended the Exchange Act by requiring that companies report stock option grants “within two days of the grant date.”63 This amendment significantly decreased the opportunities for backdating by giving executives only two days to take advantage of hindsight.64 Section 403 appears to have had some success in reducing options backdating: a prominent academic study found that between 1992 and 2002 stock returns were abnormally negative prior to unscheduled stock option grants and

57 Forelle & Bandler, supra note 2.
58 Id.
59 Vanyo & Weisman, supra note 1, at 632 (citing 15 U.S.C. § 78n(a) (2006)).
60 Vanyo & Weisman, supra note 1, at 632 (citing 17 C.F.R. 240.14a-101 (2006)).
61 Forelle & Bandler, supra note 2; see also Stock Options “Backdating”: Regulator Investigations and Shareholder Lawsuits Show No Signs of Waning, supra note 2, at 2.
64 See Cox, supra note 11.
abnormally positive thereafter. Slightly later, a later study found that this pattern decreased significantly after the enactment of Sarbanes-Oxley.

Sarbanes-Oxley further encourages transparency by requiring corporations’ principal executive and financial officers to certify the accuracy of quarterly and annual reports. The certification rules promote accountability, in part because the SEC has made it clear that executives or financial officers who falsely certify may be liable under Section 10(b) and Rule 10b-5 of the Exchange Act.

In 2003, the SEC “approved changes to the listing standards of the New York Stock Exchange and the NASDAQ Stock Market.” The revised standards require “shareholder approval of almost all equity compensation plans” and require companies to “publicly disclose the material terms of their [equity compensation] plans in order to obtain [such] approval.”

In December 2004, FASB released new standards, “replacing FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersed[ing] APB Opinion No. 25, Accounting for Stock Issued to Employees”. The new standards, known as FAS 123R, mandate that corporations use the fair value method of

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66 Randall A. Heron & Erik Lie, *Does backdating explain the stock price pattern around executive stock option grants?*, available at http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf.


69 Cox, *supra* note 11.

70 Id.

accounting to calculate expenses for stock option grants and disallow the use of the intrinsic value method.\textsuperscript{72}

Finally, in July 2006, the SEC adopted changes in disclosure requirements concerning executive compensation.\textsuperscript{73} The new rules require public companies to disclose, in clear tabular form, the fair value of option grants on the grant date, as determined under FAS 123R’s new accounting standards.\textsuperscript{74}

D. Scandals

Though The Perfect Payday sparked public interest in options backdating in May 2006, academic studies drew regulatory attention earlier than that.\textsuperscript{75} Erik Lie’s studies at the University of Iowa were particularly influential in showing the frequency and improbability of unscheduled stock option grants succeeding drops or preceding rises in the stock price.\textsuperscript{76} By the end of May 2006 the SEC was investigating 20 companies and “federal prosecutors had launched separate criminal inquiries into more than a dozen . . . .”\textsuperscript{77}

Public and regulatory interest has not abated, and has resulted in several high profile corporate shakeups.\textsuperscript{78} United Health, under investigation by the SEC, the Internal Revenue Service (“IRS”) and federal prosecutors, recently announced that its two top executives had agreed to repay $390 million in stock option compensation, its chief executive officer (“CEO”) and chairman was resigning, and it might have to restate up to twelve years of earnings due to inaccurate options accounting.\textsuperscript{79} KB Home’s CEO, head of

\textsuperscript{72} SHARE-BASED PAYMENT, supra note 71, at §1.
\textsuperscript{75} Cox, supra note 11.
\textsuperscript{76} See id. (discussing Lie, supra note 65); see also Forelle & Bandler, supra note 2.
\textsuperscript{77} Etter, supra note 9.
\textsuperscript{79} See Steve Stecklow & Vanessa Fuhrmans, United Health Executives Forfeit $390 Million in Options, WALL ST. J., Nov. 9, 2006, at B1, available at
human resources and executive vice president/chief legal officer have all left KB Home following internal investigations into options backdating, an SEC investigation and a shareholder suit; the company’s CEO has agreed to “forfeit $13 million in [options backdating] gains.”

United Health and KB Home are certainly not alone. As of mid November, the federal government was investigating more than 130 companies, prosecutors have charged five former executives with criminal wrongdoing, and more than fifty executives and directors have lost their jobs in the backdating scandal.

The results of the SEC, Department of Justice and IRS investigations, as well as the financial restatements and the shareholder suits that have emerged from the backdating scandals will probably not become clear until 2007 at the earliest. In the meantime, public corporations would be well advised to review their own grant practices and eliminate improprieties.

Sara Mills

http://online.wsj.com/article/SB116299996219517252.html; see also Wall Street Journal Online, Perfect Payday: Options Scorecard, supra note 78.


Id.: see generally Wall Street Journal Online, Perfect Payday: Options Scorecard, supra note 78.

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II. SEC EXECUTIVE COMPENSATION DISCLOSURE REQUIREMENTS

A proposal for new Securities and Exchange Commission (SEC) executive compensation disclosure requirements was unveiled in early 2006. The new regulations are currently set to be enforced in early 2007. The rules relate specifically to disclosure of executive and director compensation, director independence, security ownership of officers and directors, and related party transactions in public company proxy statements and other SEC filings.1

A. Background

In the aftermath of corporate scandals, including Enron and Worldcom, there has been a renewed request for greater disclosure of executive compensation.2 Following the scandals, the passage of the Sarbanes Oxley Act of 2002 (also known as the Public Company Accounting Reform and Investor Protection Act of 2002) was aimed at improving the “reliability of corporate disclosures by modifying the governance, the reporting, and the disclosure rules for public companies.”3

The proposed rule regarding executive compensation disclosure was likely motivated by corporate scandal, the implementation of Sarbanes Oxley, shareholder activism and rising executive pay.4 Executive compensation disclosure was last considered by the SEC in 1992, when the Commission adopted amendments to the disclosure rules that avoided the mostly narrative disclosure approach implemented in 1983, and provided formatted tables that summarized all compensation and disclosed various elements of compensation in specific categories.5

B. Intent of the New Regulations

The new regulations are intended to provide investors with a more complete picture of the compensation earned by a company’s executive officers and members of its board of directors. Further goals include providing “information about key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members.”

The SEC was motivated to propose new regulations following criticism from investors that the current landscape of executive compensation disclosure regulations, last modified by the SEC in 1992, “fails to provide investors with clear and understandable disclosure of compensation” amounts, policies and practices. Moreover, the recent increase in the number of shareholder proposals and lawsuits concerning executive compensation indicates “an unprecedented investor commitment to dramatically changing current executive compensation practices.” Consideration was likely given to the high profile case brought by Walt Disney shareholders alleging that the directors “consciously and intentionally disregarded their responsibilities,” in response to a multi-million dollar payout to a former president who lasted on the job only one year and two months.

The SEC has admitted that the current regulations for executive compensation disclosure do not provide investors with sufficient information regarding the total compensation of an executive. However, SEC chairman Christopher Cox “was careful to note the rules are intended as ‘clarity’ and not ‘wage controls.’” Regarding the greater disclosure of perquisites, Alan L. Beller, the Securities and Exchange Commission's Director of the Division of Corporation Finance stated that, “a perk, by any other name, is still a

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6 See generally id.
7 Id. at 6542.
9 Id.
perk, and therefore must be considered for disclosure . . . [and that] companies . . . should give serious consideration to items that have previously been called business expenses, but actually are perks.”

It has been noted that shareholders want “proof that executive pay is based on reasonable performance metrics and benchmarks” because executive compensation may often come across as esoteric or convoluted. In March 2006, Cox also stated that “[i]t's already hard enough for shareholders to exert themselves without inadequate information compounding the problem.”

C. Changes Under the New SEC Executive Compensation Disclosure Rules

The new regulations call for a narrative, under the title of the Compensation Discussion and Analysis (CD&A), to provide a “discussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the tables.” The new regulations also expand the list of executives and directors who will be subject to the disclosure requirements. Furthermore, the Form 8-K disclosure requirements have been modified and will require faster and more detailed disclosure of current compensation agreements. Disclosure, as provided under these new regulations, will all be required to be in “plain English.”

The narrative in the CD&A is a departure from the current rule which calls for tables outlining compensation. The departure is predicated on the fact that tables alone were too strict and rigid and often times certain forms of compensation didn’t fit easily into a category. Furthermore, if an item of compensation is not expressly called for in the tables it is often omitted, leaving out material information, such as total compensation.

The SEC has maintained the strengths of the old rule by retaining an approach which calls for compensation to still be

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13 Matthews, supra note 2, at 10.
15 Id.
17 Id. at 6545.
18 Id.
19 Id.
20 Id.
disclosed in tables allowing for “clarity and comparability.” The new rule also includes the Summary Compensation Table (SCT), which provides for new columns including one that would “disclose options, stock appreciation rights, and similar equity-based compensation awards with option-like features.” Additionally, narrative disclosure would be required to describe “any material factors necessary to an understanding” of the executive or director’s compensation. Also, in response to criticism of the current rules, the SCT will include a “Total Compensation” category to provide more complete information to investors.

The Compensation tables will be organized into three broad categories detailing compensation. These categories include: (1) compensation regarding the last three fiscal years including currently paid compensation and deferred compensation, like stock options; (2) holdings of equity related to compensation or those that are a source of potential gain; (3) and retirement and other post-employment benefits. Although disclosure would still be required for the last three fiscal years, a transition rule would phase in the new disclosures over three years. Stock option grant disclosure would include disclosing stock option grants and policies. Also, “any policy that results in the exercise price of an option not being the closing market price on the date of the grant will require an additional description of the methodology for determining the exercise price.”

Specifically, the tables include categories for salary, bonus, stock awards, stock options, non-stock incentive plan compensation

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21 Id.
25 Id. at 6547.
26 Lindo, supra note 22, at 9.
and for all other compensation.\textsuperscript{29} Items included in the “All Other Compensation” column that exceeds $10,000 should be separately identified and quantified in a footnote.\textsuperscript{30}

1. **Compensation Discussion and Analysis**

One of the more notable changes in the proposed rule is the new Compensation Discussion and Analysis (CD&A), “which will replace the existing Performance Graph and the Compensation Committee Report on Executive Compensation.”\textsuperscript{31} The CD&A is an overview that would provide narrative disclosure that puts into context the objectives and implementation of executive compensation policies.\textsuperscript{32} The CD&A is meant to discourage the use of formulaic or boilerplate language.\textsuperscript{33} Where compensation policies are similar the description of executive compensation can be grouped together, but where there “are material differences a separate discussion is required.”\textsuperscript{34} The CD&A is considered “substantially different from the existing Compensation Committee Report and will require the input of management, the compensation committee” and possibly even outside consultants.\textsuperscript{35}

The CD&A will be considered part of the proxy statement and any other filing in which it is included.\textsuperscript{36} Since the CD&A will be “filed with the SEC” it is “subject to more stringent liability standards under applicable securities laws.”\textsuperscript{37} The disclosure would also require certification from the Chief Executive Officer and Chief Financial Officer, similar to the requirements under Sarbanes Oxley.\textsuperscript{38}

The officers whose compensation will be disclosed under the new rule include the principal executive officer, the principal financial officer and three other most highly compensated officers.\textsuperscript{39} Disclosure for the CEO and CFO must be made even if one of these officers is not employed at the company at the end of the fiscal

\textsuperscript{29} Executive Compensation and Related Party Disclosure, 71 Fed. Reg. at 6548.

\textsuperscript{30} Id. at 6551.

\textsuperscript{31} Lindo, supra note 22, at 9.


\textsuperscript{33} Id.

\textsuperscript{34} Pillsbury Winthrop Shaw Pittman LLP, supra note 28, at 3.

\textsuperscript{35} Id.


\textsuperscript{37} Pillsbury Winthrop Shaw Pittman LLP, supra note 28, at 3.


\textsuperscript{39} Id. at 6563.
year.\textsuperscript{40} Other than the principal executive officer and the CFO, the threshold dollar amount that would require disclosure is $100,000.\textsuperscript{41} In recent time, director compensation has become more complex leading the SEC to propose “formatted tabular disclosure for director compensation, accompanied by narrative disclosure of additional material information.”\textsuperscript{42} Disclosure of director compensation would be very similar to the executive compensation disclosure proposed by the new SEC regulations.

2. **Perquisites**

Under the new SEC regulations, companies would be required to disclose compensatory perquisites.\textsuperscript{43} Compensatory perquisites include items that are not generally available on a non-discriminatory basis to all employees and that confer a direct or indirect personal benefit.\textsuperscript{44} Examples include the “use of company-provided aircraft, yachts, and commuter transportation services” and “additional clerical or secretarial services devoted to personal matters or investment management services.”\textsuperscript{45} An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive’s duties, which might include additional secretarial services used for company purposes or a reserved parking space.\textsuperscript{46} Perquisites should be disclosed unless the aggregate amount of such compensation is less than $10,000.\textsuperscript{47} Where perquisites are subject to identification, there must be a specific description of the benefit.\textsuperscript{48} Also, the proposed rule calls for the “aggregate incremental cost to the company and its subsidiaries as the proper measure of value of perquisites and other personal benefits.”\textsuperscript{49}

\textsuperscript{40} Id.
\textsuperscript{41} Id.
\textsuperscript{42} Id. at 6564.
\textsuperscript{43} Id. at 6552-3.
\textsuperscript{44} Lindo, supra note 22, at 9. See also Executive Compensation and Related Party Disclosure, 71 Fed. Reg. at 6553.
\textsuperscript{45} Id.
\textsuperscript{47} Id. at 6552-3.
\textsuperscript{48} Id. at 6553.
\textsuperscript{49} Id. at 6554.
3. **Form 8-K Requirements**

Form 8-K requires disclosure of material agreements entered into outside “the ordinary course of business within four business days of the triggering event.” Executive compensation agreements are usually considered to fall under this category. Therefore, many executive compensation agreements will be required to be disclosed within four business days of the applicable triggering event. Amendments to these material agreements would also have to be disclosed within four business days. Specifically, the SEC has explicitly stated that any compensation plan, contract or arrangement that any director or named executive officer participates in must be disclosed within the four day time period. Regarding current disclosure under Form 8-K, the SEC is looking for a “disclosure that informs investors of specified material events and developments.”

4. **Foreign and Small Business Issuers**

The SEC proposes that foreign private issuers would be required to file any compensatory plan for management or directors only under certain circumstances. Specifically, a foreign private issuer would be required to disclose their compensatory plan “when the foreign private issuer either is required to publicly file the plan (or portion of it) in its home country or if the foreign private issuer had otherwise publicly disclosed the plan.” Small business issuers “would provide for a disclosure threshold of the lesser of $120,000 or one percent of the average of the small business issuer’s total assets for the last three completed fiscal years”.

5. **Disclosure**

The annual proxy statement of a company would continue to be the primary medium for disclosure of executive compensation agreements.
The proposed rules would require identification of each director, or director nominee who is independent and each non-independent director who is a member of the compensation, nominating or audit committee. The proposed rules would also require a narrative description of the processes and procedures for determining executive and director compensation, including (i) the scope of authority of the committee, (ii) the ability of the committee's to delegate that authority, (iii) the name and role of any compensation consultant who advised the committee as to executive and director compensation decisions, including whether the consultant was engaged by the committee or another person, (iv) contact among the consultant and any executive officer (v) any role an executive officer played in determining compensation for an executive or director.

D. Criticism of the New Requirements

Many commentators wanted the CD&A to be the responsibility of the Compensation Committee arguing that “senior executive officers are not in a position to certify to the processes and methodologies used by the compensation committee in setting their own compensation.” Firms will have to explain how they determine the exercise price of their stock option grants to executives. Many executives have written letters to the SEC complaining about putting that kind of analysis into a filed document. The executives assert that “including such details in their SEC filings makes them liable for every minute piece of information, some of which they might not normally oversee.” It has been stated that, “in-house counsel may find themselves urging the classification of the CEO’s personal use of the company jet as a perk requiring disclosure -- to avoid embarrassing and public SEC proceedings -- when the CEO may insist on classifying such use as a legitimate business expense.” Corporations are worried that greater disclosures of related-party transactions will discourage some

58 Lindo, supra note 22, at 8.
59 Id.
60 Lindo, supra note 22, at 8.
61 Id.
62 Marquez, supra note 28, at 1.
63 Id.
64 Matthews, supra note 2, at 911.
prospective board members from serving for fear of broadcasting their family members' bank-account totals.”

E. Conclusion

Currently the SEC has revised the rule pursuant to the numerous suggestions it gathered prior to April 2006. The SEC is currently soliciting more comments on specified areas of the proposed regulation. In particular, the SEC is requesting comments regarding the specific employees and executives that should be required to disclose their compensation under the regulation. Ultimately, regardless of the comments provided to the SEC, the proposed regulations will likely go into effect in 2007. The only aspect that remains to be finalized is the exact level of detail executives will have to provide when disclosing their compensation.

Thor McLaughlin

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65 Burr, supra note 14, at 6.
67 Id.
68 Student, Boston University School of Law (J.D. 2008).
III. REGULATION OF EXOTIC & NON-TRADITIONAL MORTGAGES

This year government regulators attacked recent innovations in the mortgage field for being overly risky and potentially contrary to consumer protection. With interest rates on the rise and housing prices flattening out, the Office of the Comptroller of the Currency, along with the Board of Governors of the Federal Reserve System, the Federal Depository Insurance Corporation, the Department of the Treasury, Office of Thrift Supervision, and the National Credit Union Administration (collectively the “OCC”), ordered new guidance on so called exotic mortgages (“exotics”). According to government regulators, some consumers purchase these exotics without understanding the extra risk they carry over traditional mortgages, and some lenders issue exotics acting with similar ignorance. In response, the OCC issued the “Interagency Guidance on Nontraditional Mortgage Product Risks” (the “Interagency Guidance”), a set of recommendations and guidelines for institutions providing exotic mortgages with adjustable rates or deferred principal or interest repayment.

A. Exotic Mortgages versus Traditional Mortgages

Exotic and non-traditional mortgages fall outside the confines of a traditional mortgage, which typically include a 20% down payment followed by a fifteen to thirty year fixed rate repayment plan for the remaining balance. Exotic mortgages often take the form of interest-only payments for the first five years, followed by much higher principal payments and interest payments for the remainder of the mortgage term. Such loans often result in negative amortization since the first payments frequently do not

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2 Nutting, supra note 1.
3 Id.
5 Id.
cover all the interest owed on the loan. Payment option adjustable rate mortgages (“ARMs”) also fall under the OCC’s regulation of exotic mortgages. ARMs are often set at a fixed rate for a five year “honeymoon” period and adjust thereafter as interest rates fluctuate. As the Federal Reserve Bank has raised interest rates over the past two years, OCC regulators have become concerned that many consumers who did not plan for rising mortgage rates will not have the requisite income increases to pay off their exotics. On September 29, 2006, regulators issued the Interagency Guidance, recommending stricter consideration of mortgage applications before selling exotic loans to consumers who may not be able to afford them.

B. Historical Climate

Exotic mortgages became popular through the end of the 1990s as interest rates fell to historic lows and a greater segment of consumers sought to purchase their first homes. At the same time housing prices rose sharply. This atmosphere of easy access to money came to an end when the Federal Reserve Bank began its more than fifteen interest rate increases in June 2005. When interest rates rise, even as little as twenty-five basis points, consumers with ARMs find themselves paying more each month, often resulting in their having a harder time making their usual payments. Those with negative amortization ARMs will find higher payments compounded by decreasing home equity.

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12 Id.
The low interest rates of the past decade partially caused the boom in housing purchases, which fueled the concurrent increase in home prices throughout the nation, and in turn made it harder for the average family to buy a home.\textsuperscript{14} As a result, exotics became extremely popular for families that could not afford a traditional mortgage.\textsuperscript{15} In fact, many observers believe exotics may have partially fueled this housing boom.\textsuperscript{16} They currently make up 31\% of all residential mortgages, and even with the new Interagency Guidance, some experts do not see this number decreasing in the near future.\textsuperscript{17} While they have provided easy access to capital, exotics can be problematic because they require the consumer to make certain assumptions about future pay raises or interest rates, which can have devastating consequences if incorrect.\textsuperscript{18}

If the housing market crashes, as many forecasters predict, most homeowners will be left with much less equity in their homes.\textsuperscript{19} While the numbers may not suggest it, experts predict that consumers who chose exotics and have experienced negative amortization may be those hit hardest.\textsuperscript{20} A million dollar home in which the owner controlled $500,000 of principal, may drop to $750,000 market value, thereby halving the owner’s equity. As years go by, the consumer will own less and less of this same home, because he cannot afford the payments that would increase equity. Eventually this homeowner may have no equity in his or her own house. Since many of these loans have frozen payments for the first five years, a buyer who is planning to buy a home and sell it a few years later, or one who is expecting house prices to rise sharply, may find that this style of financing makes sense, as the equity lost will be minimal or even non-existent in an up-market. But as a long-term solution, exotics can be devastating.\textsuperscript{21}

\textsuperscript{14} Nutting, supra note 1, at 2.
\textsuperscript{15} Regulators Issue Guidance on Exotic Mortgages, supra note 11.
\textsuperscript{16} Downey, supra note 9, at D01.
\textsuperscript{17} Paul Muolo, News Analysis: Exotics Continue to Cut into Market Share of Fannie, Freddie; Interest-only and pay option ARMs currently account for 31\% of the loan origination market, \textsc{Nat’l Mortgage News}, Nov. 6, 2006, at 8.
\textsuperscript{18} Regulators Issue Guidance on Exotic Mortgages, supra note 11.
\textsuperscript{20} Ted Cornwell, ARMs Yield Performance Surprises: "My gut feeling is that if we go into a recession, all of these numbers double.", \textsc{Nat’l Mortgage News}, Oct. 30, 2006, at 10.
\textsuperscript{21} Downey, supra note 9, at D01.
C. Concerns

Regulators are mostly concerned that exotic mortgage consumers do not understand the implications of the loans they purchase. This could occur through pure consumer ignorance, the inability of a broker to properly educate a consumer, or through deceptive practices by the mortgage broker. The Interagency Guidance does not show great regulatory concern for the latter, though mortgage providers often specifically market exotics to consumers who cannot afford this type of mortgage beyond the initial low-payment five-year introductory period. These lenders tend to provide exotic products to borrowers who probably would not qualify “for a similar sized mortgage under traditional terms and underwriting standards.”

Deception, fraud, and a general lack of knowledge are not usually problems with traditional mortgages. Many consumers understand the basic principles of a traditional mortgage as a way to build equity in their home. The concept of negative or no amortization in a mortgage, however, can be so foreign as to be mostly incomprehensible to the average consumer. Homeowners who do not understand the concept of exotic mortgages and their consequences can find themselves losing homes to foreclosure or losing all the equity in their homes if any of a number of situations occur: the buyer’s salary does not increase, interest rates rise, or the housing market drops.

D. New Interagency Guidance

The OCC’s new Interagency Guidance includes two principles regarding protection of the individual mortgage consumer, and one protecting the lending industry as a whole. In response to consumer protection concerns, lenders must now: (1) ensure that

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23 Nutting, supra note 1, at 2.
26 Nutting, supra note 1, at 5.
their underwriting standards for non-traditional mortgages comport with “prudent lending practices” that consider the borrower’s ability to repay the loan;\textsuperscript{28} (2) not take on riskier loans than they would under traditional mortgages;\textsuperscript{29} and (3) ensure the borrower has enough information about the product, its terms, and its risks to make a prudent choice.\textsuperscript{30} The regulators felt that a properly informed consumer base is vital to reducing predatory lending.\textsuperscript{31}

Finally, the Interagency Guidance asks lenders to recognize that exotic mortgages may be riskier than traditional mortgages and are “untested in a stressed environment.”\textsuperscript{32} Because these mortgages have uncertain risk, mortgage providers should have higher standards for their risk management, and should hold capital levels high enough to survive more loan failures than they would with traditional mortgages.\textsuperscript{33} Just as regulators require higher capital and risk management standards for banks taking on riskier enterprises, they now similarly require mortgage providers to protect their shareholders by holding greater capital reserves for enterprises whose risk is still unknown.\textsuperscript{34} The OCC showed particular concern that if there are mass consumer defaults, it might cause bank failures and force the economy into a recession.\textsuperscript{35}

While it should protect consumers and banks alike, the Interagency Guidance is not an entirely new set of regulations on exotics.\textsuperscript{36} The OCC designed the Interagency Guidance to interplay with Regulation Z (Truth in Lending) and Regulation X (Real Estate Settlement Procedures), not to replace them.\textsuperscript{37} Lenders must still follow all applicable regulations for selling loans, but the Interagency Guidance provides new underwriting and risk management standards.\textsuperscript{38} If mortgage providers fail to follow these standards, the appropriate agencies will increase their monitoring, and examiners may require “timely remedial action.”\textsuperscript{39} The Interagency Guidance makes it clear that lenders “with sound underwriting, adequate risk

\begin{footnotesize}
\begin{enumerate}
\item \textit{Interagency Guidance, supra} note 8, at 15.
\item Tedeschi, \textit{supra} note 22, at 11.
\item \textit{id.}
\item \textit{id.}
\item Tedeschi, \textit{supra} note 22, at 11.
\item \textit{Interagency Guidance, supra} note 8, at 8.
\item \textit{id.}
\item \textit{id.}
\item \textit{id.}
\item \textit{id.} at 14.
\end{enumerate}
\end{footnotesize}
management, and acceptable portfolio performance will not be subject to criticism merely for offering such products."\(^{40}\)

**E. Effects**

The new Interagency Guidance does not affect consumers who currently own exotic mortgages, but may make it more difficult for them, or first time exotic purchasers, to refinance on similar terms or to add a second lien to their home.\(^{41}\) One of the OCC’s main concerns in considering a new Interagency Guidance centers on exotic mortgages as a second lien.\(^{42}\) This new financing may reduce homeowner equity to the point that the consumer no longer owns a sufficient stake to care if he repays the loan or suffers foreclosure.\(^{43}\) This situation significantly increases the risk to providers, and suggests such lenders should hold sufficient capital reserves to protect against the associated defaults.\(^{44}\)

The Interagency Guidance imposes similar standards on non-owner occupied homes.\(^{45}\) Lenders must be wary of consumers who will rely on rental income to pay their exotic mortgage. If the property suffers an extended period of vacancy, the borrower may lose much more equity than with a traditional mortgage.\(^{46}\) As payments rise beyond the introductory rate, each period of vacancy becomes more costly than the last, and decreases the chance the consumer will be able to make his payments and avoid foreclosure.

Concerns about possible foreclosure from unforeseen circumstances bring up two additional facets to the Interagency Guidance: interest-rate shock and loan documentation. Interest rate shock, the feeling of shock as soon as the introductory rate lapses, may arise from lack of consumer information, but more fundamentally, comes from a large variance between introductory rates and rates for the remainder of the mortgage. The Interagency Guidance asks providers to decrease that gap in order to better protect the consumer.\(^{47}\)

\(^{40}\) *Id.* at 10.
\(^{41}\) *Id.* at 6.
\(^{42}\) *Id.* at 13.
\(^{43}\) *Id.*
\(^{44}\) *Id.* at 14.
\(^{45}\) *Id.* at 13.
\(^{46}\) *Id.*
\(^{47}\) *Id.* at 13.
The OCC also determined that many lenders have decreased their documentation requirements, often in exchange for higher premiums.\textsuperscript{48} Mortgage providers have particularly decreased documentation of income verification in favor of credit scoring.\textsuperscript{49} In providing so called “collateral-dependant loans” many lenders do not require income verification so long as a consumer’s credit score is acceptable.\textsuperscript{50} In many situations, however, this limited verification leads to banks providing mortgages that consumers cannot actually afford.\textsuperscript{51} In order to decrease risk further, the Interagency Guidance asks lenders to avoid combining reduced documentation practices with exotic mortgages.\textsuperscript{52}

F. Criticism

Critics of the Interagency Guidance generally fall into two categories: consumer groups and financial institutions. Generally, community organizations and consumer associations favor increased regulation and believe the new regulations constitute a step in the right direction.\textsuperscript{53} A subsection within this group, however, believes that the OCC’s Interagency Guidance may be too little too late and will not actually help most consumers for two reasons. First, many subprime borrowers, who should not have received home loans, already own exotic mortgages.\textsuperscript{54} Second, while the Interagency Guidance is a good start, because it is reactive, it is not sufficient to have a great effect on the market.\textsuperscript{55}

Financial institutions and industry organizations generally favor non-regulation, believing the market can work itself out, but the group does not follow a unitary line. Most agree, in theory, that they should not provide exotic mortgages to subprime borrowers.\textsuperscript{56} Some of the larger companies, however, argue the regulations will favor smaller companies not falling under OCC regulation.\textsuperscript{57} At the same time, many smaller companies believe the Interagency

\textsuperscript{48} Id. at 20.
\textsuperscript{49} Id. at 13.
\textsuperscript{50} Id.
\textsuperscript{51} Id. at 6.
\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} Downey, supra note 9, at D01.
\textsuperscript{55} Id.
\textsuperscript{56} Interagency Guidance, supra note 8, at 6.
Guidance will be a boon for the large lenders like Fannie Mae and Freddie Mac, companies that specialize in traditional mortgages. If exotic mortgages decline due to the new Interagency Guidance, these traditional powerhouses will gain a greater share of the mortgage market, and be the real beneficiaries of the OCC’s action. The two mortgage-industry groups do agree in one area, their condemnation of the Interagency Guidance’s consumer protection provisions. They claim individual states are in the best position to develop consumer protection laws, and that the Interagency Guidance is an improper preemption of state action.

A third group of critics are private organizations that side with the industry members. This group believes exotic mortgages have been a great boon for Americans who could not otherwise afford to buy a home. The group contends that the Interagency Guidance is an example of too much government interference in a consumer’s private transaction and is overly prescriptive. There is no doubt that exotic mortgages have opened home ownership to an entirely new segment of the population. While the OCC agrees with this group as to the benefits of exotics, it shows concern for the costs at which the benefits have arisen.

The “Interagency Guidance on Nontraditional Mortgage Product Risks” may prove to be a boon for some members of the mortgage industry and a burden for others. Though it might keep many Americans out of home-ownership, it should protect them from their own lack of knowledge on the subject. It may also protect the millions of other consumers whose life savings would be lost if too many banks defaulted at the same time forcing the United States economy into a sharp downturn.

Alex Binkley

58 Muolo, supra note 17, at 8.
59 Id.
61 Interagency Guidance, supra note 8, at 3.
62 Nutting, supra note 1, at 5.
63 Interagency Guidance, supra note 8, at 2.
64 Student, Boston University School of Law (J.D. 2008).
IV. REAL ESTATE ACTIVITIES OF BANKS

Section 29 of the National Bank Act “conditionally allows” national banks to own real estate.”¹ Section 29 also establishes a general presumption against banks purchasing, holding, or selling real property.² In December 2005, the Office of the Comptroller of the Currency (“OCC”) was asked to interpret three cases regarding the exceptions to section 29.³ Subsequently, the OCC issued three interpretive letters.⁴

12 U.S.C. § 29 provides, “[A] national bank may purchase, hold and convey real property it uses, in good faith, for banking purposes, but it may not engage in real estate speculation or accumulate large real estate holdings.”⁵ These restrictions aim to prevent national banks from participating in risky investments and real estate speculation.⁶

There are two exceptions to section 29: 1) “[N]ational banks may hold real estate obtained in satisfaction of debts;” and 2) “[A] national bank is permitted to acquire and hold such real property ‘as shall be necessary for its accommodation in the transaction of business.’”⁷ The OCC has interpreted the second exception “to allow national banks to buy real estate for two purposes: 1) to acquire real estate for bank offices, employee housing, and other ‘bank premises’ uses, and 2) to acquire real estate as part of a permitted bank financing activity.”⁸

² JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION 151 (3d ed. 2001).
⁴ Id.
⁷ See generally Brown v. Schleier, 118 F. 981, 984 (8th Cir. 1902); see supra, note 2, at 151.
⁸ Horn, supra note 1, at 10.
A. The Interpretive Letters

In Interpretive Letter #1044, the OCC stated that the construction and holding of a mixed-use building was a permissible use of bank premises.\(^9\) Bank of America’s (“BOA”) headquarters in Charlotte consisted of two office buildings. BOA proposed to build a third building, and planned for this building to be a mixed-use building.\(^10\) The building would have retail and restaurant space, twelve floors of office space, five floors of hotel space operated by the Ritz Carlton, and four floors of condominiums.\(^11\) The bank also stated it would meet certain percentages in use of the hotel rooms, but that it would not use any of the condos.\(^12\) “The condominiums would be sold through an unaffiliated real estate broker, and, once sold, the Bank would retain no ownership interest in the top four floors of the building.”\(^13\)

The OCC found that section 29 does not prohibit a national bank from constructing a mixed-use building “in an expanded headquarters complex.”\(^14\) “Both the OCC and the courts have recognized that it is appropriate for a bank to maximize the utility of its banking premises,”\(^15\) provided the development is “done in good faith,” meaning that it is for banking purposes and not contrary to section 29.\(^16\) Once the banking purposes have been established, section 29 permits the Bank to maximize utilization of the banking premises.\(^17\) The OCC concluded BOA was acting in good faith because the property was bank premises, the bank “demonstrated need for additional office space,” and the building could reduce BOA’s annual expenses.\(^18\) Furthermore, the mixed-use building was

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\(^{9}\) OCC Interpretive Letter 1044, at 1.
\(^{10}\) Id.; see also, NAR President: Congress is Watching the OCC, US NEWswire, May 17, 2006, at 1.
\(^{11}\) See supra note 9, at 2; NAR President: Congress is Watching the OCC, at 1.
\(^{12}\) With respect to the hotel, the Bank anticipates that it would occupy approximately 22% of the office and hotel space in the Proposed Premises. This percentage exceeds what has been expressly permitted in previous Letters. See supra note 9, at 5 (citing Interpretive Letter No. 1034; Conditional Approval No. 298 (Dec. 15, 1998)).
\(^{13}\) See supra note 9, at 2.
\(^{14}\) See supra note 9, at 4; 9 GOODWIN PROCTER FINANCIAL SERVICES ALERT 19, Dec. 27, 2005.
\(^{15}\) Brown v. Schleier, 118 F. 981, 984 (8th Cir. 1902), aff’d, 194 U.S. 18 (1904); OCC Interpretive Letter 1044, at 3 (citing Interpretive Letter No. 1034, reprinted in [Current Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-563; (Apr. 1, 2005)).
\(^{16}\) OCC Interpretive Letter 1045, at 2.
\(^{17}\) See supra note 15, at 4 (citing Brown, 118 F. at 984).
\(^{18}\) OCC Interpretive Letter 1044, at 4.
necessary to make such development economically viable in the downtown market, and the rejuvenation of the downtown area “would protect the value of the Bank’s current headquarters buildings.” Once bank premises property is acquired in good faith, national banks are permitted to make best economic use of the property. Thus, if including the condominiums is necessary to the economic viability of the development, they should not be prohibited by 12 U.S.C. § 29.

In Interpretive Letter #1045, the OCC permitted a national bank to develop a hotel, managed by a national hotel management company, to provide housing for the bank’s out-of-town visitors and employees. PNC Financial Services group, the institution at issue in Interpretive Letter #1045, intends to build the hotel on existing bank premises adjacent to bank headquarters, and intends to use the occupied rooms in the hotel for an estimated annual 37.5% total occupancy. PNC seeks to reduce its annual lodging expense, and to increase the quality of the experience of visitors and increase the desirability of working in PNC’s headquarter city. The OCC found that “[b]ecause providing lodging for bank visitors, and doing so in a cost-efficient manner, is a legitimate business concern for the Bank . . . the proposed hotel would fall within the meaning contemplated by section 29.” In recognizing the authority of national banks to maximize the utility of bank premises, the OCC cited Brown v. Schleier which stated:

When an occasion arises for an investment in real property for either of the purposes specified in the statute, the national bank act permits banking associations to act as any prudent person would act in making an investment in real estate, and to exercise the same measure of judgment and discretion. The act ought not to be construed in such a way as to compel a national bank, when it acquires

19 Id. at 5.
20 Id. (“With respect to the four floors of condominiums that the Bank would sell, the Bank represents that including the development of these condominiums for sale is necessary to make construction of the Proposed Premises economically viable.”).
21 OCC Interpretive Letter 1045, at 1.
22 Id. at 2; OCC Publishes Interpretive Letters Concerning Use of Bank Premises, supra note 5, at 3.
23 OCC Interpretive Letter 1045, at 2-3.
24 Id.
real property for a legitimate purpose, to deal with it otherwise than a prudent landowner would ordinarily deal with such property. 25

In Interpretive Letter #1048, the OCC permitted Union Bank of California, N.A. to purchase 70% equity interest in windmill farms and use profits of the business as repayment of the loan. 26 This project uses wind turbines to generate and sell electricity, which receives tax credits under section 45 of the Internal Revenue Code, 26 U.S.C. § 45. 27 The Bank proposed a structure that would allow it to take advantage of the section 45 Tax Credits. 28

“The economic substance of a transaction, rather than its form, guides [the OCC’s] analysis of whether a national bank is prohibited from engaging in a certain activity.” 29 Union Bank’s proposal would allow it to acquire an indirect interest in the land upon which the wind turbines would be affixed. 30 Such an interest in real estate is subject to section 29. 31 “National banks may not acquire, own, or convey an interest in real estate for any purpose other than those specified in section 29.” 32 However, “national banks may acquire an interest in real estate when doing so is an integral part of an authorized banking activity, provided that doing so is not inconsistent with any of the purposes underlying the limitations of section 29.” 33 This principle is supported by OCC precedent. 34 A key element of this transaction is that the interest in real estate must be acquired as an integral part of an authorized banking activity: “By taking advantage of the tax credits, the Bank would be able to facilitate this financing by reducing the cost of

25 Brown v. Schleier, 118 F. 981, 984 (8th Cir. 1902).
26 OCC Interpretive Letter 1048, at 1.
27 Id.
28 Id.
29 Id. at 4.
30 Id. at 2. 4.
31 Id. at 5-6.
32 Id. at 4, 6 (“National banks may acquire a section 29 interest in real estate when doing so is an integral part of or incidental to an authorized banking activity, provided that doing so is not inconsistent with any of the purposes underlying the limitations of section 29.”).
33 Id. at 4 (“Twelve U.S.C. § 24(Seventh) provides national banks with broad authority to make loans or other extensions of credit.” The OCC found this transaction very similar to a loan or extension of credit.).
34 Id. at 6.
borrowing while receiving an appropriate yield.”35 Thus, the OCC found the equity financing appropriate under the circumstances.

B. Concern over the Letters

Following these interpretive letters, many lobbied to get Congress to reconsider the OCC’s position because they believed the letters authorized banks to venture into commercial enterprises disallowed under 12 U.S.C. §29.36 The National Association of Realtors (“NAR”) was among those most strongly opposed to the interpretive letters.37 Very soon after the release of the interpretive letters, the president of the NAR, Thomas M. Stevens, expressed his concern.38 The NAR urged Congress to “block OCC action that permits banks to engage in commercial real estate development and merchant banking.”39

The NAR was primarily concerned that the letters allowed “three of the largest national banks in the nation to invest in the development of office buildings, hotels, residential condominiums, and even a windmill farm.”40 Stevens was troubled that these letters would allow “national banks . . . to become actively involved in real estate development and broker activities,” defying Congressional intent.41 The NAR asked the OCC to reconsider its rulings and urged Congress to address these issues. Stevens further expressed fear that the rulings posed “a significant threat to the safety and soundness of the entire banking system, financial markets, and the U.S. economy.”42 Stevens stated, “if Congress does not want banks to engage in real estate brokerage or management, it is inconceivable

35 Id.
36 NAR President: Congress is Watching the OCC, supra note 10, at 1; NAR President Seeks to Discuss Bank Powers with Secretary Snow, US NEWSWIRE, Feb. 17, 2006, at 1.
37 Id.
38 Id.
39 Id.
40 NAR President Seeks to Discuss Bank Powers with Secretary Snow, supra note 36, at 1.
41 Id.
42 Id. (“The savings and loan scandal of the 1980’s and the sluggish Japanese economy, where banks are intertwined with real estate and commercial enterprises, are dramatic examples of the negative consequences of mixing banking and commerce.”).
that it intends to permit national banks to engage in real estate
development, which is a much riskier activity.”

Congressmen have also engaged in debate over the letters. Todd Harper, director for Paul Kanjorksi (D-Pa), stated, “More than 50 Members of Congress have signed onto a letter to the OCC and Mr. Kanjorksi and Congressman Barney Frank (D-Mass.), ranking minority members of House Financial Services Committee, sent a detailed [letter].” Finally, Rep. Edolphus Town believes that the OCC’s ruling “created potential loopholes” for banks to enter the real estate business.

C. Congressional Hearing

As a result of this outcry by the NAR and Congress itself, Congress held a hearing on the interpretive letters on September 27, 2006. Congress allowed the NAR to express its views to a House panel. Julie L. Williams, the First Senior Deputy Comptroller, also testified before Congress regarding the OCC’s position on the letters. Ms. Williams argued, the letters do not “authorize national banks to engage in the real estate development or investment business.” Ms. Williams stated in her Testimony:

Since many claims have been made about what the letters do and do not authorize, let me be very clear that they do not breach the boundaries between banking and commerce, do not authorize national banks to engage in the business of real estate

43 Id.
44 NAR President: Congress is Watching the OCC, supra note 10, at 2; see also, Joe Adler, Legislators Question OCC Realty Rulings, 171 AM. BANKER 187, Sept. 28, 2006, at 18.
45 Adler, supra note 44, at 19.
48 Hearings, supra note 47 (statement of Julie L. Williams), at 1.
investment or development, have nothing to do with merchant banking, have nothing to do with allowing national banks to conduct real estate brokerage, and were carefully evaluated by OCC supervisors to assure that the activities would be consistent with the safe and sound operations of the banks involved.49

The letters themselves have been divided into two sections for discussion purposes: “Bank Premises Letters” (dealing with two projects allowing banks to develop mix-used buildings) and the “Project Financing Letter” (dealing with a bank’s ability to invest in equity of an energy company).

1. The Bank Premises Letters

Interpretive Letters 1044 and 1045 “permitted banks to develop property they already owned in ways that enhance how the property served each bank’s banking operations.”50 The letters were based on “judicial precedent and OCC interpretations that authorize a national bank to “hold and develop property used in connection with its own operations,” subject to the limitation that the development “must not be speculative or motivated by realizing a gain on appreciation of the real estate property value.”51 There must also be a “legitimate and good faith business need.”52 Further, as stated in the letters, the OCC reemphasized that courts have held that a national bank can “maximize the utility of its banking premises.”53 Acquisition of real estate must be “conducted in good faith in furtherance of a bank’s banking operations,” and the burden to show proper intent is on the bank.54

2. The Project Financing Letter

Interpretive Letter 1048 involved the financing of a wind energy product. Ms. Williams stated, a bank:

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49 Hearings, supra note 47 (testimony of Julie L. Williams), at 2.
50 Id. at 3-4.
51 Id. at 4.
52 Id.
53 Id. at 5-6 (citing Brown v. Schleier, 118 F. 981, 984 (8th Cir. 1902)).
54 Id. at 6.
“1) may not participate in the operation of the business receiving the bank’s financing; 2) may not realize any gain on the appreciation of the value of its interest in the business or assets held by the business; and 3) must provide in the project agreement many of the same terms, conditions, and covenants typically found in lending and lease financing transactions to protect its interests.”

However, the OCC noted that a “key factor” in allowing this particular equity transaction is to allow the bank the tax benefits enacted by Congress. The OCC has permitted “national banks to provide financing that takes the form of equity, e.g., to finance low-income housing, the renovation of historic buildings, and other types of community projects,” because these projects have proven to be “low risk.” The OCC was further persuaded by the fact that courts have held that “permissible loan-equivalent transactions can take different and non-traditional forms in order to accommodate the demands of the market; the economic substance of the transaction . . . guides the analysis of whether the transaction is a permissible lending activity.”

D. What is Next?

In closing, Ms. Williams also expressly limited the interpretation in all of the letters. She stated the Letters were limited to their respective facts, limited in scope, within existing precedent and created no safety and soundness concerns. As the OCC explicitly stated in a subsequent interpretive letter:

... the Letters have absolutely nothing to do with real estate brokerage . . . . The Letters deal only

55 Id. at 9.
56 Id.
57 Id. at 10 (citing Interpretive Letter 1048).
58 Id. at 9 (citing M & M Leasing Corp. v. Seattle First Nat’l Bank, 563 F.2d 1377 (9th Cir. 1977)).
with limited situations where holding an interest in real estate has long been recognized as permissible for national banks. The Letters absolutely do not open the door for national banks to engage in broad-based real estate development activities, nor do they violate the separation of banking and commerce.60

However, some, including the NAR, believe that the letters will lead to national bank entry into the “dirt business.”61 For the NAR, the main concern is not these interpretive letters alone, but the erosion of the separation of banking and commerce.62 Still, some believe the OCC has done nothing new with the most recent letters, correctly allowing “national banks some leeway in how they manage their needs for bank premises, and meet in a flexible manner the particular financing needs of their commercial customers.”63 The OCC has often allowed “national banks to acquire mixed-use commercial properties,” so long as the bank does so in “good faith.”64 Lastly, while the “financing equivalent” energy letter (1048) may constitute a “creative interpretation” by the OCC, it is nevertheless within the OCC’s line of previous interpretations.65 The question now remains whether this will actually take banks into the dirt business, or whether it will cause Congress to “‘legislate’ banks out of the real estate business.”66

Brandon McGathy67

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60 OCC Interpretive Letter 1053 (Jan. 31, 2006), at 1.
61 Horn, supra note 1, at 10.
62 NAR President Seeks to Discuss Bank Powers with Secretary Snow, supra note 36, at 1-2.
63 See supra note 1, at 10.
64 Id.
65 Id. at 11.
66 See supra note 1, at 11.
67 Student, Boston University School of Law (J.D. 2008).
V. DATA SECURITY

For decades, government entities and private businesses have been collecting and compiling information on each of us. However, with the rise of information technology and the spread of databases that record almost every detail of every nearly every individual’s personal information, almost no citizen or customer can go totally unnoticed. Databases old and new are being copied and aggregated into “digital dossiers”—aggregated records of an individual’s personal data, such as their social security numbers, credit card numbers, credit information, bank accounts, purchase histories, internet browsing-histories, psychological profiles, and even marital status. The internet has not only increased the number and size of these databases, but it has also brought them within the reach of anyone interested. “Data brokers” have popped up to meet the high demand for detailed private information. Possibly the gravest risk these massive pools of digital dossiers pose is that they will be breached, thus placing extensive private information in the wrong hands and leading to massive identity theft. This is exactly what happened with the ChoicePoint debacle.

In 2005, ChoicePoint, a Georgia-based “data broker” that buys, sells, and compiles consumer data, suffered a serious security breach. ChoicePoint subsequently notified just over 160,000 victims that their personal information has been compromised, and at least 800 cases of identity theft resulted. ChoicePoint’s legacy, however, is based only partly on the havoc it wreaked: the breach also ushered in a sea-change in the law governing data security. As a result of the ChoicePoint breach and the wave of high-profile

2 Id.
3 Id. at 2-5.
4 Id.
5 Id. at 3, 20-21.
6 Id.
8 Id.
9 Id.
10 Id.
breaches that followed, many states have proposed and enacted laws, following California’s lead, that require companies who suffer from a breach to notify any individuals whose information was compromised. At the time of the ChoicePoint breach, California had the only law of this kind on the books, and without it, both enforcement agencies and the public may never have learned about the breach at all. The remainder of this article will highlight some of the major data breaches of 2006 and the legislative responses.

A. No One is Safe, Not Veterans, Nor Retail Shoppers

Since ChoicePoint in 2005, there have been over 200 high-profile breaches involving both private and public entities. A brief discussion of a few of the more high-profile breaches of the last year will illustrate the key features of most incidents.

1. Roughly 18 Million Veterans See Their Personal Information Stolen

In the largest security breach to date, a laptop containing the social security numbers and personal information of over 17 million veterans was stolen from a Veterans Administration employee after he took the laptop home counter to VA policy. Initially, the VA refused to provide credit monitoring for the victims of the breach whose information had been compromised, as the VA merely reminding veterans that they were entitled to a free copy of their credit record every year. Under heavy public pressure, the VA eventually agreed to foot the bill for one-year of free credit monitoring for all victims. Interestingly, the VA’s breach, like so many of the other major breaches, did not arise from high-tech

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12 CAL. CIV. CODE §§ 1798.29, 1798.80-1798.84 (2005).
14 Zachary A. Goldfarb, VA to Offer Credit Monitoring, WASH. POST, June 22, 2006, at A27 (noting that reports initially listed the number as closer to 27 million, but this estimate was eventually reduced to between 17-18 million after inspection of the data revealed many duplicate entries).
16 Goldfarb, supra note 14.
17 Id.
hacking but instead the low-tech theft of an unprotected laptop.\textsuperscript{18} Stunningly, the sensitive information on the laptops was not “encrypted,”\textsuperscript{19} as doing so would have likely prevented any harm to the victims.\textsuperscript{20}

2. TJX Data Breach – One of History’s Largest Breaches

In January of 2007, retailer TJX Companies, which operates T. J. Maxx and Marshall’s, admitted that it had been hit by a major security breach that could expose up to forty-million customers to identity theft.\textsuperscript{21} Fifth Third Bank was identified as the sponsoring bank that handled TJX’s accounts, making it responsible for ensuring that the retailer met the industry’s data security standards, and thus may face staggering liability as well.\textsuperscript{22} In any event, those hardest hit will likely be consumers, who must now continually monitor their credit, and credit card companies, which typically have zero-liability programs on consumer credit cards.\textsuperscript{23} Moreover, TJX waited for some time before divulging the details of the intrusion, as it became aware of the breach sometime during “mid-December 2006.”\textsuperscript{24} Although at first TJX claimed it waited at the behest of law enforcement, it later retreated on this position, admitting that it was also a “business decision.”\textsuperscript{25} While TJX did not appear to violate any particular laws by waiting to notify the victims, many breach notification statutes have strict timelines that must be adhered to.\textsuperscript{26}

\textsuperscript{19} To “encrypt” is to “alter (a file, for example) using a secret code so as to be unintelligible to unauthorized parties.” THE AMERICAN COLLEGE DICTIONARY, 463 (2002). Encrypting files is relatively simple and inexpensive, and would deter most basic attempts to access data without authorization.
\textsuperscript{20} Levitz & Hechinger, supra note 18.
\textsuperscript{23} Sidel, supra note 21.
\textsuperscript{24} Jenn Abelson, TJX Breach Snares Over 200,000 Cards in Region, BOSTON GLOBE., Jan. 25, 2007, at D1.
\textsuperscript{25} Id.
\textsuperscript{26} See e.g., CAL. CIV. CODE §§ 1789.29, 1789.82-84 (2005) (requiring notice “in the most expedient time possible and without unreasonable delay” and allowing time for law enforcement needs pursuant to a criminal investigation and necessary measures to determine the scope of the breach).
3. Summary and Other Breaches

According to the Privacy Rights Clearinghouse, there have been over two-hundred and fifty major breaches since ChoicePoint’s, and roughly ninety million people have been affected.\textsuperscript{27} For example, in the banking and financial services industry, there have been several significant breaches, including ones involving Bank of America\textsuperscript{28} and Citigroup.\textsuperscript{29} Many of these breaches could have been avoided had those storing the data simply been more careful with company laptops or made an effort to keep the private information encrypted. In fact, while companies and public agencies have beefed up their security from hackers and other digital intruders, it has been the laptop that has proven most vulnerable.\textsuperscript{30} With the threat of data breach seemingly omnipresent, the rising volume and number of the pools of digital dossiers, and the difficulty consumers have in protecting themselves from identity theft once their information is leaked, it is no surprise that lawmakers have made notification a priority.

B. Legislative Response

When the ChoicePoint debacle broke, California was the only state with a data breach notification law.\textsuperscript{31} At least 32 states have passed laws largely mimicking California’s, including at least thirteen states in 2006: Arizona, Colorado, Hawai‘i, Idaho, Illinois, Indiana, Kansas, Maine, Nebraska, New Hampshire, Utah, Vermont, and Wisconsin.\textsuperscript{32} Although business lobbyists have pushed hard for a single federal law to replace the differing state laws, their effort has

\textsuperscript{27} CHRONOLOGY OF DATA BREACHES, supra note 11.
\textsuperscript{28} Davis Lazarus, Security Breach Fallout Reaches 200,000 Debit-Card Holders, S.F. CHRON., Feb 10, 2006, at D1 (noting that Bank of America, pursuant to California’s notification law, was forced to notify customers that accounts had been compromised “at a third-party location unrelated to Bank of America”).
\textsuperscript{29} Citigroup Clients Hit by Hundreds of Illegal Debits, L.A. TIMES, March 9, 2006, at C3 (noting that Citigroup admitted that customers actually had money illegally withdrawn from their debit-card accounts due to a third-party data breach.).
\textsuperscript{30} Levitz & Hechinger, supra note 18.
become increasingly politicized and no single federal law has been enacted.\textsuperscript{33} To some privacy-law advocates, this has been encouraging because the proposed federal bills have been almost universally softer than existing state laws that a federal law would preempt.\textsuperscript{34} Thus, in this section I will outline the major features of the California law and show how some of the recent state enactments differ, and then turn briefly to the state of federal law in the absence of a comprehensive scheme.

1. Major Features of California’s Law and Recently Enacted State Laws

California’s data breach notification law has been the model for similar laws enacted in other states.\textsuperscript{35} The primary features of any data breach notification law are:

(1) Who is covered?
(2) Who would be covered but is exempt?
(3) What kind of data is protected?
(4) What is a “breach” within the meaning of the law? And
(5) What kind of notice is required (who, how, and when)?\textsuperscript{36}

Although California’s law applies to both private entities engaged in business\textsuperscript{37} as well as government agencies,\textsuperscript{38} ten states—Colorado, Connecticut, Delaware, Georgia, Maine, Montana, North Carolina, North Dakota, Texas, and Utah—do not impose their breach notification laws on government entities.\textsuperscript{39} Another distinguishing feature is that, almost universally, these laws exempt “encrypted” data from coverage, because the encryption effectively eliminates most of the risk from a data breach. Further, some of the most recent laws, such as those passed in Colorado\textsuperscript{41} and Indiana,\textsuperscript{42} exempt data that is sufficiently “redacted” such that it is “unreadable” or

\textsuperscript{34} Kini & Shreve, supra note 31, at 103-08.
\textsuperscript{35} Id. at 94.
\textsuperscript{36} Id. at 94-102; see also CAL. CIV. CODE §§ 1798.29, 1798.80-1798.84 (2005).
\textsuperscript{37} CAL. CIV. CODE §§ 1789.82-84 (2005).
\textsuperscript{38} § 1789.29.
\textsuperscript{39} BREACH OF INFORMATION LAWS, supra note 32.
\textsuperscript{40} See definition of “encrypt,” supra, note 19.
\textsuperscript{41} COL. REV. STAT. § 6-1-716 (2006).
\textsuperscript{42} IND. CODE § 24-4-9 (2006).
“unusable.” Finally, California’s law defines “personal information” as including an individual’s social security number, driver’s license or State ID number, account numbers, credit or debit card numbers, including in combination with any access or PIN codes or passwords that would allow access to the individual’s financial accounts.43

a. “Breach” – Acquisition, Access, and Reasonable Risk

One of the major distinctions between California’s law and those of other states is in how they define “breach.” California’s law defines breach as the “unauthorized acquisition of computerized data that compromises the security, confidentiality or integrity of personal information.”44 Several states define it in a way that is less burdensome on data brokers, by limiting “breaches” only to unauthorized access that leads to a reasonable belief of a material risk of identity theft or fraud.45 This formulation grants the companies who leaked the data the authority to determine whether the risk of identity theft is substantial enough to warrant notice, raising the question of what incentive these companies might have to provide notice at all. Conversely, several states have defined breach as the “unauthorized access” of data 46 which is an even more inclusive definition than California’s “acquisition” standard,” as it includes any exposure of private information to an unauthorized party.47 Thus, although most states use the same framework, these laws still differ in significant ways, particularly on who is and is not covered and in how “breach” is defined.

b. Credit Freeze Laws

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43 CAL. CIV. CODE §§ 1789.29(e), 1789.82(e) (2005).
44 § 1789.82(d) (emphasis added).
45 See OHIO REV. CODE ANN. § 1349.19 (2006). We will see this is the same approach taken by the Interagency Guidelines offering an interpretation of the Gramm-Leach-Bliley Act, as well as most of the proffered federal laws that have circulated in the House and Senate.
47 The “access” formulation here is similar to that used in Title II of the Electronic Communications Privacy Act, also known as the Stored Communications Act. 18 U.S.C. §§ 2701-11 (2006) (prohibiting the “unauthorized access” of data held in “electronic storage”).
Some states have begun allowing victims of data breaches to freeze their credit reports. A credit freeze bars lenders and borrowers from reviewing an individual’s credit history. As few lenders will issue credit without seeing a credit report, identity thieves find it difficult to open fraudulent accounts in the name of someone who has frozen their account. Typically, it costs $10-12 to freeze or modify the individual’s account, though this fee is often waived for security breach victims. Although imperfect, credit freezes can be an important tool for individuals to protect themselves, and at least twenty-four states have enacted credit freeze laws, including at least thirteen in 2006.

2. Federal (In)action

Despite heavy lobbying from data-brokers and businesses, Congress has not yet enacted a comprehensive data security notification law. If Congress does, however, the law will not likely be as strict as most existing state laws. In any event, while data security law is state dominated, federal regulation, though not comprehensive, still plays an important role. First, several states still have no data breach laws and many others exempt state entities subject to federal requirements. Thus the federal laws that govern data breaches, although limited, are all the regulation there is in these states. Second, with the recent high-profile and high-value settlements between ChoicePoint and the FTC, there is a kind of “de facto” federal law of certain minimum requirements that companies and entities must meet if they want to avoid liability.

48 See e.g., CONN. GEN. STAT. § 36a-701b (2006); KY. REV. STAT. ANN. §§ 67.1-3 (2006).
49 Sandra Block, Is Freezing Your Credit the Way to Safeguard Your ID?, USA TODAY, June 19, 2005.
50 See e.g., KY. REV. STAT. ANN. §§ 367.1-3 (2006).
52 Waldmeir, supra note 33.
53 See e.g., IND. CODE §24-4.9 (2006) (exempting entities that maintain and comply with notifications plans under the Gramm-Leach Bliley Act, the USA Patriot Act, and Health Insurance Portability Act, among others).
54 Stipulated Final Judgment and Order for Civil Penalties, Permanent Injunction, and Other Equitable Relief, United States v. ChoicePoint Inc., No. 06-CV-0198 (N.D. Ga. 2006).
a. Gramm-Leach Bliley, Interagency Guidance, and the FCRA

Banks, thrifts, and other financial institutions are required to comply with the Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice, which interprets section 501(b) of the Gramm-Leach Bliley Act ("GLB Act"). The guidelines describe the required elements of proper response to data breaches, which must include:

(1) assessment of the nature and scope of the incident;
(2) prompt notice of an incident to the bank’s primary federal regulator;
(3) notice to the appropriate law enforcement authorities;
(4) steps to contain and control the incident, such as by monitoring, freezing or closing compromised accounts, while preserving records and other evidence; and
(5) notifying customers “when warranted.”

Other commentators have detailed exactly how the Interagency Guidance differs from state laws like California’s, but for our purposes it suffices to note that the primary difference between these guidelines—besides only applying to banks—is in how they each define “breach.” To qualify as a “breach,” the Interagency Guidance requires that the unauthorized access create harm or possible harm to customers. As a result, the duty to inform does not arise immediately on acquisition or access, as with some other laws.

Finally, so-called “data brokers” like ChoicePoint are subject to other federal regulations because they are in the business of

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58 Id.
59 Id.
60 Id. at 98.
distributing private information to third-parties. For example, the FTC heavily relied on the Fair Credit Reporting Act (“FCRA”) in its complaint against ChoicePoint, which repeatedly noted that ChoicePoint did not exercise reasonable methods to determine the legitimacy of who it sold information to. The FCRA was the FTC’s primary weapon in prosecuting ChoicePoint’s failures and remains an important tool with the continued rise of huge data brokers.

b. De Facto Federal Regulation

ChoicePoint’s settlement—which required it to pay a $10 million civil penalty and another $5 million in consumer redress—was the largest in FTC history. The FTC also recently settled two other data breach actions. In each, the FTC premised the action as an “unfair practice,” rather than as a “deceptive practice.” The FTC thus sent a message both that it will remain flexible in defining what is and is not permissible and that the focus will be on basic fairness as opposed to specific deceptive or misleading actions.

In any event, thus far the FTC has not been altogether clear about what will and will not satisfy its minimum “de facto” standards. The FTC has listed several general and specific failures to act reasonably to protect the private information the companies stored, but it does appear that the FTC strongly encourages encrypting stored private data. Regardless, companies should be doing this already as every state law to date exempts from liability and the notice requirements companies that encrypt consumer data.

C. Conclusion

Since ChoicePoint, significant data-breaches have splashed the front of newspapers and many individuals have become victims

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63 Stipulated Final Judgment and Order for Civil Penalties, Permanent Injunction, and Other Equitable Relief, United States v. ChoicePoint Inc., No. 06-CV-0198 (N.D. Ga. stipulated final judgment 2006).
65 Complaint, United States v. ChoicePoint Inc., No. 06-CV-0198 (N.D. Ga. 2006); see generally Johnson & Das, supra note 45.
66 Johnson & Das, supra note 55, at 234.
67 See e.g., CAL. CIV. CODE §§ 1789.80-84 (2005).
of identity theft. State legislatures have responded quickly, enacting fairly strict notification and credit freeze laws to protect their citizens, while federal regulation in this area continues to be dominated by a patchwork of relatively light minimum standards.

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VI. MUTUAL FUND INDUSTRY

A. Continued Fallout from Mutual Fund Scandals of 2003

In the summer of 2003, New York Attorney General Eliot Spitzer began investigating market timing and late trading abuses in the mutual fund industry.1 The investigation uncovered a scheme whereby large investors exploited the fact that while stock share prices continually change throughout the day, mutual fund shares are priced once a day.2 Market timing includes the short-term buying and selling of shares of the same fund to profit from these pricing differences.3 Market timing has adverse affects for long-term shareholders by forcing fund managers to alter their investment mix, either holding a higher cash position or selling securities to cover sales.4 Market timing also generates unwanted taxable capital gains for remaining shareholders.5 Fund managers agreed to the trades, despite the negative effects on performance, because of the lucrative fee revenue they trades generated.6

1. Changes to Share Redemption Rules to Combat Market Timing

The Securities and Exchange Commission ("SEC") passed Rule 22c-2 on March 11, 2005, in response to the market timing scandal.7 Rule 22c-2 provides that if a fund redeems shares within seven days of purchase, a majority of its independent directors may choose to impose a redemption fee on the transaction.8 The redemption fee may not exceed two percent of the proceeds of the sale and the proceeds from the fee go back to the fund.9 The fee

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2 Id.
4 Id.
5 Id.
6 See Masters, supra note 1.
9 Id. § 270.22c-2(a)(1)(i).
helps funds discourage short-term trading and offset the costs borne by remaining long-term investors.\textsuperscript{10}  

In addition to the redemption fee, Rule 22c-2 requires mutual funds to either enter into shareholder information agreements with their intermediaries or prohibit the intermediaries from making trades on behalf of others.\textsuperscript{11}  An “intermediary” is a financial institution that holds a mutual fund’s shares on behalf of another, such as a broker, dealer, or bank, but not anyone the fund treats as an individual investor.\textsuperscript{12}  Mutual funds were hard pressed to enforce their redemption policies before Rule 22c-2 because shares purchased by intermediaries on behalf of individual shareholders were reflected in the fund’s books as belonging to the intermediary.\textsuperscript{13}  This did not give the mutual funds sufficient information to tell which redemptions by individual shareholders violated their redemption policies.\textsuperscript{14}  Intermediaries that do not have a shareholder information agreement with a fund are not prohibited from making purchases on their own behalf because the fund does not need any additional information to adequately scrutinize those transactions.\textsuperscript{15}  

The shareholder information agreements require intermediaries to give mutual funds information on shareholder transactions.\textsuperscript{16}  Intermediaries must also restrict or prohibit future purchases or exchanges of a mutual fund’s shares if the fund identifies the shareholder as having violated the fund’s redemption policy.\textsuperscript{17}  The agreements also require intermediaries to use their “best efforts” to investigate whether a specific shareholder is itself a financial intermediary (or “indirect intermediary”).\textsuperscript{18}  Mutual funds can also require that intermediaries either get detailed shareholder transaction information from the indirect intermediaries, or prohibit the indirect intermediaries from making any future purchases on behalf of others.\textsuperscript{19}  The Rule reflects amendments and clarifications the SEC made on October 3, 2006.\textsuperscript{20}  

\textsuperscript{10} Mutual Fund Redemption Fees, 70 Fed. Reg. at 13,330.  
\textsuperscript{11} 17 C.F.R. § 270.22c-2(a)(2).  
\textsuperscript{12} See Id. § 270.22c-2(c)(1).  
\textsuperscript{13} Mutual Fund Redemption Fees, 70 Fed. Reg. at 13,330.  
\textsuperscript{14} Id.  
\textsuperscript{15} Mutual Fund Redemption Fees, 71 Fed. Reg. at 58,261-262.  
\textsuperscript{16} 17 C.F.R. § 270.22c-2(c)(5)(i).  
\textsuperscript{17} Id. § 270.22c-2(c)(5)(ii).  
\textsuperscript{18} Id. § 270.22c-2(c)(5)(iii).  
\textsuperscript{19} Id. § 270.22c-2(c)(5)(iii)(A)-(B).  
\textsuperscript{20} See generally Mutual Fund Redemption Fees, 71 Fed. Reg. at 58,257.
In addition to making substantive changes, the amendment also changed the compliance dates for Rule 22c-2.\textsuperscript{21} The SEC extended the date by which funds must enter into shareholder information agreements with their intermediaries by six months, to April 16, 2007.\textsuperscript{22} The date by which funds must be able to request and promptly receive information under these agreements was also extended, by one year, to October 16, 2007.\textsuperscript{23} The compliance date for implementing a redemption fee remains October 16, 2006.\textsuperscript{24}

2. SEC Push for Mutual Fund Board Independence

The SEC also responded to the 2003 mutual fund scandals by proposing amendments to the fund governance standards.\textsuperscript{25} Both the Investment Company Act of 1940 and the SEC’s rules promulgated under it rely on the ability of a mutual fund’s board of directors to “manage the conflicts of interest that advisers have with the funds they manage.”\textsuperscript{26} The SEC worried that boards dominated by management would be unable to fulfill these duties.\textsuperscript{27} The change to the board governance standards calls for seventy-five percent of a mutual fund’s board of directors to be independent of management, including the chairman of the board.\textsuperscript{28} The Investment Company Act of 1940 calls for a minimum of forty percent of a mutual fund’s board of directors to be independent of management.\textsuperscript{29} The SEC rule aims to enact this change by making ten commonly used exemptive rules subject to the new board governance standards.\textsuperscript{30}

The U.S. Chamber of Commerce challenged the adopted rule and on June 25, 2005, the Court of Appeals remanded the rule to the SEC for failure to adequately consider the costs of implementing the changes.\textsuperscript{31} On June 29, 2005, the SEC readopted the proposed rule.\textsuperscript{32}

\begin{thebibliography}{9}
\bibitem{21} Id. at 58,262.
\bibitem{22} Id.
\bibitem{23} Id.
\bibitem{24} Id.
\bibitem{26} Id. at 46,379.
\bibitem{27} Id.
\bibitem{28} Id. at 46,389.
\bibitem{30} Investment Company Governance, \textit{supra} note 25, at 46,390.
\bibitem{31} Chamber of Commerce of the U.S. v. Sec. and Exch. Comm’n (Chamber I), 412 F.3d 133, 145 (D.C. Cir. 2005).
\end{thebibliography}
Again, the U.S. Chamber of Commerce challenged the adopted rule. The D.C. Court of Appeals vacated the changes on April 7, 2006, because the SEC relied on extra-record material critical to the costs of implementing the rule without affording an opportunity for comment, in violation of § 553(c) of the Administrative Procedure Act. The court withheld the order to vacate for ninety days because a large percentage of the mutual fund industry was already in compliance with the proposed changes and the time would give the SEC the opportunity to seek additional comment. The most recent comment period on the changes closed on August 21, 2006.

3. Related Settlements of Interest


On January 12, 2006, Swiss company UBS agreed to pay $49.5 million to settle claims that it engaged in market timing between October 2000 and December 2002. The settlement includes $24.8 million to the state of New Jersey, $18 million to a fund for investors, and $5.8 million to the New York Stock Exchange.

Brokerage firm Bear Stearns & Co. agreed to pay $250 million to settle SEC claims that the firm allowed hedge funds to engage in market timing and late trading from 1999 to 2003.

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33 See Chamber of Commerce of the U.S. v. Sec. and Exch. Comm’n (Chamber II), 443 F.3d 890 (D.C. Cir. 2006).
34 Id. at 908.
35 Id. at 909.
38 Id.
40 Id.
$250 million, which includes a $90 million fine and repayment of $160 million in ill-gotten profits, will be distributed back to the injured mutual funds and their shareholders.\textsuperscript{42}

On July 22, 2006, Kansas-based Waddell & Reed Financial agreed to pay $77 million to settle market timing allegations; the SEC claimed that three Waddell clients paid $3.6 million between 1998 and 2003 to engage in market timing, despite company policies against such a practice.\textsuperscript{43} The settlement includes a payment of $50 million to shareholders, a $25 million reduction in mutual fund fees over five years, and $2 million for shareholder education.\textsuperscript{44}

The largest settlement of the year came in Prudential’s August 28, 2006 agreement to pay $600 million in fines and restitution for improper market timing.\textsuperscript{45} Under the settlement, Prudential will pay $300 million to the U.S. Treasury, $270 million into an SEC fund for harmed investors, $25 million to a Postal Inspection Service consumer fraud fund, and $5 million to the state of Massachusetts.\textsuperscript{46} Unlike many other settlements, Prudential admitted criminal wrongdoing, but prosecutors agreed to drop the charges if the company stays out of trouble for five years.\textsuperscript{47}

B. New Scandals – Kickbacks on 12b-1 Fees

On August 26, 2006, BISYS Group agreed to pay $21.4 million to settle SEC charges of helping mutual fund companies defraud shareholders.\textsuperscript{48} The SEC alleged that BISYS, which provides administrative services to mutual funds, rebated portions of fund-administration fees to the funds’ investment advisors.\textsuperscript{49} The settlement consists of $10 million in ill-gotten gains, plus interest, and a $10 million fine, all of which will go into a fund for those harmed by the scheme.\textsuperscript{50} During July 1999 and June 2004, BISYS allegedly “kicked back” $230 million to twenty-seven mutual fund

\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Brooke A. Masters & Carrie Johnson, \textit{Prudential to Pay $600 Million to Avoid Fund Trial}, The WASH. POST, Aug. 29, 2006, at D01.
\textsuperscript{46} Id.
\textsuperscript{47} Id.
\textsuperscript{48} \textit{In re BISYS Fund Services, Inc.}, No. 3-12432, 2006 SEC LEXIS 2134, at *1-3 (SEC Sept. 26, 2006).
\textsuperscript{50} Id.
companies. The SEC has not identified the twenty-seven firms, but BISYS’s customers are “mostly smaller names, with an emphasis on banks.”

Under Rule 12b-1, mutual fund companies are allowed to pay distribution fees to finance activities intended to result in the sale of fund shares, provided such payments are detailed in a written plan and approved by the fund’s disinterested directors. BISYS failed to disclose the kickbacks, as required under Rule 12b-1(d). The SEC probe into Rule 12b-1 kickbacks continues, focusing on BISYS’ competitors and the mutual funds it services.

C. Other Developments

1. Mutual Funds Must Disclose Suspicious Transactions

On May 4, 2006, the Financial Crimes Enforcement Network (“FinCEN”) issued a final rule requiring mutual fund companies to report suspicious transactions. The rule “is part of an effort to catch drug dealers, terrorists and other money launderers.” The reporting requirements go into effect on October 31, 2006 and will bring mutual funds “in line” with other financial institutions that the government already requires to report suspicious activities.

A mutual fund must disclose transactions that involve funds or assets in excess of $5,000, and transactions or patterns of transactions which the fund knows, suspects, or has reason to suspect fit into one of four categories. The first category of transactions “involve[s] funds derived from illegal activity” or transactions

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54 In re BISYS Fund Services, Inc., 2006 SEC LEXIS 2134, at *2-3.
“intended or conducted in order to hide or disguise funds or assets derived from illegal activity.”60 Hiding or disguising funds includes, but is not limited to, the manipulation of “the ownership, nature, source, location, or control of such funds or assets.”61 The second category covers transactions that are structured to evade other aspects of the Bank Secrecy Act.62 The third category includes transactions that serve “no business or apparent lawful purpose” or which would be uncustomary for the particular customer in question.63 The last category includes transactions used “to facilitate criminal activity.”64

Mutual funds often conduct business using a network of separate entities, any of which may have superior access to the required transaction information.65 Mutual fund companies are free to contract with these entities to perform the required reporting, but the final responsibility remains with the mutual fund companies themselves.66

In cases where more than one mutual fund is involved in a transaction and both have reporting obligations under the rule, the mutual funds may opt to report their suspicions jointly.67 “Joint filing” is also an option for transactions between mutual funds and other financial institutions that have similar reporting obligations under 31 C.F.R. pt. 103 (this part deals, generally, with the record keeping of financial transactions).68

Suspicious transactions must be reported to FinCEN by completing a Suspicious Activity Report (“SAR”) no later than 30 calendar days after detection.69 The filing can be delayed by up to 30 days if no suspect is identified in the initial detection.70 Mutual funds (including employees, directors, officers, and agents) are protected from liability related to disclosing investor information by filing a SAR.71

60 Id. at § 103.15(a)(2)(i).
61 Id.
62 Id. § 103.15(a)(2)(ii).
63 Id. § 103.15(a)(2)(iii).
64 Id. § 103.15(a)(2)(iv).
66 Id. at 26,216.
67 31 C.F.R. § 103.15(a)(3).
68 Id.
69 Id. § 103.15(b)(1), (3).
70 Id. § 103.15(b)(3).
71 Id. § 103.15(e).
2. Mutual Fund Industry to Embrace Interactivity in Data Disclosure

In an attempt to modernize the aging Electronic Data Gathering, Analysis and Retrieval (“EDGAR”) system, the SEC announced a $54 million upgrade in September. The current EDGAR system contains the financial information in disclosure forms but lacks the “tools for investors to compare data across companies or industries.” The SEC, under the direction of Chairman Christopher Cox, wants companies, including mutual funds, to report data using the eXtensible Business Reporting Language (“XBRL”). Using this technology, companies will “tag” financial data in a uniform format, allowing investors to make comparisons across companies or industries.

On June 12, 2006, Investment Company Institute (“ICI”) President Paul Schott Stevens announced an initiative to extend XBRL to include more mutual fund-specific data elements, including investment objectives, investment strategies, risk, historical performance, and fees. The ICI argues that mutual fund investors rely on this data, not financial data, to make investment decisions, and that such additions will serve mutual fund investors better than XBRL alone. ICI plans to have a proposal available in early 2007.

D. Conclusion

In 2006, the regulation of the mutual fund industry continued to reflect a balance between the need for greater protection for investors and the fear of stifling investment companies’ ability to successfully invest shareholder money. Rule 22c-2 and the debate over mutual fund board independence reflect this ongoing struggle.

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74 Id.
75 Id.
76 Id.
77 Id.
78 Id.
The year also ended with numerous multi-million dollar settlements from the late trading and market timing scandals of 2003, keeping the mistakes of the past fresh in investors’ minds.

Geoffrey Moss\textsuperscript{79}

\textsuperscript{79} Student, Boston University School of Law (J.D. 2008).
VII. HEDGE FUND REGISTRATION RULE FOLLOWING THE GOLDSTEIN DECISION

In June 2006, the U.S. Court of Appeals for the D.C. Circuit issued an important ruling affecting the hedge fund industry.¹ In December 2004, the Securities and Exchange Commission (“SEC” or “the Commission”) promulgated the “Hedge Fund Rule” (the “Rule”), which required certain hedge funds to register with the SEC.² Prior to the Rule, the Investment Advisers Act of 1940 (the “IAA”) exempted hedge funds from registering with the SEC because they had “fewer than fifteen clients.”³ In Goldstein v. SEC, the petitioners challenged the SEC’s equation of “client” with “investor” in the Rule.⁴ The court of appeals held that the Rule was invalid because it conflicted with the purposes of the IAA.⁵

A. Definition of a Hedge Fund

Since their creation as an investment instrument, hedge funds have been “notoriously difficult to define.”⁶ An SEC Staff Report defined a hedge fund as “an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.”⁷

Hedge funds are different from the investment vehicles regulated by the SEC under the Investment Company Act of 1940 (ICA), which “directs the Commission to regulate any issuer of securities that ‘is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities.’”⁸ This describes hedge funds, however, most hedge funds are exempt from the ICA because “they have one hundred or fewer beneficial owners and do not offer their securities to the public, or because their

¹ See Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).
⁴ See Goldstein, 451 F.3d at 874.
⁵ See id. at 883.
⁶ Id. at 874.
investors are all ‘qualified’ high net-worth individuals or institutions.”

Since hedge funds are exempt from regulation by the SEC under the ICA, they can “engage in very different investing behavior.” Unlike investment companies registered under the ICA, hedge funds are secretive, even to their own investors, about the strategies they employ. The management structure of hedge funds is also unique because they are typically structured as limited partnerships where “the general partner manages the fund (or several funds) for a fixed fee and a percentage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities.”

Hedge funds have been the subject of concern “because they often are far more volatile than regular mutual funds.” In an attempt to earn large returns, “hedge-fund managers typically pursue a wider array of investments – including foreign securities, commodities and currencies – and often trade rapidly in an out of markets around the world.”

B. The Investment Advisers Act of 1940 & Hedge Fund Exemption

The Goldstein case addressed the applicability of the Investment Advisors Act of 1940 (IAA), from which hedge funds have traditionally been exempted. Under the IAA, an investment adviser is a person “who for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” Entities that qualify as investment advisers under the IAA must register with the SEC, but there is a “private adviser exemption” in the IAA. This section exempts “any investment adviser who during the course of the

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9 Id. (citing 15 U.S.C. § 80a-3(c)(1), (7) (2000)).
10 Id.
11 See STAFF REPORT, supra note 7, at 46-47.
12 Goldstein, 451 F.3d at 876; see also STAFF REPORT, supra note 7, at 9-10, 61.
13 Kara Scannell et al., Stop Order: SEC Dealt Setback as Court Rejects Hedge-Fund Rule, WALL ST. J., June 24, 2006, at Al.
14 Id.
15 Goldstein, 451 F.3d at 876.
preceding twelve months has had fewer than fifteen clients and who
neither holds himself out generally to the public as an investment
adviser nor acts as an investment adviser to any investment company
registered under [the ICA].”18 Typically, the general partners of
hedge funds “meet the definition of ‘investment adviser’ in the
Advisers Act,” but “usually satisfy the ‘private adviser exception.’”19
The SEC had interpreted the private adviser exception to refer “to the
partnership or entity itself as the adviser’s ‘client.’”20 Thus, “[e]ven
the largest hedge fund managers usually ran fewer than fifteen hedge
funds and were therefore exempt.”21

C. The Promulgation of the Hedge Fund Rule & The
Goldstein Case

The SEC issued the Rule in December 2004 because the
Commission believed that its “current regulatory program for hedge
fund advisers [was] inadequate.”22 Additionally, the Commission
felt that the rapid growth of hedge funds “spurred concern that more
unsophisticated investors were becoming exposed to [hedge funds]
through pension plans and other investments.”23

Generally, the Rule required “advisers, who administer the
funds, to annually report a few basic details such as the names of
their funds, their location and the assets under management, and to
open their books to routine SEC inspections.”24 More specifically,
the Rule defined what constitutes a private fund, and required private
funds for the purposes of 15 U.S.C. § 80b-3(b)(3) to “count as clients the
shareholders, limited partners, members, or beneficiaries . . . of
[the] fund.”25 As a result, the Rule had “the effect of requiring most
hedge fund advisers to register by February 1, 2006.”26 The SEC’s
decision to equate “client” with “investor” for purposes of the Rule
“altered [the Commission’s] . . . longstanding definition of hedge-

18 Id.
19 Goldstein, 451 F.3d at 876.
20 Id. (citing 17 C.F.R. § 275.203(b)(3)-(1) (2006)).
21 Id.
Reg. 72,054, 72,059 (Dec. 10, 2004).
23 Scannell et al., supra note 13.
24 Id.
25 Goldstein, 451 F.3d at 877 (citing Registration Under the Advisers Act of Certain
26 Id.
Prior to the new Rule, the Commission “had considered the funds themselves to be the hedge fund’s ‘clients,’ not the actual investors.” The Rule, however, “reinterpreted ‘clients’ to refer to the investors.”

The adoption of the Rule was not without controversy. The SEC’s five commissioners only narrowly passed the new Rule. The Rule was supported by former SEC Chairman William Donaldson who voted with the two Democratic commissioners over the objections of the two Republican commissioners. Noted conservatives, including former Federal Reserve Chairman Alan Greenspan, also opposed the new regulation.

Critics of the rule, including many hedge funds, believed “that the rule [was] cumbersome, costly and [gave] unskilled SEC staffers license to look for problems where none exist[ed].” Moreover, critics claimed that the SEC’s new definition of what constituted a hedge fund “client” was “nonsensical, since most investors in hedge funds don’t have any interaction at all with their advisors.” Conversely, proponents of the new rule believed that “it [helped] the agency deter fraud and abuse, as well as a blow-up like the 1998 collapse of Long Term Capital Management that nearly triggered a financial meltdown.”

Following the adoption of the Rule, “Philip Goldstein, an investment advisory firm Goldstein co-owns (Kimball & Winthrop), and Opportunity Partners L.P., a hedge fund in which Kimball & Winthrop is the general partner and investment adviser (collectively ‘Goldstein’) challenge[d] the [SEC’s] equation of ‘client’ with ‘investor’ [in the Rule].” Goldstein argued that “the Commission’s action misinterpreted § 203(b)(3) of the Advisers Act . . . [which] exempts from registration ‘any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients.’” In defense, the SEC argued that because the Advisers Act

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27 Scannell et al., supra note 13.
28 Id.
29 Id.
30 See Goldstein, 451 F.3d at 877.
31 Scannell et al., supra note 13.
32 Id.
33 Id.
34 Id.
35 Id.
36 Goldstein, 451 F.3d at 874.
37 Id. at 878 (citing 15 U.S.C. § 80b-3(b)(3) (2000)).
does not define “client,” the statute is ambiguous and open to a method of counting clients. The court of appeals disagreed with the SEC’s position, holding that “[t]here is no such rule of law” and that “[t]he lack of a statutory definition does not necessarily render the meaning of a word ambiguous.” The court also held that “[i]f Congress employs a term susceptible of several meanings . . . it scarcely follows that Congress has authorized an agency to choose any of these meanings.”

D. The Court of Appeals’ Rationale for Invalidating the Hedge Fund Rule

The court’s ruling in Goldstein in no way addressed whether requiring hedge funds to register with the SEC was or was not publicly beneficial. Rather, “[i]t centered on a definitional conundrum: whether the investors in an adviser’s hedge fund are ‘clients.’” The court found that a 1970 amendment to the IAA demonstrated that Congress understood at that time that “investment company entities, not their shareholders, were the adviser’s clients.” Another section of the IAA “strongly suggests that Congress did not intend ‘shareholders, limited partners, members, or beneficiaries’ of a hedge fund to be ‘clients.’” Moreover, the court held that the IAA does not define “client,” but “it does define ‘investment adviser’ as any person who, for compensation engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.”

Applying these ideas to the Rule, the court found that an investor in a hedge fund can “benefit from the adviser’s advice . . . but he does not receive the advice directly . . . having bought into the fund, the investor fades into the background; his role is completely passive.” Additionally, “[i]f the person or entity

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38 Id.
39 Id.
40 Id.
42 Id.
44 Goldstein, 451 F.3d at 879.
46 Id. at 879-80.
controlling the fund is not an ‘investment adviser’ to each individual investor, then a fortiori each investor cannot be a ‘client’ of that person or entity.”

The court in Goldstein also based its rationale on the fact that the Supreme Court has “embraced a similar conception of the adviser-client relationship.” In Lowe v. SEC, the Court held that the “existence of an advisory relationship depended largely on the character of the advice rendered.” Applying this analysis from Lowe to hedge funds, the appeals court concluded that in a hedge fund, a “direct relationship exists between the adviser and the fund, but not between the adviser and the investors in the fund. The adviser is concerned with the fund’s performance, not with each investor’s financial condition.”

In a previous decision, Shays v. FEC, the D.C. Circuit Court held that a federal agency’s interpretation is not “reasonable” if it is “arbitrary and capricious.” Applying this standard to the SEC’s Rule, the court concluded that the Commission failed to explain adequately “how the relationship between hedge fund investors and advisers justifies treating the former as clients of the latter.” The court explained that “[t]he number of investors in a hedge fund—the ‘clients’ according to the Commission’s rule—reveals nothing about the scale or scope of the fund’s activities.” Rather, the court believed that “[i]t is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund’s importance to national markets.”

In finding for the petitioners, the D.C. Court of Appeals held that the Rule was “arbitrary” and that “the SEC had contorted the legal interpretation of who can be considered a ‘client’ of a hedge fund.” As a result, the court “vacated the rule and sent it back to the agency for reconsideration.”

47 Id. at 880.
48 Id. at 880.
49 Id. (citing Lowe v. SEC, 472 U.S. 181, 208 (1985)).
50 Id.
51 Id. at 882 (citing Shays v. FEC, 414 F.3d 76, 96-97 (D.C. Cir. 2005)).
52 Id.
53 Id. at 883.
54 Id.
55 Scannell et al., supra note 13.
56 Id.
E. Reactions to the Goldstein Decision

Following the D.C. Court of Appeal’s decision in Goldstein, invalidating the Rule, the SEC chose not to petition the U.S. Supreme Court for a writ of certiorari.\(^{57}\) SEC Chairman Christopher Cox explained that the Commission would not appeal because “the appellate court’s decision was based on multiple grounds and was unanimous, [and thus] further appeal would be futile and would simply delay and distract from our goal of advancing investor protection.”\(^{58}\) Rather than pursue an appeal of the Goldstein decision, Chairman Cox stated that “the Commission is moving aggressively on an agenda of rulemaking and staff guidance . . . to address the legal consequences from the invalidation of the rule.”\(^{59}\) In his comments, Cox described one potential proposal for regulating hedge funds in the wake of the Goldstein decision:

Among the significant new proposals will be a new anti-fraud rule under the Investment Advisers Act that would have the effect of ‘looking through’ a hedge fund to its investors. This would reverse the side-effect of the Goldstein decision that the anti-fraud provisions of the Act apply only to ‘clients’ as the court interpreted that term, and not to investors in the hedge fund. . . . Commission staff are also considering whether we should increase the minimum asset and income requirements for individuals who invest in hedge funds.\(^{60}\)

On July 25, 2006, following the Goldstein ruling, Chairman Cox testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs on proposed new rules dealing with hedge funds.\(^{61}\) These rules “would expand the Commission’s authority to hold

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58 Id.
59 Id.
60 Id.
61 Hedge Fund Regulation: Hearing Concerning the Regulation of Hedge Funds Before the S. Comm. on Banking, Housing and Urban Affairs, 109th Cong. (2006) [hereinafter Hearing] (statement of Christopher Cox, Chairman, United States Securities & Exchange Commission).
hedge fund advisers accountable for fraud against individual hedge fund investors; remove legal impediments that might otherwise force currently registered hedge fund advisers to deregister; and update protections for unsophisticated investors by raising the thresholds to qualify for sophisticated investor status.62 While advocating for additional SEC oversight of hedge funds, Chairman Cox stated that:

[T]he Commission’s future regulatory actions in this area . . . should be non-intrusive. There should be no interference with the investment strategies or operations of hedge funds, including their use of derivatives trading, leverage, and short selling. . . . The costs of any regulation should be kept firmly in mind. Similarly, there should be no portfolio disclosure provisions. A hedge fund’s ability to keep confidential its trading strategies and portfolio composition should be protected. And hedge funds should be able to continue to charge their clients performance fees, just as they do now.63

Individuals involved in the hedge fund industry expect that most hedge funds will “take a wait-and-see attitude. Few are expected to de-register until it is clear what the SEC’s next step is.”64 Some insiders believe that if hedge fund registration is put aside, “a number of hedge funds would act to de-register, due to the costs involved.”65 Others believe differently, arguing “that many larger hedge-funds would elect to remain registered entities, no matter how the issue resolves.”66 One reason larger hedge funds could choose to remain registered is that “pension funds and other institutional investors have been shifting to invest in hedge funds, and these investors tend to stick to firms that are registered with the agency.”67

Some hedge fund managers believe that the newly elected “Democratic-controlled Congress will seek tighter regulation of hedge funds.”68 Others believe “that things are likely to proceed much as before – with the industry getting a regulatory once-over

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63 Hearing, supra note 61.
64 Scannell et al., supra note 13.
65 Id.
66 Id.
67 Id.
before some relatively moderate regulations, such as an increase in the net worth required for an individual to invest in hedge funds, are put into place." Some hedge fund managers are concerned that U.S. Representative Barney Frank, the chairman of the House Financial Services Committee, will push for additional federal oversight of hedge funds. Representative Frank’s aides say that “he plans to take a broad view of the hedge-fund issue, and is specifically concerned about public pension funds investing in hedge funds, and what that means for individual investors.”

One aspect of hedge funds that might receive greater scrutiny in the future is “retailization”: “the marketing of . . . [hedge funds] to small investors.” A Democratic Congress might be more concerned about “retailization” of hedge funds “because their constituents are viewed as people of more-modest means and with less of an understanding of the risks and benefits of hedge-fund investing.” However, Phillip Goldstein, the hedge fund manager who successfully challenged the SEC’s Rule believes differently. Goldstein feels “that those who talk about ‘retailization’ are really talking about hedge-fund investments made through pension funds, a separate issue that should be dealt with on the pension-fund level, not on the hedge-fund level.” Moreover, Goldstein believes that any additional regulation of hedge funds “will be more in the line of systematic risk to the economy having to do with borrowing, rather than what the SEC was pushing [with the Rule], which was just registration, which didn’t seem to really address any particular problem.”

F. Conclusion

The major debate regarding additional oversight of the hedge fund industry is the same one that has been occurring in the financial services community for years: greater regulation versus less regulation. As one financial reporter explained, the current anti-regulation sentiment regarding hedge funds “is emblematic of a
greater regulatory backlash these days, most forcefully expressed in the movement against Sarbanes-Oxley.”77 Whether one agrees or disagrees with the idea of hedge fund registration, it is unlikely that the court’s decision in *Goldstein* will end the debate.

Brendan Riley78

77 Eisinger, *supra* note 41.
78 Student, Boston University School of Law (J.D. 2008).
VIII. SEC RULES ON INDEPENDENT DIRECTORS & CHAIRMEN

In January 2004, the Securities and Exchange Commission (“Commission”) proposed amendments to ten rules (“Exemptive Rules”) under the Investment Company Act (“the Act”). Each of the Exemptive Rules permits investment companies (“funds”) to engage in transactions or conduct that present “serious conflicts of interest” and would otherwise be restricted or prohibited by the Act. The proposed amendments would require any fund relying on the Exemptive Rules to follow two promulgated conditions related to governance practice. First, the fund’s board must be composed of “at least seventy-five percent independent directors,” and second, that “the chairman of the fund board be an independent director.”

The Commission proposed the rule amendments following a troubling series of enforcement actions involving “late trading of mutual fund shares, inappropriate market timing activities and misuse of nonpublic information about fund portfolios.” In each case, the enforcement actions targeted serious management abuses where “the fund was used for the benefit of fund insiders rather than fund shareholders.” The Commission reasoned that the proposed amendments to fund governance standards would place fund boards in a better position to exercise “independent influence over fund management and other fund service providers.” Thus, the proposed requirement that each fund’s board be comprised of at least seventy-five percent independent directors would help ensure that “independent directors carry out their fiduciary responsibilities” by maintaining control of the board and its agenda. Moreover, effective and independent fund boards may prevent abuses such as late trading and market timing, thus increasing market confidence in

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2 Id. at 3,473.
3 Id.
4 Id.
5 Id. at 3,474.
6 Id. at 3,472.
7 Id.
9 Id. at 46,381.
fund management. Similarly, funds will also benefit from an independent chairman of the board who can “have a substantial influence on the fund board’s agenda and boardroom’s culture.”

The Commission expects that an independent chairman will advance “meaningful dialogue between the fund adviser and independent directors and will support the role of the independent directors in overseeing the fund adviser.”

Although the proposed amendments to fund governance standards are not currently in force, the Commission seems determined to adopt the two conditions or at least some version of them. The following will discuss the current state of the proposed rule amendments and the fund industry’s response to them.

A. Court Invalidates the Commission’s Amendments to the Rules Under the Act

1. Chamber of Commerce of the United States v. SEC

The Chamber of Commerce of the United States (“the Chamber”) has twice challenged the two conditions that require funds to have at least seventy-five percent independent directors and independent chairman. In the first case, Chamber of Commerce of U.S. v. SEC (Chamber I), decided in 2005, the court held that the Commission had authority to issue amendments to the governance standards, but the Commission had violated the Administrative Procedure Act (“APA”) when “it failed … to determine the costs of the two conditions and when it failed to address a proposed alternative to the independent chair condition.” The court then remanded the case to the Commission, which decided not to modify the two conditions. In a subsequent action, Chamber of Commerce
of U.S. v. SEC\(^{18}\) (Chamber II), the Chamber challenged the Commission’s decision not to modify the two conditions and argued the Commission had failed to comply with section 553(c) of the APA “by relying on materials not in the rulemaking record without affording opportunity for public comment.”\(^{19}\) In return, the Commission responded by challenging the Chamber’s standing to sue under Article III of the Constitution on the grounds that the Chamber “has failed to show a continuing injury-in-fact.”\(^{20}\) The court upheld the Chamber’s standing, as it did in Chamber I, because the costs of implementing the two conditions could present “barriers to entry, especially for small funds”.\(^{21}\) Furthermore, the court ruled that the Commission had the authority to decide whether to modify the two conditions in response to the court’s previous decision in Chamber I.\(^{22}\)

After ruling that the Chamber had standing and the Commission had authority to issue the two conditions without modification, the court turned back to the Chamber’s claim that the Commission had violated the comment requirement under section 553 of the APA.\(^{23}\) Section 553 requires that “an agency give notice of a proposed rule” by setting forth its terms or substance and “give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments.”\(^{24}\) The court noted that since Chamber I did not require additional fact gathering, the Commission could exercise its discretion whether to engage in further fact gathering for which “notice and comment are typically required.”\(^{25}\)

The Commission maintained that section 553 did not require it to open the rulemaking record for further comments for two reasons.\(^{26}\) First, the rule’s two conditions were “set out in materially the same terms in the notice of proposed rulemaking” (“NOPR”), and thus all interested parties had “the opportunity to comment on the proposed amendments and specifically on their costs.”\(^{27}\) Second,
although the Commission “relied on materials not made subject to public comment”, those materials were “merely supplemented data in the rulemaking record that had been subject to the public comment” and thus were already “publicly available.”

The Commission explained further that the principal costs associated with the independent chair condition were derived from the “increased compensation for the independent chair and the costs of additional staff”. Since the Commission had estimated that as of the time it had proposed the two conditions, since almost sixty percent of funds meet the seventy-five percent independent director requirement, the costs of complying with the conditions would be relatively small compared to the assets for which boards are responsible.

The court agreed with the Commission that the NOPR provided adequate notice since it identified the amendments to the Act and solicited comments and data on the conditions and their costs. However, the court ruled that the Commission relied excessively upon “extra-record materials” in determining the costs of the two conditions “without affording an opportunity for comment to the prejudice of the Chamber” and thus violating APA section 553 (c). The court found the Commission’s request for information on costs did not give adequate notice to interested parties that “in the absence of receiving reliable cost data during the comment period, the Commission would base its cost estimates on an extra-record summary of extra-record survey data”. Moreover, the court noted that while the Commission decided not to reopen the rulemaking record after the ruling in *Chamber I*, individual funds had offered to provide data on the actual costs of implementing the conditions and the Investment Company Institute (“ICI”) had offered to gather data from its members. Thus, the Commission missed an opportunity to further evaluate the potential detrimental effects of the compliance costs. Finally, on April 7, 2006, consistent with its determination that the Commission had violated the comment requirement of section 553 of the APA, the D.C. Circuit vacated the two conditions,

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28 *Id.*
29 *Id.* at 895.
30 *Id.*
31 *Id.* at 901.
32 *Id.* at 908.
33 *Id.* at 904.
34 *Id.* at 905.
35 *Id.*
but suspended issuing its mandate for ninety days in order to give the Commission the opportunity to request further comments.\(^{36}\)

2. **The Commission’s Response to the Court’s Ruling**

The Commission responded to the court’s decision by inviting further comments on the amendments.\(^{37}\) The Commission opened the record for further comment until August 21, 2006.\(^{38}\) The Commission specifically sought comment on the adequacy of its estimates of the potential costs associated with the two conditions.\(^{39}\)

B. **Fund Industry’s Response to the Proposed Rules**

1. **Most Funds Have Already Complied with the Seventy-five Percent Rule**

   The Commission had estimated that at the time of its initial proposal of the amendments, approximately sixty percent of all funds had at least seventy-five percent independent directors.\(^{40}\) Moreover, according to a study released by the ICI, the leading trade organization for the mutual-fund industry, and the Independent Director Council, an affiliated organization, the fund industry shows a trend toward greater independence of fund directors, who meet without management and seek advice of outside counsel far more often than in the past.\(^{41}\) The study surveys covered fund-governance practices over the past ten years, more than 1,500 directors and up to 8,000 funds.\(^{42}\) The survey found that the average ratio of independent directors at funds demonstrated steady growth to seventy-eight percent in 2004, from seventy-five percent in 2002 and seventy-one percent in 1994.\(^{43}\) However, according to the survey,

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\(^{36}\) Id. at 909.


\(^{38}\) Id.

\(^{39}\) Id. at 35,367.


\(^{42}\) Id.

\(^{43}\) Id.
only forty-three percent of funds had independent chairman in 2004.\textsuperscript{44} Marguerite Bateman, managing director of the Independent Directors Council, suggests that if the Commission ultimately prevails “many of the funds without an independent chairman might designate their lead independent director to fill that role.”\textsuperscript{45}

\section*{2. Industry’s Major Players Oppose the Fund Rule}

The ICI is officially opposed to the amendments in their present form and instead supports a “more flexible approach” that would require only two-thirds of fund directors to be independent, compared to the Commission’s proposal of seventy-five percent independent directors.\textsuperscript{46} The ICI also proposes that fund directors be allowed to select a chairman.\textsuperscript{47} The ICI suggests that the Commission rule imposes an “especially burdensome” cost to smaller funds without any evidence that an independent chairman produces sufficient benefit.\textsuperscript{48}

The Chamber, which successfully challenged the two conditions in court, has not yet declared a formal position on the ICI’s two-thirds proposal.\textsuperscript{49} However, it continues to oppose the Commission’s proposed conditions.\textsuperscript{50} According to David Chavern, the Chamber vice president and chief of staff, the fund industry does not need the seventy-five percent rule because there is no evidence that the scandals in the fund industry were due to management dominated boards.\textsuperscript{51} Moreover, Chavern argues “if there is a rule, there should be a disclosure rule” that would require funds to disclose whether they have independent or in-house chairman.\textsuperscript{52}

Some of the “giants of the fund business” have decided, consistent with the Chamber’s opposition to the two conditions, not

\textsuperscript{44} Id.
\textsuperscript{47} Id.
\textsuperscript{48} Id.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Id.
to elect independent chairman. According to Fidelity Investments spokesman Vincent Loporchio, the independent chairman rule “has already served its purpose of stimulating thorough industry review and public scrutiny.” Loporchio reasoned that since the promulgation of the rule many funds had examined their governance standards and implemented changes. Accordingly, the Commission should now focus its attention to means that “encourage more prominent disclosure” to investors of individual fund governance structure. The Vanguard Group, Inc. has also elected not to comply with the promulgated rule until they become official. According to Vanguard’s spokesman John Demming their funds continue to be well served by its current board. Vanguard’s seven member board is chaired by Jack Brennan, who is the only interested director.

3. The Fund Rule Has its Supporters

Although met with significant opposition since its promulgation, investor advocates have supported the Commission’s rule, believing that investors’ interests would be better protected by independent directors. One of the most resolute proponents of the rule is Allan Mostoff, president of the Mutual Fund Directors Forum (“MFDF”) in Washington, who argues that although “the regulatory climate has changed” and the mutual fund scandal of the past few years is “no longer front and center in people’s minds”, the rule is “crucial part” to the Commission’s “entire package of reforms.” Many individual investors are also supporting both the seventy-five percent independent director and independent chairman conditions. As one investor explains in a letter commenting on the Commission’s rule, requiring independent directors and chairman

53 Arden Dale, Court Ruling on SEC Fund Rule Won’t Mean Board Change, DOW JONES NEWSWIRE, Apr. 10, 2006.
54 Id.
55 Id.
56 Id.
57 Id.
58 Id.
59 Id.
61 Id.
62 Schroeder, supra note 50.
will help ensure that mutual funds are managed in the best interest of their shareholders and will be a “safeguard for the small investor.”

C. The Future of the Fund Rule

The fund rule was met with opposition from its inception in 2004 when the Commission’s five commissioners approved it by a three-to-two vote under then chairman William Donaldson. Commissioners Paul Atkins and Cynthia Glassman voted against the rule due to lack of evidence that funds would perform better if chaired by independent chairman. In June 2005, after the D.C. Circuit ruled that the Commission had failed to consider the costs and alternatives to the rule, the Commission reaffirmed the rule only eight days before current Commission Chairman Christopher Cox replaced Chairman Donaldson. Some commentators speculate that since the fund industry has achieved substantial compliance with the Commission’s rule, Cox might decide to “avoid another decisive vote by declaring that the SEC’s goal” has been predominately achieved. Moreover, in April 2006, when the court gave the Commission ninety days to solicit more comments on the cost of implementing the rule and then respond to input, the Commission solicited comments past the deadline and failed to ask the court for an extension. The rule was considered “dead unless reborn” because Chairman Cox had indicated that he would not “revisit controversial issues.”

However, on December 15, 2006 the Commission reopened the comment period on the proposed amendments. The Commission stated in the release that it afforded the additional comment period to permit public comment on research, prepared by the Office of Economic Analysis, on the proposed amendments to the fund governance provisions. Later, on December 29 2006, the
Commission received the research and set the comment period deadline to March 2, 2007. The Commission plans to use the gathered comments to plan its next step.

D. Conclusion

There has been much speculation in the investment community about the future of the independent director and chairman rule. While no one knows whether the Commission will adopt the rule in its present form or make a compromise, it seems that the public debate surrounding the promulgated rule has already encouraged funds to adopt governance standards that better serve the interest of shareholders.

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IX. VENTURE CAPITAL AND PRIVATE EQUITY

A. Venture Capital

1. Venture Funding Reaches Five-Year High

Venture capital fundraising is at its highest level in five years.\(^1\) In 2006, venture funds received $28.6 billion, with nearly ninety percent coming through the first three quarters.\(^2\) Although fundraising slowed toward the end of the year, the annual total still eclipsed 2005’s mark by $600 million.\(^3\)

The significant funding growth was marked by the creation of several venture capital megafunds. In July, New Enterprise Associates closed a $2.5 billion fund that will focus on information technology and health-care.\(^4\) Oak Investment Partners responded with its own $2.56 billion fund shortly thereafter.\(^5\) Finally, Polaris Venture Partners and VantagePoint Venture Partners each raised $1 billion diversified funds in 2006.\(^6\) Although these megafunds garnered much of the headlines, the average fund size was a modest $143 million.\(^7\)

The substantial cash infusion allowed venture capitalists to put their money to work, as they completed 3,416 deals, ten percent more than in 2005.\(^8\) Moreover, the excess cash produced larger venture investments than in the past.\(^9\) The $7.5 million average venture deal was the largest since 2000.\(^10\)

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2. See id.
3. See id.
5. NATIONAL VENTURE CAPITAL ASSOCIATION, supra note 1.
6. Id.
7. See id.
10. See id.
Software and Biotechnology on Top, Energy on Fire

Although the size of deals rose in 2006, investors’ allegiances to favored sectors remained constant. Software, which has perpetually received the lion’s share of venture funding, remained atop investors’ lists. During the year, venture funds committed $5 billion to software companies, which was twenty percent of all venture dollars. Moreover, sixty percent of venture capitalists cited software as their principal focus area for the future. Following closely behind, biotechnology received $4.5 billion in 2006, which was the industry’s largest investment in ten years. Medical devices investment was similarly strong, and grew by twenty-three percent to $2.65 billion.

Although software and biotechnology remained the market share leaders, energy investment made the most significant strides. Investment in the sector surged 108% to a five-year high. Nearly $1.8 billion was infused into energy companies during the year, and more specifically, $537.6 million was committed to alternative energy companies. The number of alternative energy deals doubled, and capital investment shot up 190%. Federal and state initiatives, driven by a desire to reduce domestic oil dependence, propelled this surge. For example, the federal government

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12 See id.
13 See id.
15 PricewaterhouseCoopers, Total U.S. Investments By Industry, supra note 11.
16 See id.
17 See id.
18 See id.
19 See id.
21 Id.
provided tax credits to companies that blended ethanol in an attempt to incentivize production. Additionally, many states provided similar credits, and set ambitious clean energy goals. California, for instance, aims to generate twenty percent of its energy from renewable sources in the next three years. Twenty-one other states boast similar programs. As a result, alternative energy investment promises to flourish in the future.

3. Next Stops: India and China

Venture capital’s expansion into high growth foreign markets looks to be equally robust. Although the United States still receives the bulk of venture dollars, fifty-three percent of American venture capitalists plan to explore international opportunities in the next five years, and China and India are the main attractions.

Venture capital investment in China soared fifty-five percent in 2006, as American investors spread $1.1 billion across 105 deals. Moreover, Chinese venture funding is likely to strengthen in the future, as thirty percent of venture capitalists plan to make China their primary global expansion target. Information technology companies will garner much of the attention, given that IT investment jumped eighty-five percent in 2006. One investor opines, “China is the future . . . . [It] sort of reminds [me] of the computer business in 1982 when everything was growing by leaps and bounds.”

23 See id.
25 Id.
26 Id.
27 Deloitte, supra note 14.
29 PricewaterhouseCoopers, Venture Capital Investing Hits $25.5 Billion in 2006, supra note 8.
30 See Deloitte, supra note 14.
31 VC in IT Booms in First Three Quarter, SINOCAST CHINA IT WATCH, Nov. 20, 2006 (on file with the Boston University Annual Review of Banking and Financial Law).
However, American optimism for China is not unbridled, and investors realize that major hurdles remain. Venture capitalists cite lax intellectual property laws and unfamiliarity with the Chinese business landscape as their primary concerns. As a result, American investors are more risk averse with their Chinese investments than with their domestic counterparts, and consequently target more mature Chinese businesses. For example, twenty-two percent of Chinese companies are profitable prior to their venture infusion, compared with only seven percent in the United States. Similarly, sixty-nine percent of Chinese companies already sell their product, which is thirteen percent more than venture-backed American businesses.

India was close on China’s heels and received $856 billion from seventy-one deals in 2006. A survey also revealed that one-fourth of American venture capitalists prefer Indian companies for global investment. However, comparable obstacles exist in India, as in China. Excessive travel time and unfamiliarity with the business environment are the paramount concerns. Nonetheless, India and China are viewed as intriguing expansion opportunities because of their lower build-up costs and entrepreneurial cultures. It is important to note that with all of the media attention China and India have received, forty-seven percent of American venture capitalists intend to invest exclusively in the United States. Currently, they prefer domestic investments because they have fewer impediments to success and greater familiarity. Nevertheless, as venture fundraising continues to increase, American investors who are in search of quality deals might change their tune.

33 See Deloitte, supra note 14.
34 Id.
35 See VC in IT Booms in First Three Quarters, supra note 31.
36 Id.
37 Id.
38 PricewaterhouseCoopers, Venture Capital Investing Hits $25.5 Billion in 2006, supra note 8.
39 See Deloitte, supra note 14.
40 See id.
41 Id.
42 Id.
43 Id.
44 Id.
4. Expansion-Stage Investment Keeps Growing

Venture capitalists remained steadfast, however, regarding their predilection for expansion-stage\(^{45}\) companies, which received forty-four percent of venture dollars in 2006.\(^{46}\) Expansion-stage companies took in seven percent more money than in 2005, and have actually received the largest share of venture dollars in each of the last ten years.\(^{47}\)

A more interesting story has been the battle for second place. Five years ago, later-stage\(^{48}\) investment nearly paralleled early-stage\(^{49}\) investment.\(^{50}\) Now, later-stage investment is more than twice as large.\(^{51}\) The last year produced signs, however, that less mature companies were returning to favor, as early-stage investment increased by $150 million, a four percent gain.\(^{52}\) Even more striking was the fact that start-up companies, an even more nascent stage of development than early-stage, received forty-five percent more dollars than in 2005.\(^{53}\)

In the past, venture funds typically focused on a particular stage of development because the expertise required to evaluate investment opportunities at various stages was significant and the number of experts was limited.\(^{54}\) However, the spike in megafunds has facilitated multistage investing.\(^{55}\) The challenge and prestige associated with running these funds has attracted a myriad of skilled

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\(^{45}\) An expansion stage company has a commercially available product or service that generates significant revenue growth but may not be yet be profitable. PRICEWATERHOUSECOOPERS, MONEYTREE REPORT (2006), available at http://www.pwcmoneytree.com/moneytree/nav.jsp?page=definitions.


\(^{47}\) See id.

\(^{48}\) A later stage company has a widely available product or service. It is generating significant revenue, and probably has a positive cash flow. MONEYTREE REPORT, supra note 45.

\(^{49}\) An early-stage company has a product or service that is in testing or pilot production, and may or may not be generating revenues. Id.

\(^{50}\) See PRICEWATERHOUSE COOPERS, TOTAL U.S. INVESTMENTS BY STAGE OF DEVELOPMENT, supra note 46.

\(^{51}\) See id.

\(^{52}\) See id.

\(^{53}\) See id.

\(^{54}\) Marietta Cauchi, Multistage Venture Funds Take Hold, WALL ST. J., June 7, 2007, at B3E.

\(^{55}\) Id.
professionals, and megafunds’ incredible capital reserves give them the flexibility to invest across stages.\textsuperscript{56}

\textbf{B. Private Equity}

\textbf{1. Private Equity Breaks Fundraising Record}

Venture capital’s strength carried over to private equity as a whole. Three hundred and twenty-two private equity firms raised a record $215.4 billion in 2006.\textsuperscript{57} This was the largest total since 2000, and nearly one-third greater than last year’s funding.\textsuperscript{58} Interestingly, even though private equity fundraising rose, the number of funds decreased.\textsuperscript{59} This anomaly can be explained by the major players flexing their muscle in 2006. During the year, thirty-four percent of all buyout activity was conducted by the same eight firms.\textsuperscript{60} Texas Pacific Group led the charge with seventeen deals totaling $101 billion.\textsuperscript{61} Blackstone completed nineteen deals worth $93 billion, and Bain came in third with $85 billion spread across twelve deals.\textsuperscript{62}

\textbf{2. Megafunds Up, Up, and Away}

Blackstone also made headlines in 2006 when it closed a $15.6 billion private equity fund, which at the time became the largest ever.\textsuperscript{63} That distinction did not last long, though, as KKR closed a $16.1 billion fund in early 2007.\textsuperscript{64} Interestingly, Blackstone

\textsuperscript{56} Id.
\textsuperscript{58} Id.
\textsuperscript{59} N\textsc{ational} V\textsc{enture} C\textsc{apital} A\textsc{s}sociation, \textit{ supra} note 1.
\textsuperscript{60} Wolfe, \textit{ supra} note 57.
\textsuperscript{62} These spending figures include international investments. Their sum exceeds the earlier fundraising total of $215.4 billion because that amount only considers domestic funding. Id.
\textsuperscript{63} Dennis K. Berman & Nicole Lee, \textit{Blackstone Fund Sets a Record at $15.6 Billion}, \textsc{Wall St. J.}, July 12, 2006, at C4.
\textsuperscript{64} Laura Kreutzer, \textit{KKR Passes $16B Mark Amid Record Fund-Raising Year}, \textsc{LBO Wire}, Jan. 11, 2007, available at \url{http://lbo.djnewsletters.com/exclusives.asp?sec=DEALBOOK&sid=LJLMIPIKL1}. 
is now attempting to raise a $20 billion fund. The upshot of these megafunds is that as they get larger, there are more dollars chasing less attractive deals. Consequently, these funds will be forced to expand their investments globally to new markets. China and India are the most attractive targets because they have developed stock markets that provide profitable exit options.

3. Deal or No Deal?

Private equity megafunds had no shortage of domestic opportunities in 2006, as seven of the ten largest deals of all time were announced, including:

<table>
<thead>
<tr>
<th>Target</th>
<th>Acquirer</th>
<th>Price (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Office Properties Trust</td>
<td>Blackstone</td>
<td>38.9</td>
</tr>
<tr>
<td>Hospital Corporation of America</td>
<td>Bain, KKR, Merrill Lynch</td>
<td>32.7</td>
</tr>
<tr>
<td>Harrah’s Entertainment</td>
<td>Apollo, Texas Pacific</td>
<td>27.4</td>
</tr>
<tr>
<td>Clear Channel Communications</td>
<td>Bain, Thomas H. Lee</td>
<td>25.7</td>
</tr>
<tr>
<td>Kinder Morgan</td>
<td>Carlyle, Riverstone, Goldman Sachs</td>
<td>21.6</td>
</tr>
<tr>
<td>Freescale Semiconductors</td>
<td>Blackstone, Carlyle, Permira, Texas Pacific</td>
<td>17.6</td>
</tr>
<tr>
<td>Albertson’s</td>
<td>Cerberus</td>
<td>17.4</td>
</tr>
</tbody>
</table>

When HCA announced that it would be acquired for $32.7 billion in July, it became the largest leveraged buyout of all time,

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67 Id.
68 Id.
2007 DEVELOPMENTS IN BANKING LAW 83
eclipsing KKR’s $31 billion purchase of RJR Nabisco in 1988. However, Blackstone quickly trumped the HCA record when it announced its intention to buy Equity Office Properties a mere four months later. After a fierce bidding war, the Equity Office price tag settled at nearly $39 billion. The enormity of recent buyouts has cast doubt upon acquired companies’ ability to service their debt. Some analysts are concerned about a wave of credit defaults ahead. Meanwhile, others feel that a $50 billion dollar acquisition, with even greater debt, is not unreasonable. The alacrity with which records are being broken illustrates that someone will likely try soon.

4. Club Deals Come Under Scrutiny

Other than the lofty price tag, the manner in which the HCA buyout was completed was also significant because KKR, Bain Capital, and Merrill Lynch’s private equity arm all collaborated to make the purchase. This was a “club deal” because it involved several buyout firms combining to bid on a large target that otherwise might have been unattainable. This relatively new buyout formula has been closely scrutinized by the United States Department of Justice under federal antitrust laws. Because club deals limit the number of bidders, they might unjustly depress acquisition prices and, thus, harm the target’s shareholders. The Department of Justice has not yet adjudicated the validity of club deals, but has indicated that it will be watching closely by subpoenaing extensive records of these transactions.

72 Top Ten Deals: The Biggest Private Equity Deals of All Time, supra note 69.
74 Id.
75 Id.
76 Top Ten Deals: The Biggest Private Equity Deals of All Time, supra note 69.
77 See Dennis K. Berman and Henry Sender, Private Equity Firms Face Anticompetitive Probe, WALL ST. J., Oct. 10, 2006, at C3.
78 Id.
79 See id.
C. Conclusion

In summation, 2006 was an extremely active year for venture capital and a record year for private equity. Venture funds actively pursued alternative energy companies, and explored China and India as future investment opportunities. Private equity firms, meanwhile, actively pursued just about everything, and announced seven of the ten largest deals ever, including Equity Office’s record $39 billion acquisition. With the magnitude and volume of 2006’s deals, it will be interesting to see if these investors actually make any money.

Brett Church\textsuperscript{80}

\textsuperscript{80} Student, Boston University School of Law, (J.D. 2008).
X. SEcurities eXchange MERGER ACTIVITY

The year 2006 witnessed a marked increase in the consolidation of derivative and stock exchanges. The most significant events included the completed merger of equals between the New York Stock Exchange (NYSE) and Euronext, the failed hostile takeover attempt of the London Stock Exchange (LSE) by Nasdaq, and the battle between the Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE) for the Chicago Board of Trade (CBOT).

A. NYSE and Euronext Merger

The merger between the NYSE and Archipelago Holdings, a fully electronic consolidated equity and options exchange, was completed on March 7, 2006. On March 8, 2006, the newly formed NYSE Group began to trade on the NYSE, completing the demutualization of the exchange and the beginning of its life as a public company. One of the evident reasons for the IPO was to use high-priced shares to make acquisitions.

The NYSE made its next move on May 22, 2006, when it made a $10.2 billion bid for Euronext. Euronext owns stock markets in Paris, Amsterdam, Brussels and Lisbon, as well as the London International Financial Futures Exchange (LIFFE), which is the second largest derivatives exchange in Europe. The Deutsche Borse in Frankfurt, which had been courting Euronext for some time,

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3 David Roeder, CBOT Warms to ICE Age, CHI. SUN-TIMES, Apr. 10, 2007.
4 Donna Block, NYSE Debuts As a Public Company, DAILY DEAL/THE DEAL, Mar. 9, 2006.
5 Id.
7 Jenny Anderson & Heather Timmons, NYSE Group Reaches Deal to Acquire Euronext, N.Y. TIMES, June 2, 2006, at C3.
raised its own bid on May 23, 2006\(^9\) but was turned down. On June 1, 2006, the NYSE-Euronext merger was announced.\(^{10}\) According to NYSE CEO John Thain, the deal promises savings of $375 million.\(^{11}\) The projected market capitalization is $21 billion,\(^{12}\) which would make it the largest securities exchange by market capitalization if the CME-CBOT merger does not go through, and the second largest if it does.\(^{13}\) In addition, it would constitute the first intercontinental securities exchange.\(^{14}\)

### 1. European Opposition to the Merger

Despite the public determination of Euronext’s management to combine with the NYSE, the merger aroused much opposition.\(^{15}\) The perception that the American NYSE would dominate the French exchange caused governments and politicians to come out against the deal, calling instead for a “European solution.”\(^{16}\) The Deutsche Borse refused to withdraw its bid and maintained that it was the better partner.\(^{17}\) Borsa Italiana was also in talks with Euronext when the NYSE offer came in and was asked to be a third partner in the new union.\(^{18}\) Massimo Capuano, the Italian exchange’s CEO turned down the proposal, choosing instead to sign a non-binding letter of intent to merge with Deutsche Borse, with the goal of making a joint offer to Euronext.\(^{19}\) This three-way merger was a potential

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\(^10\) NYSE, Euronext Announce Merger Agreement, Japan Econ. Newswire, June 2, 2006.


\(^12\) Id.


\(^15\) Chirac Backs “European” Bourse Links, supra note 8.

\(^16\) Id.


“European solution” and had the support of Italian Prime Minister Romano Prodi, President of France Jacques Chirac, President of the European Central Bank Jean-Claude Trichet, and German Chancellor Angela Merkel. The governments of France, Italy, and Germany even went so far as to coordinate lobbying efforts to get the NYSE voted down in favor of the three-way European merger.

In order to ease suspicion of American domination and win European approval, Thain announced in October 2006 that he was open to having more Europeans on the board. Under the original agreement, eleven Americans and nine Europeans were to sit on the board. By November, an agreement was reached to split a twenty-two member board evenly. That change, along with assurances from European regulators that their markets would not be subjected to American regulations, helped win the approval of French lobby groups and shareholders.

Thain continued to say that he would be open to acquiring the Borsa Italiana, as well as merge the Deutsche Borse’s cash equities. The German exchange rejected the offer, calling it “unattractive,” and in October 2006, asked the European Commission to approve its bid for Euronext. The move was perceived as hostile.

On November 7, 2006, merger talks between the Deutsche Borse and Borsa Italiana were terminated due to disagreements, foreclosing the prospect of a “European solution,” but the Deutsche

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22 Kantere, supra note 17.
23 Id.
28 Id.
30 Id.
31 Reuters, supra note 26.
Borse continued to seek a merger with Euronext. It was not until November 15, 2006 that the Deutsche Borse finally dropped out of the race. In October 2006, Capuano said he intended to go ahead with the float of the Borsa Italiana if the German-Italian-French effort did not work out (earlier in the year, the Milan exchange had plans to float in order to give it the financial flexibility to merge with other exchanges, but a new Italian law postponed the effort, and the exchange has still not gone public).33

On December 19, 2006, Euronext shareholders voted overwhelmingly in favor of the merger, and on the following day, NYSE shareholders followed suit. On April 4, 2007, NYSE Euronext began trading as a public company.

2. Hedge Fund Opposition to the Merger

Activist hedge fund TCI, which owned sizeable stakes in both Euronext and Deutsche Borse, pushed for a merger of the two. The fund demanded that the proposal be put to a vote at a shareholder meeting and planned to organize a parallel meeting to voice its preference to shareholders if that demand was not met. TCI was expected to make £1 billion under a Euronext-Deutsche Borse merger. Its position collapsed, however, when the Deutsche Borse withdrew its bid on November 15.

3. Potential Regulatory Issues of a Euronext-Deutsche Borse Merger

The NYSE found an ally in the LIFFE when the Deutche

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33 Galbraith, supra note 18.
35 Id.
38 Id.
39 Id.
40 James Quinn, Stock Exchanges TCI Is Banking on the Germans, DAILY TELEGRAPH (London), Sept. 18, 2006, at City 2.
41 NYSE/Euronext Merger Set for Shareholder Approval as Opponents Go Quiet, supra note 25.
Borse continued to press its bid. Many in the City of London feared losing LIFFE to Frankfurt, including Hugh Freedbert, the CEO of LIFFE, who has gone public with his view of the consequences of a merger with Deutsche Borse: namely, LIFFE would disappear, the City would lose 5000 jobs, all of the expertise in LIFFE would relocate to Frankfurt, and the City would lose standing as a financial center. The London stockbrokers’ lobby group, APCIMS, exhorted local brokers to unite against Deutsche Borse’s bid. The merger with the NYSE, on the other hand, found the group’s support because, unlike Deutsche Borse, the NYSE has no derivatives exchange. It is believed that this will strengthen London’s position as a derivatives center by allowing it to draw on the deep pool of equity in the NYSE and expand around the world.

But the City’s main weapon was not public sentiment, it was antitrust regulation: Eurex and LIFFE together constitute more than 90% of Europe’s derivatives market. On October 20, 2006, the European commission formally began a competition inquiry into the consequences of a Deutsche Borse–Euronext merger. The commission would have decided by November 21, 2006 whether to let the bid proceed had Deutsche Borse not withdrawn its bid.

B. **Nasdaq’s Failed Attempt to Acquire the LSE**

On March 9, 2006, Nasdaq made a $4.2 billion cash offer to the LSE, which was rejected and withdrawn. On April 11, 2006, Nasdaq bought a surprise 14.99% stake in the LSE and since then

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44 *Id.*
45 Cohen & Tett, *supra* note 42.
47 Dunne, *supra* note 29.
49 *Id.*
has become the LSE’s largest shareholder, incrementally increasing its stake to 28.75%.  

However, with a strong increase in profits, projections of more to come, and a share price that has increased threefold in the last two years, the LSE continues to resist Nasdaq advances. Supported by these numbers, Clara Furse has stated that her exchange will not, and does not, need to pursue mergers willy-nilly. “We are not for sale,” she said in November 2006, while also advising would-be buyers that any offer should be higher than £2.7 billion (approximately $5.1 billion). This price alone should deter unwelcome advances, but it also limits the LSE’s options. London-based ICAP, the world’s largest interdealer broker, entered into merger talks with the LSE in September but called them off by October, citing a belief that LSE’s shares were overvalued.

In a newspaper article released on October 3, 2006, CEO Robert Greifeld declined to comment on whether Nasdaq was going to make another offer, and in a November 9, 2006 article, Clara Furse, LSE’s CEO, said that she had not heard from Nasdaq “for some time.” Subsequently, on November 20, 2006, Nasdaq made a $5.1 billion bid that was quickly dismissed as “wholly inadequate”—failing to recognize the LSE’s “outstanding growth record and prospects.” Nasdaq made its bid a “final offer,” which

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53 Hilton, supra note 46.
54 Boadicea of the LSE Repels All Invaders; Clara Furse, Maggie Thatcher Without Attitude, Has Fought off the Old Boys Network and Foreign Suitors to Forge an Independent London Stock Exchange, Prosperous and Free of Scandal, BUS. (London), Nov. 11, 2006.
55 James Moore, We Are Not for Sale, LSE Chief Furse Tells Predators, INDEP. (London), Nov. 9, 2006, at Business 44.
56 id.
57 Jill Treanor, LSE Fends Off Nasdaq Takeover Threat with Strong Growth and £2.7bn Price Tag, GUARDIAN (London), Nov. 9, 2006, at Guardian Financial Pages 25.
60 Treanor, supra note 57.
meant that it could only be changed upon LSE’s suggestion or the emergence of another bidder. Furse declined to meet with Nasdaq representatives, and on December 12, 2006, Nasdaq made its bid hostile by taking its offer directly to shareholders. If Nasdaq had been able to purchase 90% of the shares, under British law it would have been able to force the sale of the remaining 10%. Even if it was only able to buy 50% of the shares, it would have been able to replace the board with members of its own choosing who would have approved the acquisition. The original deadline for LSE shareholders to tender into the offer was January 11, 2007, after which, if Nasdaq failed, it would not be able to bid again for as long as one year.

The LSE issued a defense document, insisting that the bid undervalued the LSE; the LSE forecasted high earnings and dividends for the end of 2006 through the end of the fiscal year in March 2007. Griefeld responded that the LSE was “ignoring the elephant in the room at its peril,” by ignoring changes in the competitive environment. He predicted that increasing consolidation in the industry and customer group competition would weaken LSE revenue. The recently announced Project Turquoise, which is an attempt by seven investment banks to create a pan-European stock exchange with lower fees and shortened order processing time, may work against LSE independence. The banks account for about half of all equity trades in Europe and pose a

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67 Id.
68 Rogerson, supra note 65.
69 Aaron Lucchetti & Allistair MacDonald, *Nasdaq Faces Last Gasp at Landing Troubled LSE; Failure to Woo Investors Will Freeze U.S. Exchange out of Bidding for a Year*, GLOBE & MAIL (Canada), Nov. 21, 2006, at B16.
71 Id.
72 Id.
serious threat to the LSE, which makes selling to Nasdaq seem more attractive.\textsuperscript{74}

In the meantime, Nasdaq has prepared to list or partially list its own shares in London should the acquisition succeed,\textsuperscript{75} and has promised to “leave the [LSE’s] board independent and its management intact,” as well as to hold Nasdaq board meetings in London.\textsuperscript{76} These moves are intended to assuage UK fears that the takeover would diminish London’s role.\textsuperscript{77}

Nasdaq extended its offer for two weeks, but even with the extended time frame only 0.41\% of LSE shares were tendered, leaving Nasdaq well short of the 50\% mark required to begin a takeover.\textsuperscript{78} Nasdaq is now barred from making another bid for the LSE for one year, unless another bidder emerges. Griefeld has not disclosed his intentions.\textsuperscript{79} The end result of this failed bid is an additional $1 billion in debt incurred to finance the attempt and a “junk” level credit rating.\textsuperscript{80}

The LSE’s growth since Sarbanes-Oxley was introduced in the United States makes it a highly appealing target.\textsuperscript{81} Euronext, Deutsche Borse, OMX (the Scandinavian and Baltic exchange operator), and Macquerie (the Australian operator) have all made failed attempts to acquire the LSE.\textsuperscript{82}

\section{C. The Chicago Battle and its Impact on the Euronext/NYSE Merger}

On October 17, 2006, the Chicago Mercantile Exchange (CME) made a surprise announcement that it had agreed to buy the

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\textsuperscript{74} Weber, \textit{supra} note 73.


\textsuperscript{76} Heather Timmons & James Kanter, \textit{British Shun a New Offer by Nasdaq}, N.Y. TIMES, Nov. 21, 2006, at Section C, Column 6, Business/Financial Desk 1.

\textsuperscript{77} Roberts, \textit{supra} note 75.


\textsuperscript{79} Id.


\textsuperscript{81} John Authers, \textit{NYSE Group Aims for Dollars 1.7bn Offering}, \textit{FIN. TIMES} (London), Apr. 27, 2006, at Companies International 16, USA Edition 2.

Chicago Board of Trade (CBOT) for $8 billion. The merger would create the world’s largest financial exchange, valued at $25 billion. There is concern that the merger could be anticompetitive because it concentrates 85% of the United States’ market for exchange-traded futures in a single exchange and might allow the exchange to increase costs rather than pass savings on to consumers. The Futures Industry Association (FIA) has officially come out against the merger because, in its opinion, a CME-CBOT deal would “substantially lessen competition.” The move could also increase barriers to entry into the U.S. derivatives market. LIFFE, after the merger with the NYSE, was hoping to do exactly that. In fact, the expected synergy value took the expansion of LIFFE into the U.S. expressly into account. An antitrust inquiry by the Department of Justice and a shareholder vote are still required to approve the deal.

This agreement caused some consternation in Europe, where the European commission was already investigating the LIFFE-Eurex merger, which would have created a similar situation there. Some argued that if the CME-CBOT merger gains regulatory approval, Europe should reevaluate its regulations to stay competitive with the U.S. market.

On March 15, 2007, the Intercontinental Exchange (ICE), a relative newcomer to the industry, made an unsolicited $9.9 billion bid for the CBOT, taking the entire industry by surprise. As one insider noted, “[p]eople are walking around stunned.”

83 Dave Carpenter, Chicago Merc to Acquire CBOT, BUFF. NEWS, Oct. 18, 2006 at B7.
84 Id.
88 Id.
89 Id.
90 Id.
91 Dunne, supra note 29.
93 Exchanges, supra note 85.
The CME has argued that a CME-CBOT merger has a “vastly superior strategic rationale” compared to a CBOT-ICE merger, including a greater ability to cut costs, gain synergies, and combine without disruptions in trading. Nevertheless, a former CBOT chairman felt that the difference in bid price between the two offers was too great to turn down the higher without risking shareholder lawsuits. Moreover, a March 23, 2007 news article quoted a CBOT member who noted, “if there were a vote today, it would be a landslide for ICE . . . . There’s so much money on the table, there’s no way people will sit back and accept less.” As of April 10, 2007, CME Chairman Terry Duffy had refused to raise his bid, citing the ICE’s inferior strategic rationale, but many analysts foresee a protracted bidding war. The CME-CBOT merger that was once considered a “foregone conclusion” is now anything but.

The contest has been characterized by some as a New York versus Chicago duel. Large New York investment banks co-founded the ICE and have agreed to advise and finance it in this merger—some say in order to prevent Chicago from establishing a stranglehold on the exchange-traded derivatives market and from expanding into the over-the-counter (OTC) market which those large banks dominate. Penetrating the OTC market could be an extremely profitable proposition. In 2005, the value of OTC contracts was nearly $285 trillion, while the exchange market was valued at only $58 trillion. On the other hand, if ICE is successful, some predict that derivatives trading will leave Chicago for New York and London, where the ICE operates. ICE, for its part, has promised to relocate to Chicago should they succeed.

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95 Chicago Mercantile Postpones Sharehol der Vote on Acquisition of CBOT, INVESTREND, Apr. 3, 2007.
96 Id.
97 Roeder, supra note 3.
98 Id.
100 Roeder, supra note 3.
102 Diesenhouse, supra note 99.
103 Susan Diesenhouse, N.Y. Banks Back ICE in Futures Power Play, CHI. TRIB., Apr. 10, 2007, at 1.
104 Id.
105 Id.
106 Id.
107 Id.
D. Regulatory Issues

The main regulatory issue regarding mergers of exchanges from different countries is determining how and by whom the resulting entity will be regulated. Many credit the recent rise of non-U.S. exchanges to the desire of companies to avoid Sarbanes-Oxley compliance, which is considered burdensome and intrusive. In 2005, twenty-four of the largest twenty-five IPO’s were listed on non-US exchanges. The number of initial public offerings in 2006, as of October 6, fell 23% on the NYSE, while it increased by 37% on the LSE. CEO of APCIMS in London, Angela Knight, suggested “erecting statues of [Senator Sarbanes and Representative Oxley], to ‘thank them for all their efforts on our behalf.’” In this way, the news of the NYSE-Euronext merger and the Nasdaq bid on the LSE created a very serious concern in Europe that its competitive advantage would be stripped away if the SEC had the power to apply Sarbanes-Oxley to their markets in the event of a European-US exchange merger.

Almost as soon as the NYSE-Euronext deal was announced in June, this fear began to stir up European opposition to the merger. Thain, Theodore, the SEC, and several U.S. senators all made attempts to quiet those fears. On June 2, 2006, Thain stated that the deal had been carefully structured to keep the U.S. and European regulatory environments separate. Theodore made public statements to the same effect, and on June 16, 2006, the SEC issued a rare public statement, dismissing claims that the U.S. would be able to export Sarbanes-Oxley to a foreign exchange in the event

108 Daniel Del’Re, NYSE Rings the Bell as Competition Among Exchanges Heats Up, INVESTORS BUS. DAILY, Oct. 6, 2006, at A06.
110 Del’re, supra note 108.
111 Id.
112 Grant, supra note 109.
113 Id.
of a merger.116 A non-U.S. exchange would only be subject to U.S.
regulation “if that exchange is operating within the U.S., not merely
because it is affiliated with a U.S. exchange.”117

The SEC did not take a position on any particular merger and
did leave the door open for regulation of companies listed on foreign
exchanges (“Whether a non-U.S. exchange, and thereby its listed
companies, would be subject to U.S. registration depends upon a
careful analysis of the activities of the non-U.S. exchange in the
United States.”).118 However, Annette Nazareth, one of the five SEC
commissioners, went on to say that the NYSE-Euronext merger, as
proposed, would not subject foreign markets to U.S. regulations.119

“The notion that this is a backdoor means of exporting Sarbanes-
Oxley requirements internationally is completely misguided,” said
Nazareth.120 The SEC and regulators in Euronext countries have
been cooperating on this issue.121

To further ease concerns, it was announced in July that
lawyers and regulators were working on adding a provision to the
NYSE-Euronext merger agreement that would break up the deal if
any attempt was made to apply U.S. law to companies listed in
Europe.122 With the same goal in mind, it was announced in
September that the NYSE-Euronext merger would create separate
U.S. and European entities to ensure that the exchanges would not be
affected by foreign regulation.123 Euronext will form a Dutch
foundation, and the NYSE will create a three-person Delaware

116 John Authers et al., SEC Moves to Ease European Fears Over Regulation,
FT.COM, June 16, 2006, available at
queryText=SEC+Moves+to+Ease+European+Fears+Over+Regulation&x=0&y=0&aje=
=true&dse=&dsz=&location=http%3A//search.ft.com/ftArticle%3fqueryText=SEC+
Moves+t+to+Ease+European+Fears+Over+Regulation%26y=0%26aje=true%26id=06
0616006358%26x=0http://search.ft.com/searchArticle?queryText=SEC+Moves+t+to+
Ease+European+Fears+Over+Regulation&y=0&javascriptEnabled=true&id=060616
006358&x=0.
117 Id.
118 Donna Block, SEC Calms Europe on Sarbanes-Oxley, DAILY DEAL/THE DEAL,
June 20, 2006.
119 Europeans Getting Cold Feet Over Proposed NYSE/Euronext Merger, supra note
20.
120 Id.
121 Jeremy Grant, US Watchdog Allays Fears About Regulatory Creep, FIN. TIMES
122 NYSE-Euronext Merger Deal May Include Anti-Sarbanes-Oxley Break-up
123 Grant, supra note 109.
trust. In the event a U.S. regulatory body tries to impose its rules on the entire body, Euronext shares would be transferred from the U.S. holding company to the Dutch foundation.

In December 2006, European regulators issued a letter which stated that they would not stand in the way of the merger as long as certain conditions, which essentially prevent the new group from altering current European market structure, are agreed to in advance. Efforts to integrate Euronext’s markets or change the rules governing them will require regulator approval. Regulators will also have the right to veto the appointment of any director to the company board or management committee, as it already has with respect to European companies, if the person does not meet the “fit and proper person” standard. The NYSE-Euronext entity must also report to regulators any future transactions that may have a significant impact on the company’s business. In the event that any of these conditions are breached, the European markets will be removed from the holding company to operate in accordance with European regulations. The SEC continued to reassure the College of European Regulators that regulatory creep would not be a problem, as they finalized a memorandum of understanding.

London reacted with similar apprehension to a potential Nasdaq-LSE deal. The SEC and the Financial Services Authority (FSA), the British stock market regulator, have been meeting to discuss the regulatory issues. The meetings led FSA Chairman Callum McCarthy to announce on June 12, 2006 that neither the FSA nor the SEC believed that U.S. ownership of the LSE would, per se, 

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124 Id.
125 Id.
128 Id.
129 Id.
130 Hilton, supra note 126.
131 NYSE/Euronext Merger Set for Shareholder Approval as Opponents Go Quiet, supra note 25.
132 Mark Smith, UK Firms Spring Sarbanes Trap, HERALD (Glasgow), June 13, 2006, at Business 16.
subject the LSE to U.S. regulations. Nevertheless, the fear of Sarbanes-Oxley caused the British government to announce legislation that would protect the City from U.S. regulations. The legislation would give the FSA a “new and specific power to veto rule changes proposed by exchanges that would be disproportionate in their impact.” SEC officials were taken aback by the announcement and claimed that it was “inconsistent with the dialogue” it had been having.

Europe suffered a scare when the Commodity Futures Trading Commission (CFTC), the U.S. futures market regulator, announced that it would look into whether it should extend its regulatory reach. The announcement was prompted by a futures exchange owned by a U.S.-based operator which was offering contracts in the U.S. while located in London and thus subject to Britain’s FSA rather than the CFTC. At the end of October 2006, however, the CFTC decided that it would not attempt to regulate the London-based exchange. Some regarded the decision as necessary in order to allow the U.S. to participate in the global capital markets, while others complained that the exchange was committing regulatory arbitrage by locating in the jurisdiction with the most lenient regulatory regime. The fear is that such a practice could lead to a race-to-the-bottom in regulatory standards.

E. Miscellaneous Tie-Ups Among Securities Exchanges

In May 2006, Australia’s antitrust regulator approved the Australian stock exchange’s takeover of the SFE national futures market. The merger will produce the ninth largest listed exchange in the world.

135 Eaglesham, supra note 133.
136 Id.
137 Id.
138 Grant, supra note 121.
139 Id.
140 Id.
141 Id.
142 Roberts, supra note 75.
144 Id.
In October 2006, OMX AB, the operator of the Scandinavian and Baltic exchanges, consolidated all of the companies from its Stockholm, Helsinki and Copenhagen exchanges and next year will include the Icelandic stock exchange which it acquired in September 2006. The move marks the first time that companies listed on separate national exchanges will be listed together on one exchange.

F. Conclusion

The situation in the securities exchange industry truly constitutes merger mania. One would be hard-pressed to find a single exchange that is not in discussions with at least one other exchange regarding a possible tie-up. Nevertheless, while there were many memorandums of cooperation and understanding signed in 2006 (and certainly more in the making), it is still unclear whether any of these will lead to full mergers.

Peter Kim

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146 Id.
148 Student, Boston University School of Law (J.D. 2008).
XI. PATRIOT ACT RENEWAL

In response to the September 11, 2001 terrorist attacks against the United States, the U.S. government enacted the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“PATRIOT I”). As PATRIOT I’s full title indicates, its purpose was to provide the executive branch with the tools necessary to combat terrorism. In accomplishing this aim, PATRIOT I significantly affected the “financial community, including, for example, banks, brokers and dealers, investment companies, insurance companies, depositary institutions, loan and finance companies and credit card issuers and operators.” This Act was renewed in 2006 with a few modifications. This article provides an examination of the nature of these modifications and their effects on the financial community as evidenced by a broad survey of news stories throughout 2006.

A. Background

On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (“PATRIOT I”). PATRIOT I provided broader electronic surveillance, increased immigration enforcement, and resulted in more stringent anti-money laundering statutes and regulations for “financial institutions.” The term “financial institutions” encompasses credit unions, futures commission merchants, securities brokers-dealers, casinos, money service businesses, money transmitting businesses, commodity trading advisors, commodity

2 Id.
6 Shapiro, supra note 4, at 629.

Several sections of PATRIOT I were scheduled to expire on December 31, 2005.\footnote{8}{Alan M. Christenfeld & Shepard W. Melzer, The USA Patriot Act: Revised and Revisited, 236 N.Y.L.J. 5, (Aug. 3, 2006).} The House and the Senate, therefore, both passed USA Patriot Reauthorization bills.\footnote{9}{Id.} The House and Senate conference committee members combined the bills and derived a conference report which the Senate rejected for failing to adequately protect civil liberties.\footnote{10}{Id.} Recognizing that the Senate needed additional time to address its concerns, Congress postponed the expiration of the sunsetting PATRIOT I provisions.\footnote{11}{Id.} The Senate finally agreed to the conference report after inserting certain civil liberty safeguards, and on March 9, 2006, the President signed into law the USA Patriot Improvement and Reauthorization Act of 2005 ("PATRIOT II").\footnote{12}{Shapiro, supra note 4, at 629.}

PATRIOT II makes 14 out of 16 of PATRIOT I’s provisions permanent, only § 206 (regarding roving surveillance) and § 215 (regarding orders for the production of business records) were left to expire on December 31, 2009.\footnote{13}{See Gerald G. Ashdown, The Blueing of America: The Bridge Between the War on Drugs and the War on Terrorism, 67 U. Pitt. L. Rev. 753, 785 (2006) (identifying the sunsetting provisions); Jonathan H. Marks, 9/11 + 3/11 + 7/7 = ? What Counts in Counterterrorism, 37 Colum. Hum. Rts. L. Rev. 559, 626 n.189 (2006).} This paper focuses on how PATRIOT II safeguards civil liberties pursuant to § 215 of PATRIOT I’s which granted access to certain business records, and how those provisions that PATRIOT II made permanent affect financial institutions.\footnote{14}{See USA PATRIOT Improvement and Reauthorization Act 2005, Pub. L. No. 109-177, § 106, 109 Stat. 1389 (2006) [hereinafter USA PATRIOT 2005] (stating the civil liberty safeguards applied to PATRIOT I section 215).}

B. Civil Liberty Safeguards Developed in Response to § 215

The civil liberty concerns addressed in PATRIOT II relating to financial institutions involve provisions in PATRIOT I that governed an investigative agency’s request for information from
businesses and financial institutions. Section 215 of PATRIOT I authorized the Federal Bureau of Investigation (“FBI”) to apply for court-issued orders under the 1978 Foreign Intelligence Surveillance Act (“FISA”) to gain access to any “tangible item” in foreign intelligence investigations. A § 215 order could be directed at financial institutions, internet providers, educational institutions, etcetera. Initially, FISA only permitted warrantless access to business records rather than any tangible item, and the target of a § 215 order had to be a foreign power or agent of a foreign power. PATRIOT I amended FISA to permit a § 215 order as long as it pertained to “international terrorism” or “clandestine intelligence activities.” Therefore, FISA was able to reach “groups or individuals not backed by a foreign government” under PATRIOT I. PATRIOT II attempts to guard against abuses of § 215 authority by providing for 1) greater Congressional oversight of the use of § 215 orders; 2) “enhanced procedural protections”; 3) “more elaborate application requirements”; and 4) “a judicial review process.”

1. Greater Congressional Oversight of the Use of § 215 Orders

Under § 106(h) of PATRIOT II, the Attorney General must submit an annual report to Congress, regarding the use of § 215 authority. In addition to PATRIOT I’s requirement that the Attorney General’s reports contain the total number of § 215 orders “approving requests for the production of tangible things” and the number of § 215 orders “granted as requested, granted as modified, or denied,” PATRIOT II now requires the report to include a breakdown of the number of § 215 orders “granted as requested, granted as modified, or denied” for the production of tax return

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15 Christenfeld & Melzer, supra note 8.
17 See Herman, supra note 1, at 76.
18 USA PATRIOT 2001, supra note 16, § 106 (stating the civil liberty safeguards applied to PATRIOT I section 215); Herman, supra note 1, at 76.
21 USA PATRIOT 2005, supra note 14, at § 106.
22 Id. at § 106 (h).
records, education records or medical records containing information that would identify a person.23

2. Enhanced Procedural Protections

Section 106(a)(2) of PATRIOT II requires the Director of the FBI, the Deputy Director of the FBI, or the Executive Assistant Director for National Security to personally approve an application for a § 215 order “requiring the production of ...tax return records, educational records, or medical records containing information that would identify a person”.24 This provision is likely intended to allay fears of the abuse of § 215 orders by federal authorities.25

Additionally, § 106(g) stipulates that the Attorney General must “adopt specific minimization procedures governing the retention and dissemination by the [FBI] of any tangible things” or information the FBI received in response to a § 215 order.26 “Minimization procedures” are intended to “minimize the retention, and prohibit the dissemination, of nonpublicly available information concerning unconsenting United States persons consistent with the need of the United States to obtain produce, and disseminate foreign intelligence information.”27

3. Application Requirements

Section 106(b) of PATRIOT II stipulates that an application for a § 215 order must include a “statement of facts” demonstrating “reasonable grounds to believe that the tangible things sought are relevant to an authorized investigation” conducted to “obtain foreign intelligence information not concerning a United States person or to protect against international terrorism or clandestine intelligence activities.”28 Prior to PATRIOT II, PATRIOT I had simply required

23 Id.
24 Id. at § 106(g).
26 USA PATRIOT 2005, supra note 14, at §106(g).
27 Id.
28 Id. at §106(b).
that an application for a § 215 order state that the requested records were required for an authorized investigation.29

4. Judicial Review Process

Under PATRIOT I, when an entity received a request for information from an investigative agency, that entity was prohibited from disclosing the request to anyone “other than those persons necessary to produce the tangible things” that the government sought under § 215.30 PATRIOT II restores 1) the entity’s right to contact an attorney for legal advice on the request, and 2) the opportunity for judicial review of the request.31

C. National Security Letters

Section 505 of PATRIOT I permitted the government to issue National Security Letters (“NSL”) to obtain customer records from financial institutions, credit bureaus and communications providers.32 Such customer records included credit reports and financial records and could be obtained without a court order in contrast to § 215.33 However, in Doe v. Ashcroft, a federal judge found that the absolute gag order § 505 places on recipients of NSLs and the absence of judicial review before or after the issuance of an NSL violate the First and Fourth Amendments of the Constitution of the United States.34 PATRIOT II’s § 115 addresses these constitutional concerns by 1) authorizing judicial review of NSLs, and 2) permitting NSL recipients to petition a federal court for an order to modify or set aside a nondisclosure requirement imposed by a NSL request.35

29 Swire, supra note 25, at 1358.
30 Herman, supra note 1, at 76.
31 USA PATRIOT 2005, supra note 14, at §106(f), §106(e) (B).
32 Herman, supra note 1, at 74.
33 Id.
35 USA PATRIOT 2005, supra note 14 at § 115(a) & (b).
D. Effects on the Financial Industry

Financial services companies “control access to the most valuable databases and the largest and most efficient payment systems on the planet.”36 PATRIOT I and PATRIOT II’s most significant impact on the financial industry was the implementation of more stringent anti-money laundering statutes and regulations.37 In an effort to comply with these statutes and regulations, financial institutions have adopted various measures during 2006.

1. Federal Attempts at Halting Money Laundering Taking a Toll on Banks

Federal attempts at halting money laundering had substantial affects on banks. Under PATRIOT I, and now PATRIOT II, banks had to take steps to 1) scrutinize customers, and 2) report suspect wire transfer and cash deposits to the authorities.38 The federal government has rigorously enforced these requirements as evidenced by a $10 million civil penalty imposed on BankAtlantic, a Fort-Lauderdale based thrift, as part of a settlement agreement for the bank allowing $50 million in suspicious money to flow through a Miami branch.39 Additionally, the federal government’s efforts have severely hurt many international banks.40 For example, many Latin Americans have stopped depositing their money in Miami’s international banks in part because of “burdensome anti-money laundering laws. . . that have made banks leery of adding regional clients and made those potential client wary of what Washington will do with information gathered.”41

2. Outsourcing PATRIOT II Compliance

One of the burdensome requirements placed on financial institutions under § 326 of PATRIOT I (later made permanent in

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37 Shapiro, supra note 4, at 629.
39 Id.
40 Gregg Fields & Jane Bussey, Int’l Banking: Latin America Neglects Miami Banks, MIAMI HERALD, June 11, 2006, at E.
41 Id.
PATRIOT II) is that they must establish consumer identification programs (CIPs). The purpose of CIPs is to ensure that banks have all the required information from new clients at the time an account is opened or a loan is considered. Some banks and broker-dealers have now outsourced the “messy task” of building a CIP program to other firms. This approach is called reliance “where one bank or firm depends on another to solve its problems,” and it is authorized by federal bank regulatory agencies’ interpretative guidance on CIP requirements under § 326 of PATRIOT II. According to this interpretation, if Bank A and Bank B share most of their customers, “Bank A can rely on Bank B to do some of the CIP requirements on its behalf, provided the other bank has a federal functional regulator and is subject to the Bank Secrecy Act (BSA).” Bank A must, however, ensure that it has “a contractual arrangement with Bank B and a reasonable belief it has a reasonable AML program,” annual certification and a clean BSA record. Banks or other financial institutions that rely on other firms for customer identification or due diligence as required under § 326, are still completely responsible for any failures in compliance that result.

As a means of handing the CIP requirement, some banks have also turned to “CIP-monitoring system vendors.” Such vendors can also assist financial institutions in compliance with § 314(a) of PATRIOT I which “requires firms to respond to a query from a law enforcement agency or another firm about an account or transaction that may be evidence of money laundering.”

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43 See USA PATRIOT 2001, supra note 16 at § 326 (setting forth the information financial conditions must collect from clients).
44 Sandman, supra note 41.
45 Id.
46 Taft & Poulon, supra note 5, at 318.
48 Id.
49 Id. (quoting Lisa Arquette, associate director of the Federal Deposit Insurance Corp.’s new anti-money-laundering (AML) & financial crimes branch).
50 Id.
3. Selling Gift Cards

A “handful” of banks are attempting to recoup the cost of complying with PATRIOT II by selling gift cards from retailers. Although these banks may previously have their own gift card programs, increased regulations under PATRIOT II have made it difficult for many banks to sustain their programs. Specifically, PATRIOT II requires the banks to obtain the personal information of both the purchaser and the recipient of the card when selling bank gift cards. Additionally, the customer disclosure statement required to accompany bank gift cards can exceed three pages of small print. Merchant gift cards are not subject to similar regulations and no information is needed to buy or sell them; therefore, banks can avoid the harsh federal regulation associated with PATRIOT II by selling merchant gift cards.

4. Banks Cutting Ties with Money Transfer Businesses

In 2006, Bank of America, the top retail banking company, decided to cease business dealings with Western Union Financial Services, Inc. and MoneyGram International Inc., two top remittance companies. Bank of America’s decision resulted from a realization that the benefits of keeping both companies as customers were outweighed by the costs associated with ensuring these customers’ compliance with the Bank Secrecy Act’s anti-laundering requirements as stipulated under PATRIOT I. Many other banks have made similar estimations and closed accounts with other remittance companies; in some cases maintaining only a few accounts with smaller companies that can be more easily monitored.

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51 Katie Kuehner-Hebert, Gift Cards’ Shifting Role at the Branch, 171 AM. BANKER 169, Sep. 1, 2006.
52 Id.
53 Id.
54 Id.
55 Id.
57 Id.
58 Id.
E. Conclusion

PATRIOT II has brought about minimal changes. Primarily, PATRIOT II made the provisions in PATRIOT I permanent, with the exception of § 206 (regarding roving surveillance) and § 215 (regarding orders for the production of business records) that are scheduled to expire on December 31, 2009.\textsuperscript{59} PATRIOT II’s effects on the financial industry are therefore restricted to its efforts to address civil liberty concerns arising from PATRIOT I. Other burdens on financial institutions reported during 2006 are a result of the provisions of PATRIOT I made permanent through PATRIOT II.

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\textsuperscript{59} See Ashdown, \textit{supra} note 12, at 785 (identifying the sunsetting provisions); see USA PATRIOT 2005, \textit{supra} note 14 at § 102(b); Marks, \textit{supra} note 12, at 626 n. 189.

\textsuperscript{60} Student, Boston University School of Law, (J.D. 2008).
XII. PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 ("PPA") was signed into law by President George W. Bush on August 17, 2006.1 The primary purpose for passing the PPA was to respond to the gross underfunding of the Pension Benefit Guaranty Corporation ("PBGC"), the semi-public corporate entity charged with insuring the pension benefits of nearly every American company that offers pension plans.2 The PBGC insures all qualified pension plans, and participating companies are required to pay premiums into the PBGC that adequately reflect their pension obligations to retired and current employees.3

Currently, the PBGC is running a $23 billion deficit, putting in jeopardy its ability to meet the needs of the growing current and future retirement population of pensioners.4 The PPA establishes stricter funding requirements for pension plans and provides penalties for companies that underfund their pension plans.5 The PPA also provides incentives for employers that currently offer pension plans to maintain those plans while at the same time brainstorming alternative plans for the future retirement demographic.6 In addition to trying to repair the PBGC, the PPA also provides incentives for employees to increase participation in defined contribution plans such as 401Ks and IRAs, which decrease reliance on pension plans and lessen the strain on the PBGC.7

A. Pensions in General and the PBGC Problem

A pension is a type of defined benefit plan that provides a set benefit amount to the employee for a number of years after

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3 Press Release, House Committee on Education and the Workforce, President Signs Measure to Reform Outdated Worker Pension Laws (Aug. 17, 2006); Press Release, Office of the Press Secretary, Fact Sheet, supra note 1.
4 Mark Schoeff, Jr., Firms Gauging Impact of Pension Reform Law, WORKFORCE MGMT., Aug. 28, 2006, at 33.
5 Press Release, House Committee on Education and the Workforce, supra note 3.
6 Id.
7 Press Release, Office of the Press Secretary, Fact Sheet, supra note 1.
retirement based on such factors as the employee’s length of service and compensation history with the company. Defined benefit plans (including pensions and annuities) are considered a fringe benefit to employees, and the benefits under these plans are calculated and paid out independent of the company’s profits. Pension plans became an increasingly popular retirement option with passage of the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA established a more organized, codified system to regulate private pension plans, and provided that such plans be administered through the Department of Labor, Department of the Treasury, and the PBGC. ERISA regulates employee participation and coverage levels, the vesting of benefits under the pension plan, standards for fiduciary responsibility, and minimum funding standards.

In the context of pensions, ERISA established the PBGC to regulate the private pension insurance plan. In particular, the PBGC’s goals are to (1) encourage continuity and maintenance of voluntary private pension plans; (2) provide for the timely, uninterrupted payment of pension benefits; and (3) maintain plan termination insurance premiums at levels consistent with the PBGC’s obligations. The PBGC is essentially a federal insurance program to insure employee pension plans and manage benefit distributions. Employers with pension plans pay premiums into the PBGC according to the number of employees the company covers under its pension plan. However, when employers fail to contribute the premiums that the PBGC requires, the resulting underfunding creates a shortfall and strains the system, which is still obligated to pay out benefits to current retirees. As of 2006, the current shortfall was nearly $23 billion; unless the PBGC becomes solvent, the U.S. Treasury, (and ultimately tax-payers) will be responsible for a multi-billion dollar bail-out of the system.

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9 Id.
10 Id.
11 Id.
12 Id.
14 Id.
15 Id.
16 See generally supra note 13.
17 Press Release, Office of the Press Secretary, Fact Sheet, supra note 1.
18 Schoeff, Jr., supra note 4.
B. How the Pension Protection Act of 2006 Attempts to Rectify the PBGC Underfunding

The PPA has a broad impact on numerous sectors and industries and affects nearly all employers offering retirement plans of any type.\(^{19}\) With regard to pension plans, the act provides for stricter funding requirements, prohibits companies from skipping premium payments to the PBGC, allows the PBGC to charge higher premiums to companies that skip payments, and eliminates loopholes in executive compensation packages.\(^{20}\)

1. Stricter Funding Requirements

In addressing its major priority to fully fund the PBGC, the PPA mandates that employers fully fund their plans within seven years, effective beginning in 2008.\(^{21}\) Further, the PPA prohibits companies with underfunded plans from taking on new pension obligations, and requires that the PBGC classify companies that underfund their plans be labeled as high risk, thereby having to pay higher premiums into the system as a penalty.\(^{22}\) In signing the Act, President Bush touted these funding requirements as making companies “. . . keep the promises [they] make to [their] workers.”\(^{23}\)

2. Companies May Not Skip Payments

The Act also prohibits companies from skipping premium payments, while allowing companies that run a cash surplus and are current with their funding requirements to contribute more into their pension programs to compensate for periods when company profits lag.\(^{24}\) This ensures that companies formulate more realistic and accurate pension funding calculations on an ongoing basis.\(^{25}\)

\(^{19}\) See Deborah Walker and Stephen LaGarde, *The Pension Protection Act of 2006—a Comprehensive Reform Package*, TAX ADVISER, Nov. 1, 2006, at 650


\(^{21}\) Schoeff, Jr., *supra* note 4.

\(^{22}\) Brett Ferguson and Sheila J. Cherry, *President Signs Pension Reform Bill, Urges Congress to Reform Entitlements*, 87 BNA 298 (Aug. 28, 2006); Press Release, Office of the Press Secretary, Fact Sheet, *supra* note 1.

\(^{23}\) Ferguson and Cherry, *supra* note 22.

\(^{24}\) Id.

\(^{25}\) Press Release, Office of the Press Secretary, Fact Sheet, *supra* note 1.
3. Executive Deferred Compensation

Employers may not set aside assets in a trust or other investment vehicle for deferred executive compensation if (1) its plan is at-risk; (2) the company is in bankruptcy; or (3) for one year after the company terminates its underfunded plan. If the company violates this mandate, the executive will owe taxes on any assets set aside on his or her behalf. Further, if the employer provides a gross-up to executive pay to compensate for this additional tax liability, that gross-up amount is subject to an additional 20% tax liability.

C. The PPA’s Impact on Other Retirement Benefit Plans

In addition to providing comprehensive changes to pension plans, the PPA also enhances defined contribution plans and other retirement options. A defined contribution plan (e.g., a 401K, IRA, CODA, or ESOP plan) is a retirement plan that provides an employee with an individual retirement account into which the employee can contribute a percentage of his or her pre-tax earnings. The company invests these funds on behalf of the employee and distributes the investment earnings, thereby helping to build the account balance more quickly. Defined contribution plans are especially popular at small and mid-size companies, and the company may contribute or “match” the employee’s contribution rate, thereby building the individual account even more quickly.

The current trend with American companies is towards offering defined contribution plans rather than defined benefit plans such as pensions. Unlike a defined benefit plan, a defined contribution is more attractive to employers because the plan does not guarantee any set benefit upon retirement; instead, the amount is highly dependent on the market performance of the investments into which the employee’s contributions were invested.

26 Schoeff, Jr., supra note 4.
27 Id.
28 Id.
30 Id.
31 Id.
32 Id.
33 Saul Friedman, Act II: Gray Matters, NEWSDAY, October 7, 2006 at B08.
The Pension Protection Act allows companies to automatically enroll employees into a qualified defined contribution plan, which proponents say will increase the current 70% nationwide worker participation rate into qualified contribution plans to over 90%.  The Act also permanently raises the allowable contribution into IRAs and 401Ks, provides workers with more control over their account investments, and gives workers greater access to professional financial advice about investing their funds. Supporters see these changes as providing a more useful alternative to the traditional defined benefit plans and giving employees greater ability to build up retirement savings.

D. Challenges to the PPA

The PPA passed along clear bi-partisan lines. Republican supporters such as Senate Health, Education, Labor and Pensions Committee Chairman Michael Enzi (R-WY) view problems with the insolvent PBGC as a crisis and the PPA as “a landmark bill [that] will strengthen the PBGC’s ability to safeguard financially troubled plans . . .”. However, some of the PPA’s opponents such as Reps. George Miller (D-CA), Charles Rangel (D-NY), and Rob Andrews (D-NJ) argue that the Act goes too far toward privatizing retirement and unfairly benefits certain industries and companies over others.

1. Retirement Privatization Concerns

Representatives George Miller (D-CA) and Charles Rangel (D-NY) of the House Education and the Workforce Committee oppose the Act because they fear it may result in some currently at-risk plans being cut or eliminated altogether. Regarding privatization, the Representatives caution that “erosion of the . . . pension system presents a dangerous shift from a ‘we’ society to a ‘me’ society, where every worker is on his or her own.”

34 Schoeff, Jr., supra note 4.
35 Press Release, Office of the Press Secretary, Fact Sheet, supra note 1.
36 See generally Schoeff, Jr., supra note 4.
37 Press Release, House Committee on Education and the Workforce, supra note 3.
38 Ferguson and Cherry, supra note 22.
40 Ferguson and Cherry, supra note 22.
41 Id.
Other opponents of the PPA argue that the shift to defined contribution plans is dangerous because defined contribution plans do not guarantee workers any return at all, and they are not as heavily regulated as pension plans.42 One opponent notes that only about 50% of Americans own any stock, 66% of all 401K plans are worth only about $5,000, and the median value of retirement plans held by 48 million Americans is only worth $27,000.43 In addition, employers are not required to offer 401Ks or other plans, and they are not required to match or contribute to employees’ accounts.44 If an employer declares bankruptcy, merges, or changes its investment strategies, the employee’s account is affected. The result is uncertainty and an inability to predict whether defined contribution plans will actually better secure the nation’s retirement funds.45

2. **Industry Bias with the PPA**

The PPA provides that airlines that “hard freeze” their pension plans will have an extra 10 years (in addition to the standard 7 years) to fully fund their pensions.46 This provides airlines with currently frozen plans more favorable terms to fund their pensions, thus disadvantaging those airlines which have kept up with their funding obligations.47

E. **Future Considerations**

The PPA comes at a time when the Baby Boomers are reaching prime retirement age.48 Pension systems of the past will be strained to their limits as more people leave the work force than are presently entering.49 Entitlement programs such as Social Security, Medicare, and Medicaid are projected to consume nearly 60% of the national budget by the year 2030.50 These considerations are important given that life expectancy has increased over the past

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42 Friedman, *supra* note 33.
43 *Id.*
44 *Id.*
45 *Id.*
46 *Pension Reform Changes Airline and Credit Counseling Requirements, 25-7 AM. BANKR. L.J. 8 (2006).*
47 *Id.* (arguing that Delta and Northwest would have an advantage over American and Continental).
49 *Id.*
50 *Id.*
decades, and the average retirement age has fallen. The PPA addresses these issues but does not resolve whether a system built on defined contribution plans is viable to rectify this problem. In light of the statistics regarding the current vitality of 401K accounts, future attempts to reform retirement savings must include realistic and accurate determinations of the PBGC’s ability to improve its financial situation and determine whether the PPA actually has improved the PBGC’s financial solvency position.

G. Conclusion

The Pension Protection Act of 2006 was passed and hailed as “The Most Sweeping Reform of America’s Pension Laws in Over 30 Years.” The PPA was designed primarily to correct the underfunding of the nation’s pension benefit insurer, the PBGC, and to provide incentives for employers and employees to consider investing in other retirement options instead of relying on the PBGC and the government entitlement programs. Supporters think moving toward more defined contribution plans is commendable and necessary, while opponents think the move will weaken the ability of workers to save adequately for retirement without taking on excessive risk. The PPA will certainly not be the last argument in a larger effort to continue preparing the nation for retirement. For now, supporters, along with the President, think this Act is the beginning of a major change regarding American retirement.

Shawanna Johnson

51 Pollock, supra note 2.
52 See supra text accompanying note 43.
53 See Press Release, Office of the Press Secretary, Fact Sheet, supra note 1.
54 Student, Boston University School of Law (J.D. 2008)
XIII. WAL-MART BANKING BID

In July of 2005 Wal-Mart, the world’s largest retailer, filed an application with the Utah Department of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC) to operate an industrial loan company (ILC).1 Almost two years later, on March 16, 2007, Wal-Mart dropped its bid to form the bank.2

Industrial loan companies, commonly referred to as industrial banks, are FDIC-supervised financial institutions whose distinct features include the ability to be owned by commercial firms that are not regulated by the Federal Reserve.3 Before the withdrawal of its application, Wal-Mart claimed that the Utah-based bank would be a back-office processing center with the narrow responsibility of handling millions of debit-card, credit-card, and electronic cheque-transfer payments initiated by its own customers.4 Currently, the retailer pays millions of dollars to other banking institutions for the processing of such transactions.5 Despite Wal-Mart’s assurances that its industrial bank would not get involved in branch banking, the proposal stirred the banking industry into an uproar that raged for over a year.6 As we now know, Wal-Mart caved to this strong criticism and dropped its bid.

This development article will trace the contours of the debate over Wal-Mart’s bank bid by exploring the retailer’s applications to the Utah Department of Financial Institutions and the FDIC. Part B provides an overview of the rise of industrial banks and their control by commercial firms. Part C explores why industrial loan companies have become controversial. Part D discusses developments in Wal-Mart’s application in 2006 and 2007. Part E explores the potential

6 Id.
benefits and potential drawbacks of Wal-Mart’s ownership of an industrial bank.

A. The Rise of Industrial Banks and Their Control by Commercial Firms

The monitoring of a bank’s relationship with affiliated and controlling entities is a fundamental tenet in effective bank supervision. Banking legislation, regulation, and supervisory practice in the United States account for this principle in numerous ways. Sections 23A and 23B of the Federal Reserve Act limit bank transactions with affiliates, including the parent company, of savings associations, stand-alone banks, bank and thrift holding company subsidiaries, industrial loan companies and other FDIC-insured entities. Limitations are placed on loans to bank insiders under Federal Reserve Regulation O, applying to all insured banks. Progressively harsh sanctions are levied against any insured bank whose owners fail to maintain adequate capitalization under the Federal Deposit Insurance Act. These and other safeguards “constrain the degree to which a parent company or its subsidiaries can undertake transactions with, or divert capital from, an insured institution.”

Industrial banks are unique in several respects. As mentioned above, ILCs can be owned by non-bank entities and, under certain conditions, can escape regulatory oversight of the Federal Reserve. ILCs are state-chartered and currently operate in seven states (including California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah). According to the FDIC, there are currently 61 industrial loan companies with $155 billion in assets and $110 billion in deposits. Under certain circumstances, industrial banks are not defined as “banks” under the Bank Holding Company Act (BHCA). A commercial firm controlling an institution that

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7 Federal Deposit Insurance Corporation, supra note 3.
8 Id.
9 Id.
10 Id.
11 Id.
14 Federal Deposit Insurance Corporation, supra note 3.
does not fall under the BHCA’s definition of a “bank” is not required to register as a bank holding company with the Federal Reserve Board and is therefore not subject to regulation and supervision by the Federal Reserve.\textsuperscript{15} An industrial bank will not qualify as a “bank” under the BHCA as long as it satisfies at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired by any company after August 10, 1987.\textsuperscript{16} The table below compares the powers of BHCA-governed state commercial banks and non-BHCA industrial loan companies.

\begin{center}
\begin{tabular}{|c|c|c|}
\hline
\textbf{Powers} & \textbf{State Commercial Bank That Is a BHCA Bank} & \textbf{Industrial Loan Company (or Industrial Bank) That Is Not a BHCA Bank} \\
\hline
Ability to accept demand deposits & Yes & Varies with the particular state. Where authorized by the state, demand deposits can be offered if either the ILC’s assets are less than $100 million or the ILC has not been acquired after August 10, 1987 \\
\hline
Ability to export interest rates & Yes & Yes \\
\hline
Ability to branch interstate & Yes & Yes \\
\hline
Ability to offer full range of deposits and loans & Yes & Yes, including NOW accounts, but see the first entry above regarding demand deposit accounts \\
\hline
\end{tabular}
\end{center}

\textsuperscript{15} Id.
<table>
<thead>
<tr>
<th>Authorized in every state</th>
<th>Yes</th>
<th>No. ILCs currently are chartered in seven states*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination, supervision, and regulation by federal banking agency</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>FDIC may conduct limited scope exam of affiliates</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Golden Parachute restrictions apply</td>
<td>Yes</td>
<td>Yes, to the institution; no, to the parent</td>
</tr>
<tr>
<td>Cross Guarantee liability applies</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>23A &amp; 23B, Reg. O, CRA apply</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Anti-tying restrictions apply</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Parent subject to umbrella federal oversight</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Parent activities generally limited to banking and financial activities</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Parent could be prohibited from commencing new activities if a subsidiary depository institution has a CRA rating that falls below satisfactory</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Parent could be ordered by a federal banking agency to divest of a depository institution</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
subsidiary if the subsidiary becomes less than well capitalized

<table>
<thead>
<tr>
<th>Enforcement Actions</th>
<th>Parent</th>
<th>Subsidiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Full range of enforcement actions can be applied to the subsidiary depository institutions if parent fails to maintain adequate capitalization

Control owners who have caused a loss to a failed institution may be subject to personal liability

*California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah.

**Parent, with respect to a state commercial bank, refers to a bank holding company or financial holding company subject to supervision by the Federal Reserve.

Note: NOW = negotiable order of withdrawal; CRA = Community Reinvestment Act


Commercial firms have acquired ILCs for a wide variety of reasons. Home Depot recently applied to acquire an industrial bank in order to extend home improvement loans.17 Merrill Lynch uses its ILC as “a depository for the cash balances of its investor clients, providing them with the option of holding some or all of their cash balances in FDIC-insured deposits.”18 Merrill Lynch is currently the largest industrial bank with assets of over $62 billion, making it the

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17 Id.
18 Id.
17th largest bank in the country. Toyota offers automobile financing options through its ILC. Other ILC owners include American Express, Morgan Stanley, Target, BMW, General Motors Corp., Volkswagen and Volvo. Wal-Mart’s application for an industrial bank sought to cut out third party institutions that currently handle their credit and debit card transactions. ILCs have existed since 1910, but have acquired their current level of notoriety only recently after tremendous growth in the past two decades and especially after Wal-Mart’s application last July.

B. Why Have Industrial Loan Companies Become Controversial?

The debate surrounding industrial loan companies focuses on the historical aversion towards the mixing of banking and commerce. The law generally prohibits affiliations or combinations between banks and commercial firms. “Today, the ILC charter is effectively the only vehicle by which non-financial firms can enter banking, and by which non-bank financial firms can own a depository institution without being subject to holding company supervision by the Federal Reserve System.” The controversy surrounding industrial banks has arisen from what are the perceived dangers of mixing banking and commerce. Three such concerns dominate the debate. First, is the concern that such mixing will lead to conflicts of interest and misallocation of credit when banks and commercial firms affiliate. Second are the dangers of the resulting financial and economic monopolies. Third, is the fear about extending the federal safety

19 Douglas H. Jones, Acting General Counsel, Statement on Industrial Loan Companies to the U.S. House of Representatives (July 12, 2006); Terry J. Jorde, President and CEO of CountryBank USA, Symposium Hosted by the Federal Deposit Insurance Corporation: The Future of Banking: The Structure and Role of Commercial Affiliations (July 16, 2003).
21 Wal-Mart Wants to Own Processing Bank, CARDS AND PAYMENTS, Sept, 2005.
Potential conflicts of interest have dominated the debate over the legitimacy of ILCs. Critics of Wal-Mart's bank bid presented two scenarios that illustrate how such conflicts might arise if Wal-Mart ever acquired a charter. The first scenario is from the perspective of a small business retailer in a town with a Wal-Mart SuperCenter. Imagine that such a business owner needed an operating loan or a loan to expand her business. Assuming that the business is a direct competitor with Wal-Mart, such as a hardware store, a pharmacy, or a grocery store, would a Wal-Mart owned bank agree to lend the business owner the necessary cash? Would the store owner want to share her confidential business plan with such a bank? The answer to both these questions represents a potential conflict from the perspective of a competing business seeking help from a Wal-Mart bank. In a speech to the FDIC, Terry J. Jorde, the president of a small bank in North Dakota, argued that the existence of such a bank would likely mean that the small business owner would not have the option of going elsewhere to seek credit because of Wal-Mart's demonstrated ability to underprice their competitors out of business. A second potential source of conflict comes from the perspective of a supplier to Wal-Mart. Would Wal-Mart's superior bargaining position allow it to threaten a suspension of business unless the supplier agreed to obtain its banking and credit services through Wal-Mart's bank? Both of these scenarios illustrate how the mixing of banking and commerce can interfere with a bank's role as an impartial financial intermediary “whose credit decisions should be based on merit rather than competitive concerns.”

A second source of concern about the industrial bank charter is that it enables the creation of threatening conglomerates. One of the hallmarks of the United States economic system is its diversified financial sector and a strong small and mid-sized financial and financial and

\[\text{Id.}\]
\[\text{Id.} \ (\text{the first scenario described in this paragraph comes from Terry Jorde’s Symposium speech to the FDIC}).\]
\[\text{Id.}\]
\[\text{Id.} \ (\text{the second scenario described in this paragraph comes from Terry Jorde’s Symposium speech to the FDIC}).\]
\[\text{Id.}\]
\[\text{Id.}\]
ILC critics argue that the brisk rate of consolidation in the banking industry, occurring throughout the past decade, would be sped up with the mixing of banking and industry. Such growth, it is argued, would undermine the strength of the economy by removing diversity and range from the banking sector.

The most resounding of all the criticism of Wal-Mart’s bank bid was based on the concern that while industrial bank deposits are protected by the FDIC, ILCs are not subjected to the rigorous oversight of the Federal Reserve as are all BHCA banks. A principal concern in the mixing of banking and commerce is that “commercial affiliates may seek to shift losses to the bank, or financial difficulties at an affiliate could lead to loss of confidence in the bank.” An often repeated question in the news was to imagine if Enron owned a large ILC. Even though ILCs are supervised by the FDIC, the parent company that owns the bank is not regulated by any financial regulator. “The FDIC cannot monitor the business practices of the commercial owner or its affiliates to reveal potential risks to the soundness of the entire group or the ILC.” The parent company and its affiliates “are subject to regulatory scrutiny only to the extent that they have a contractual relationship with the ILC.” Unlike the level of regulation of industrial banks, federal regulators are granted significantly greater powers to oversee BHCA banks. The supervision provided by the Federal Reserve under the BHCA extends to “general examination authority, consolidated umbrella supervision, capital requirements and enforcement authority for unsafe and unsound activities at the parent or affiliate.” The industrial bank charter has therefore attracted a great deal of attention because of its unique features and potential hazards.

C. Developments in Wal-Mart’s Bank Bid in 2006 and 2007

Wal-Mart’s application to operate an industrial loan company precipitated a strong outcry from the banking industry. For

33 Id.
34 Id.
35 Id.
36 Federal Deposit Insurance Corporation, supra note 3.
37 Terry J. Jorde, supra note 19.
38 Ergungor and Thomson, supra note 17.
39 Id.
40 Federal Deposit Insurance Corporation, supra note 3.
41 Ergungor and Thomson, supra note 17.
the first time in its 73 year history, the FDIC held public hearings in April on Wal-Mart’s bank application.\(^{42}\) Hearings were held in Virginia and Kansas over the course of three days, on April 10, 11 and 25.\(^{43}\) The hearings attracted “a parade of Wal-Mart’s regular adversaries – unions, corporate activists, small business owners – along with bankers, individuals and experts on both sides.”\(^{44}\) In June, the Utah Department of Financial Institutions (UDFI) announced that Wal-Mart’s application was incomplete, delaying its bid to open the bank.\(^{45}\) The UDFI requested that Wal-Mart supply more information on how it would handle payments.\(^{46}\) Once Wal-Mart completes its application, the UDFI must make a decision within 90 days, unless it schedules public hearings.\(^{47}\) On July 10th, Congressmen Paul Gillmor (R-OH) and Barney Frank (D-MA) introduced H.R. 5746, the Industrial Bank Holding Company Act of 2006.\(^{48}\) The proposed legislation would prohibit commercial firms from acquiring industrial loan companies.\(^{49}\)

On July 31, the FDIC made a decisive decision in declaring a six-month moratorium on all ILC application, effective through January 31, 2007.\(^{50}\) In a press-release on July 28, the FDIC explained its motivations,

> Recently, the growth of the ILC industry, the trend toward commercial company ownership of ILCs and the nature of some ILC business models have raised questions about the risks of ILCs to the deposit insurance fund, and whether their commercial relationships pose any safety and soundness risks.

\(^{45}\) Lauren Coleman-Lochner, Wal-Mart Hasn’t Completed its Bank Application, DESERET MORNING NEWS, June 27, 2006.
\(^{46}\) Id.
\(^{47}\) Id.
\(^{49}\) Id.
\(^{50}\) Heeding Lawmakers’ Call, FDIC Imposes Moratorium on ILC Applications, supra note 13.
The FDIC put the moratorium in place to provide time to assess developments in the ILC industry, to determine if any emerging safety and soundness or policy issues exist involving ILCs, and to evaluate whether statutory, regulatory or policy changes need to be made in the oversight of these charters. The moratorium also allows the agency time to further evaluate the various issues, facts and arguments raised in connection with the ILC industry, and to assess whether statutory or regulatory changes or revised standards and procedures for ILC applications and supervision are needed to protect the deposit insurance fund.\footnote{Federal Deposit Insurance Corporation, \textit{FDIC Places Six-Month Moratorium on Industrial Loan Company Applications and Notices}, \url{www.fdic.gov}, http://www.fdic.gov/news/news/press/2006/pr06073.html, (last visited Nov. 18, 2006).}

The moratorium was greeted with both positive and negative reaction. Some commentators read the moratorium as infusing doubt into the ILC as a viable charter in the future.\footnote{\textit{See You Can Bank on the Critics of Wal-Mart}, supra note 36; Jyoti Thottam, supra note 39.} Many complemented the FDIC for taking the time to make an informed decision. It is at this point unclear how the FDIC will rule on Wal-Mart's application. On March 16, 2007, Wal-Mart declared that it was dropping its bank bid.\footnote{\textit{Wal-Mart Withdraws Industrial Banking Push}, supra note 2.} Jane Thompson, president of Wal-Mart Financial Services, justified the withdrawal, “since the approval process is now likely to take years rather than months, we decided to withdraw our application to better focus on other ways to serve customers.”\footnote{\textit{Id.}} “We fully intend to continue to introduce new products and services that champion those who deserve convenient, lower priced financial services,” she added.\footnote{\textit{Id.}} The FDIC and other federal regulators welcomed the news.\footnote{\textit{Id.}} FDIC Chairman Sheila C. Bair stated that “Wal-Mart made a wise choice. This decision will remove the controversy surrounding their intentions.”\footnote{\textit{Id.}} Others remained
apprehensive of the ILC charter and called for change.\textsuperscript{58} “Wal-Mart’s withdrawal of its ILC application is a welcome development, but we urge Congress to continue its work to close the ILC loophole once and for all. The central concern in the ILC debate – the separation between banking and commerce – remains, even with today’s announcement,” the American Bankers Association said in a statement.\textsuperscript{59}

D. The Pros and Cons of a Wal-Mart Bank

According to Wal-Mart, the raging fear of a Wal-Mart bank was not based on reality.\textsuperscript{60} The company claimed that it is sought to operate a bank for the narrow purpose of processing debit and credit card transactions.\textsuperscript{61} In evaluating the pros and cons of a Wal-Mart bank, it is necessary to define the activities that such a bank would be engaged in. One possibility is that Wal-Mart actually intended to operate an ILC for the narrow purpose announced. A very different possibility is a Wal-Mart bank which would have operated like a commercial bank. It is this latter version which causes the banking industry to shudder.

Assuming that Wal-Mart bank existed solely for the purpose announced, industry observers view it as a largely positive development.\textsuperscript{62} Who would benefit from such a bank? Wal-Mart would be better off by removing the third party processors that currently charge about a couple of cents for each credit and debit card transaction. Consumers would welcome the bank because it would allow Wal-Mart to pass some of the savings to further discount their goods. “At a time when the retail giant is facing market saturation in its home market and slowing sales and profit growth, observers say Wall Street is likely to view any cost-saving effort by Wal-Mart as a positive since the freed-up funds can be

\textsuperscript{59} Id.
\textsuperscript{60} Shaheen Pasha, supra note 5.
invested in other areas of its business." 63 Who would be harmed from such a bank? The third party processors that currently handle Wal-Mart’s transactions will loose a large client. Beyond that however, most industry observers see little downside to such an arrangement. 64

Despite its protestations, Wal-Mart opponents believed that the ILC application filed in July of last year is the company’s attempt to enter into full-fledged banking. Assuming that this is the kind of bank Wal-Mart would have become, who benefits? Consumers would benefit from such a bank because Wal-Mart would be able to provide a host of banking services at lower prices than are currently charged at other banks. “Analysts estimate that one-fifth of Wal-Mart’s customers have no bank accounts, which would be twice the national rate, according to the Federal Reserve.” 65 Wal-Mart would be able to tap into this market by providing affordable bank accounts, credit cards, mortgage loans, etc. Wal-Mart would surely benefit from a growth in its services offerings, quickening its growth and making investors happy. The strong outcry resounding from many of the parties that stand to lose from a Wal-Mart bank is what had made the company’s application so controversial.

Many argue that one loser would be the banking industry in general. 66 A Wal-Mart bank providing a host of services would take away customers disgruntled with the fee structure of their current banks, thereby lowering the industry’s profits as a whole. Investors of large banks therefore have a lot to lose from such a bank, as it stands in opposition to the price structure currently employed. Small community banks would also feel pinched by the existence of such a bank as it would be able to afford lower cost services to its customers. Overall, the introduction of a Wal-Mart bank would lead to new pressures on the banking industry’s cost structure, which has been lacking in competition. 67

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63 Id.
64 Id.
66 Parlja Bhatnagar, supra note 62.
Igor Fasman\textsuperscript{68}

\textsuperscript{68} Student, Boston University School of Law (J.D. 2008).
XIV. EUROPEAN BANK MERGERS & ACQUISITIONS

The European Union’s (“EU”) banking industry has undergone drastic structural reshaping over the past two decades and it is currently in an intense phase of consolidation. After years of domestic consolidations, a boom in cross-border mergers took hold in 2006.\(^1\) In Europe, cross-border mergers and acquisitions in the retail banking sectors alone represented 70 percent of deals in 2006, worth € 27 billion.\(^2\) The European Commission (“Commission”) welcomes this trend because it promotes free movement of capital across the EU, one of the “basic freedoms” contained in the Treaty on European Union.\(^3\) However, countries like France and Poland have responded to this trend with a resurgence of nationalism and protectionism.\(^4\) The Commission is taking a strong stance to counter any protectionist policies.\(^5\)

A. General Trends

For years, the major players in the European banking industry have grown through domestic mergers and acquisitions.\(^6\) Consequently, most of the European banking market has become highly consolidated.\(^7\) For example, in France, the five largest banks now control 85 percent of assets, followed by 63 percent in the United Kingdom, and 60 percent in Spain.\(^8\) As a result, domestic mergers seem to have run their course in these developed markets, and banks are forced to look across their borders for new growth and opportunities.

Several macroeconomic changes also fueled this booming cross-border consolidation trend. First, many of Europe’s biggest banks are currently holding large amounts of excess capital.\(^9\) In a

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1 Davide Taliente, European Bank Border Crossing, MERCER MGMT.J.55, 55.
3 McCreevy Vows to Get Tough on Protectionists, IRISH INDEP., Nov. 11, 2006 [hereinafter McCreevy].
4 Id.
6 Homing in on New Markets, EUR. BANKER, Jul. 1, 2006, at 10 [hereinafter New Markets].
7 Taliente, supra note 1.
8 New Markets, supra note 6.
9 Taliente, supra note 1.
study conducted last year by Morgan Stanley and Mercer Oliver Wyman, a financial service consultant, European banks were estimated to hold € 43 billion in excess capital. As Davide Taliente, the head of European Banking at Mercer, stated, “(t)here’s too much capital and not enough growth expected from mature European markets.” Banks are forced to look for new ways to generate a yield.

Furthermore, regulatory harmonization is making cross-border mergers more feasible. The European Union continues to push for an integrated financial system with more transparent accounting standards that would significantly diminish regulatory risks. This more synchronized regulatory scheme will encourage cross-border integration and lead to a better transmission of monetary policy.

Global competition also demands large European banks to look beyond their borders in order to compete with global banking superpowers like Citigroup. In order to stay abreast with major United States banks and fast developing banks in Asia, European banks are focusing on merging with large foreign banking as well as taking over smaller and weaker domestic banks.

Viewed collectively, the major cross-border mergers that took place in 2006 shared the common theme of “the strong buying the weak and growth to the East.” Italy was, and continues to be, one of the most attractive targets for big European banks. The Italian banking sector is unique because it is relatively weak and fragmented; therefore there is more opportunity for consolidation. Italy is also desirable because Italians save more than their European peers and pay relatively high prices for retail banking services. Similarly, the “under-banked” Central and Eastern European regions

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10 Big European Bank Mergers Queue Up Behind Small Deals, TURKISH DAILY NEWS, Apr. 16, 2006.
11 Taliente, supra note 1
12 Id.
13 Id.
14 Id.
15 Id.
16 Id.
17 Big European Bank, supra note 10.
19 Id. See also, Corporate Xenophobia, FIN. EXPRESS, Feb. 17, 2006.
also drew the attention of big European banks in 2006. Countries like Turkey and Russia show strong economic growth and are prime targets for potential takeovers.

Another notable trend in cross border mergers was the high prices involved, often more than three and a half times, sometimes as much five times, the bank’s assets value on its balance sheet. Even the prices in developing Central and Eastern Europe have soared as a result of the strong demand. For example, Greece’s National Bank paid about 3.6 times over book value for its 46% share in Finansbank, the 5th largest bank in Turkey. Yet despite the high prices, cross border investors were still rewarded. For example, shares in French bank BNP rose 14 percent two months after it announced its €9 billion bid for Italian bank BNL. The continuing profitability of these transactions guarantees their continuance.

B. Notable Mergers of 2006

1. The French Raid

In a bold and unexpected move in February 2006, French banking giant, BNP Paribas, made a €9 billion bid for Banca Nazionale del Lavoro ("BNL"), Italy’s sixth-largest bank by assets. BNP purchased a 48 percent stake in BNL at €2.925 a share from its investors and will bid for the rest at a later time. This is the biggest foreign acquisition ever by a French bank and the fifth largest cross-border takeover in European banking history.

BNL has long been a target of potential takeovers. In fact, the BNP bid is the third in less than a year made for BNL. In 2005, Banco Bilbao Vizcaya Argentaria (BBVA) of Spain, which owned

21 Big European Bank, supra note 10.
22 Id.
23 Id.
24 Id.
25 Id.
27 Id. See also, BNP Paribas Move on Roman Bank could Spark Consolidation, TIMES (UK), Feb. 6, 2006, at 40.
29 BNP Paribas Move on Roman Bank could Spark Consolidation, TIMES (UK), Feb. 6, 2006, at 40.
15 percent of BNL, made the first bid for BNL.\\footnote{30} The Italian Central Bank coolly received this bid, and BBVA was forced to abandon its efforts.\\footnote{31} The Italian Central Bank received severe criticism for its involvement in crushing this BBVA bid.\\footnote{32} In November 2005, Compagnia Assicuratrice Unipol SpA’s, an Italian insurer, made a €8.4 billion bid for BNL.\\footnote{33} Still criticized for crushing the BBVA bid, the Italian Central Bank blocked the second bid to avoid appearing to be blatantly favoring national bidders.\\footnote{34} Antonio Fazio, governor of the Central Bank at the time, was largely blamed for these two failed efforts, and his nationalist approach made it “all but impossible even for foreigners with a big stake in Italian banks to buy control, and those without did not even try.”\\footnote{35} Fazio resigned in December 2005 precisely because he unfairly favored Italian banks in the BBVA merger battles.\\footnote{36} Fazio was replaced by Mario Draghi who opened the Italian financial community to foreign bidders just in time to welcome the BNL bid.\\footnote{37}

The two failed efforts left BNL extremely vulnerable to a takeover but without any suitor.\\footnote{38} BNP immediately seized this rare opportunity and was ultimately successful.

France’s No. 3 bank by market capitalization, Credit Agricole also actively engaged in cross-border acquisitions in 2006.\\footnote{39} Credit Agricole made a €3.1 billion takeover bid in June for Emporiki Bank, the fifth-largest bank by assets in Greece.\\footnote{40} Credit Agricole already held 9 percent of Emporiki prior to the bid, and the offer was seen as an attempt to pre-empt the Greek government from selling its 24 percent stake in Emporiki.\\footnote{41} Credit Agricole was initially challenged by a €3.8 billion cash and stock counter bid from Bank of Cyprus.\\footnote{42} However, Bank of Cyprus was forced to withdraw in July amid concerns regarding the bank’s management of some

\\footnote{30} French Raid, supra note 26.\\footnote{31} Id.\\footnote{32} Id.\\footnote{33} Id.\\footnote{34} Id.\\footnote{35} Id.\\footnote{36} Id.\\footnote{37} Id.\\footnote{38} Id.\\footnote{39} Paul Whitfield, Credit Agricole, Fiat in JV, DAILY DEAL, July 25, 2006.\\footnote{40} Martin Arnold & Kerin Hope, Companies Europe: Credit Agricole Targets Emporiki Banking, FIN. TIMES UK, June 14, 2006, at 26.\\footnote{41} Id.\\footnote{42} Renee Cordes, Popular Buys Two Greek Banks, DAILY DEAL, Sept. 21, 2006.
pension funds. Credit Agricole nevertheless increased its original bid by 17 percent to €3.3 billion to guarantee its success.

This transaction is an important part of Credit Agricole’s plan to boost its profit from abroad. Credit Agricole currently receives about 35 percent of its revenue from outside of France. It plans to use €5 billion of shareholder funds to engage in more cross-border acquisitions and to increase its foreign revenue to 50 percent of all revenue over three years. Pursuant to this goal, Credit Agricole also agreed in October 2006 to buy about 650 branches in Italy from Bana Intesa for around €6 billion in cash. Credit Agricole also considered bidding for an UK mortgage bank, Alliance & Leicester. This was ultimately abandoned due to concern over profitability.

2. Land of Opportunity in Central and Eastern Europe

Developing markets like Eastern Europe and Turkey offer more potential for growth than the mature, lower-growth markets in most of Western Europe. Consequently they are attractive potential acquisitions targets.

In May, 2006 National Bank of Greece acquired 46 percent controlling minority stake in Finansbank, Turkey’s eighth largest bank. Aside from its financial significance, it is important to note that these two recently hostile neighbors were able to see beyond their enmities for the sake of their common economic development goals. It stands in sharp contrast to an environment of increasing nationalism and protectionism in other EU countries such as France and Poland.

43 Id.
44 Id.
45 Whitfield, supra note 39.
46 Id.
47 Id.
48 Albertina Torsoli, Agricole to Expand in Italy for Euro 6 billion, INT’L HERALD TRIBUNE, Oct. 12, 2006, at 19.
49 Id.
51 Big European Bank, supra note 10.
53 Id.
54 Id.
3. Protectionism in Poland

The collision between the Polish government and the Italian banking giant UniCredito is one of the most controversial cross-border acquisitions in 2006. In 2005, UniCredito purchased the HVB Group of Germany and consequently acquired interests in two Polish banks, Bank BPH and Bank Pekao. UniCredito’s key motivation for the HVB deal was to consolidate the two banks in Poland. However, the Polish government opposed UniCredito’s plan to combine BPH and Pekao, alleging that UniCredito violated earlier privatization deals in Poland when it acquired HVB. In reality, it is well known that the Polish government opposed the deal for nationalist and protectionist reasons. UniCredito’s plan to consolidate BPH and Pekao would have formed the largest bank in Poland, and the Polish government is uneasy at allowing an Italian bank to control what would have been Poland’s largest bank.

In April 2006, the Polish government finally agreed to allow UniCredito to combine BPH and Pekao; but only after UniCredito agreed to sell 200 of the 480 branches of Bank BPH to the highest bidder. Under the terms of this agreement, UniCredito’s newly combined bank would not replace the state-owned PKO Bank Polasi as the largest bank in Poland, thus satisfying Polish government’s nationalist objective.

C. Resurgence of Protectionism and the European Commission’s Response

1. Examples of Protectionism

As mentioned above, some European countries like France, Italy, and Poland responded to the cross-border merger trend with a resurgence of nationalism and protectionism. While French banks such as BNP and Credit Agricole have been actively and successfully acquiring interest in banks abroad, very few foreigners would ever

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56 Id.
57 Id.
58 Id.
59 Id.
60 Id.
61 Id.
consider launching a hostile bid for a French bank. In 2005, the French government passed a law that protected 11 strategic sectors, including banking, from foreign bidders. The government cited reasons such as national security and a need to protect the safety and soundness of key industries. The Commission is questioning the legality of this decree and believes that it broke European Union rules on the free movement of capital between member states.

The Commission responded harshly to the Italian government’s interference in several proposed cross-border bank mergers. In 2005, Italy took highly controversial protectionist measures when two foreign banks, BBVA of Spain and ABN Amro of the Netherlands, launched bids for two different Italian banks. The Central Bank of Italy tried to frustrate the foreign bidders by promoting rival domestic bids. In response, tremendous criticism from the EU pressured the government to abandon this overtly nationalist political interference, and the former director of the Central Bank of Italy was forced to resign. The Commission hopes the Italian drama will serve as an example to other European countries.

It does seem as if Italy’s experience partially affected the Polish government’s negotiation with UniCredito. Polish government’s involvement in the UniCredito deal received significant criticism from the European Union. The Commission had cleared the UniCredito’s acquisition of HVB in October 2005, and consequently declared that Poland, a recent member of the European Union, does not have authority to block the Polish part of the deal. The Commission considered legal action against Poland, but the April settlement seemed to have eased the tension. The Commission’s firm stance against Italy was a strong factor of consideration when the Polish government settled in the April compromise. Nevertheless, UniCredito was forced to make significant concessions such as selling a large number of Bank BPH

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62 Merger Mania, supra note 5.
63 Id.
64 Id.
66 Id.
67 Id.
68 Landler, supra note 55.
69 Id.
70 Id.
branches and pledging not to lay off any employees for two years. Critics are calling this deal a troubling resurgence of protectionism and economic nationalism in Poland.

2. The European Commission’s Response

The Commission is “acting as guardian of the treaties and sending a clear message to all member states that no violations . . . will be tolerated.” In a speech given on November 11, 2006, EU Commissioner Charlie McCreevy promised to take on member states using regulatory rules to protect industries from cross-border takeovers. This is a part of McCreevy’s general campaign to promote a more unified European financial market built around the Euro currency. European Central Bank President Jean Claude Trichet also backs strong actions by the Commission and the European Court of Justice to eliminate economic nationalism in Europe.

The European Union has taken specific actions to combat resurging protectionism. The EU Takeover Directive (the “Directive”) was implemented by most EU countries in 2006. The objective of the Directive was to harmonize takeover codes across the EU. However, implantation of the Directive varies dramatically from country to country due to the fact that some countries are heavily influenced by nationalist protectionism. To combat the difference in interpretation, the Commission is considering new proposals to decrease the discretionary power given to national supervisory authorities over vetoing proposed mergers and acquisitions in the banking, insurance, and securities sectors. This new proposal would provide a closed list of criteria for assessing

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71 Id.
72 Landler, supra note 55
73 McCreevy, supra note 3.
74 Id.
75 Id.
78 Id.
79 Id.
prospective acquisitions including, “the reputation of and financial soundness of the proposed acquirer; the reputation and experience of any person who may run the business; the prospect of ongoing compliance by the acquired firm with the relevant sectorial directives; and the risk of money laundering or terrorist financing.”

In addition, the assessment process would have clear procedural rules with specific deadlines and various efficiency and transparency requirements. These objective standards could go a long way in combating protectionism by leaving little room for political interference. In order to become law, the European Parliament and the EU governments must all agree on the proposal, and some resistance is expected from some governments in an attempt to retain domestic regulators’ discretion over bids.

E. Conclusion

2006 saw a lot of successful cross-border mergers within the European Union. This is a promising trend because it encouraged economic and monetary integration within the European Union. Furthermore, cross-border merger also enabled European banks to remain competitive globally. However, several countries have established protectionist measures to deter foreign acquisitions and maintain domestic control. These efforts pose great difficulties for EU regulators and acquiring banks looking across their borders. The European Union, specifically the European Commission, has taken the lead in prohibiting undue government interference in cross-border bank mergers. In conclusion, the future of the European banking industry will depend on banks’ ability to expand beyond their borders. The progress made in 2006, despite occasional nationalist resistance, is a definite move in the right direction.

Mimi Hu

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82 Id.
83 Id.
84 Rega, supra note 80.
85 Student, Boston University School of Law (J.D. 2008).
XV. THRIFT/CREDIT UNION UPDATE

The most important development in the thrift and credit union world in 2006 was the passage of the Financial Services Regulatory Relief Act. The legislation included a number of helpful provisions for credit unions and thrifts, expanding their range of permissible activities, while increasing their competitiveness with other financial institutions. The year also introduced a wave of new controversies surrounding the conversion of credit unions to mutual savings associations and commercial banks.

A thrift or savings-and-loan association is a financial institution that primarily makes home-mortgage loans but also maintains checking accounts and provides other banking services.1 Thrifts are chartered and regulated by the Office of Thrift Supervision (OTS), a bureau of the U.S. Department of Treasury.2

“Net income at the 853 thrifts regulated by the OTS reached $4.29 billion in the third quarter of 2006, the second-highest total on record, behind the $4.32 billion reported for the fourth quarter of [2005].”3 Notably, ninety-nine percent of thrift institutions met or exceeded “well capitalized” regulatory standards during the third quarter of 2006.4

Credit unions are unique depository institutions created not for profit, but to serve members as credit cooperatives.5 Under the Federal Credit Union Act (FCUA), membership in any federal credit union is restricted to defined groups with a common bond of occupation or association, or those living in a well-defined geographical area.6

Credit unions’ tax-exempt status has been ratified several times by Congress, most recently in 1998 as part of the Credit Union Membership Access Act (CUMAA).7 Because credit unions are member-owned, democratically operated, not-for-profit organizations

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1 BLACK’S LAW DICTIONARY 1371 (8th ed. 2004).
4 Id.
generally managed by volunteer boards of directors, they are exempt from federal and most state taxes.8

The combination of tax-exempt status and membership orientation means that credit unions generally offer higher interest rates on savings deposits and lower interest rates on loans.9 After the recent Democratic takeover of the House and Senate, the credit union tax exemption, which came under review in the last Congress, is unlikely to be repealed.10 Bank lobbyists, however, see the tax exemption as an unfair advantage and have argued for its removal due to the fact that credit unions are growing and expanding their range of services, thereby increasing their competitiveness.11

Approximately 8,600 federally insured credit unions now serve $85 million members with $600 billion on deposit.12 While credit unions enjoy high customer satisfaction, the credit union (CU) movement is advocating for deregulation and expansion of permissible activities, which would increase their competitiveness with banks.13 The Credit Union National Association has pointed out that the CU charter is not only “inflexible” on operations and governance, but also suffers from “severe limitations” on commercial lending and investment.14

A. Financial Services Regulatory Relief Act of 2006

1. Passage

Several hours before adjournment, the 109th Congress passed a scaled down version of the banking regulatory relief bill.15 The bill reflects a compromise between a broader relief package sought by the House (H.R. 3505) and the Senate Banking Committee’s smaller set of amendments.16 Representatives of both the CU movement and

8 Id.
9 Michael W. Briggs, Credit Union Conversions: Charter Choices and Controversy, 10 N.C. BANKING INST. 1, Mar. 2006.
12 National Credit Union Administration, History of Credit Unions, supra note 5.
13 Briggs, supra note 9.
16 Id.
the thrift industry have expressed satisfaction regarding the Act’s passage.17


a. For Thrifts

The Financial Services Regulatory Relief Act (“Reg. Relief Act”) contains significant deregulation measures for the thrift industry.18 Specifically, the Reg. Relief Act “exempts federal savings associations from investment adviser and broker-dealer regulation to the same extent as banks.”19 In addition to the securities exemption, the Reg. Relief Act gives thrifts authority to make development loans for residential housing units with a purchase price exceeding $500,000.20 The bill also provides thrifts with useful clarifications regarding their status and activities.21 One of the provisions states that “a federal savings association is a citizen only of the state in which its main office is located for purposes of determining federal diversity jurisdiction in court.”22 The Reg. Relief Act further gives the OTS equal representation along with other federal banking agencies on the Basel Committee.23

b. For Credit Unions

The Reg. Relief Act of 2006 contains a number of valuable provisions for credit unions.24 It allows credit unions to provide such services as cash checking and wire transfers to persons eligible for CU membership, regardless of their current membership status.25 Another relief provision includes an increase in a maturity limit on unsecured loans from 12 to 15 years.26 The Reg. Relief Act allows

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17 Id.
19 Id.
20 Id.
21 Id.
22 Id.
23 Id.
24 Ed Roberts, Election Shadows Credit Union Relief, AM. BANKER, Sept. 29, 2006 [hereinafter Roberts, Election].
25 Id.
26 Roberts, Reg Relief Bill, supra note 15.
federal military and civilian authorities to provide favorable lease terms for credit unions that finance the construction of credit union facilities on federal sites.\textsuperscript{27} The Reg. Relief Act further exempts credit unions from a new accounting rule which bars pooling (e.g. aggregating capital after mergers).\textsuperscript{28}

3. Additional Flexibility Sought

\textbf{a. For Thrifts}

Despite a number of helpful regulatory relief provisions, Congress has not given thrifts the authority to reduce their current limits on community business lending and development investment.\textsuperscript{29} Notably, the CU movement in Congress has opposed granting additional commercial lending authority to thrifts, since this is something credit unions are seeking for themselves.\textsuperscript{30} In turn, banks have not approved an increase in lending authority for credit unions, creating a political impasse.\textsuperscript{31} Thrifts that have been steadily building their commercial and industrial portfolios now face a practical decision: modify their strategy or find a different charter that would give them wider authority to make commercial loans.\textsuperscript{32}

\textbf{b. For Credit Unions}

The Reg. Relief Act has not touched on many relief measures for credit unions included in the Credit Union Regulatory Improvements Act (CURIA), which will be introduced for the Senate’s consideration next year.\textsuperscript{33} Among other things, CURIA seeks to raise the cap on member business lending, implement a risk-based capital approach, and address the issue of the growing number of credit union conversions to mutual savings banks.\textsuperscript{34}

\textsuperscript{27} Goodwin Procter, Financial Services Alert, \textit{supra} note 18.
\textsuperscript{28} Id.
\textsuperscript{30} Id.
\textsuperscript{31} Id.
\textsuperscript{32} Id.
\textsuperscript{33} Roberts, \textit{Reg Relief Bill}, \textit{supra} note 15.
\textsuperscript{34} Roberts, \textit{Election}, \textit{supra} note 24.
B. Credit Union Conversions to Mutual Savings Organizations and Thrifts

About 30 credit unions have converted to thrifts in the last decade, and the number continues to grow. There are a variety of reasons that might lead to a charter conversion decision, including new strategic initiatives, changing market demographics, as well as financial and regulatory considerations.

Credit unions undergoing conversions are subject to specific regulatory requirements regarding notice, voting procedures, and limits on financial compensation to directors and senior management. A converting credit union must also receive a prior approval from the chartering agency to which jurisdiction the credit union seeks to convert. If a converted mutual savings association later elects to proceed to a mutual-to-stock conversion, even stricter regulations govern these second-step transactions. The regulations include “required pre-conversion meetings with the OTS, detailed requirements regarding the plan of conversion, member votes, proxy solicitations, restrictions and limitations in the offering and sale of the converting institution’s stock, and post-conversion obligations.”

1. The Debate

Supporters of credit union conversions to mutual savings institutions see it as an appropriate business choice that would allow credit unions “to gain [the] ability to raise capital for growth and expansion at a future date.” Growth could be achieved “either through the formation of a mutual holding company or the total conversion to a stock-owned institution, diversifying the institution’s customer-member base, or entering new lines of business, which may be restricted under the institution’s existing credit union charter.” Another potential benefit of conversions is the generally lower minimum capital requirement for FDIC-insured depository

36 Id.
37 Id.
38 Id.
39 Id.
40 Id.
41 Id.
42 Theriault, supra note 14.
institutions, which is a competitive concern for credit unions.\textsuperscript{43} The advocates of conversions point to the recent bankruptcy filing by Centrix Financial of Denver, the nation's largest credit union subprime lender, as an example of the inherent pressures facing the credit union industry and the importance of keeping the conversion option available to those who find it advantageous.\textsuperscript{44}

The opponents of conversions doubt the business reasons articulated in support of conversions.\textsuperscript{45} Instead, they view conversions as threats to member voting rights and the credit union charter itself.\textsuperscript{46} Some regulators and credit union advocates argue that the converting institutions have failed to adequately inform their members regarding their potential loss of control over the institution, pointing to the potential economic windfall that credit union management could receive in the event of subsequent conversion to a stock form of ownership.\textsuperscript{47} In the wake of the increasing number of recent conversions, the National Credit Union Administration and Congress have been gradually toughening the compliance requirements for converting institutions.\textsuperscript{48}

2. **Actual Trends**

a. **Community Credit Union Converted to Viewpoint Bank**

The credit union convert Viewpoint Bank has been highly successful in its new capacity as a publicly traded company, giving incentive to future credit union conversions.\textsuperscript{49} Viewpoint’s shares grew fifty percent in the first day of trading on the NASDAQ, creating millions of dollars in profit for former CU members and new depositors in the newly created $1.5-billion bank.\textsuperscript{50}

\textsuperscript{43} Id.  
\textsuperscript{44} Id.  
\textsuperscript{45} Briggs, supra note 9.  
\textsuperscript{46} Id.  
\textsuperscript{47} Id.  
\textsuperscript{48} Mullins, Conversion Notice, supra note 35.  
\textsuperscript{50} Id.
b. Lafayette Credit Union’s Bid to Become a Mutual Savings Bank

The main reason cited for the charter change was “the need for capital in order to make more loans, open new branches, expand to areas in Northern Virginia and continue to bring more products and services to members.”\(^{51}\) Other reasons included the need to move to a more “conductive” regulatory environment, and to expand the business loan program.\(^{52}\) Lafayette’s management assured the community that it would not make any adverse changes to terms or rates after conversion.\(^{53}\) Yet, a vocal group of members had opposed the conversion plan, “arguing that it would ultimately enrich officers and directors but was not in members’ best interests.”\(^{54}\)

The $330-million credit union’s bid to become a mutual savings bank depended on its members’ vote.\(^{55}\) Lafayette Federal Credit Union (Lafayette) mailed its disclosures and ballots to its more than 16,000 members so that they could vote on the proposal to switch to the federal mutual savings bank charter.\(^{56}\) At a meeting that took place on December 16, 2006, Lafayette’s members voted to approve the conversion by a margin of 18 voters.\(^{57}\) The fight continued after the opponents of Lafayette’s conversion urged the National Credit Union Administration to invalidate the vote due to voting irregularities.\(^{58}\) A week after the election inspector RSM McGladrey Inc. withdrew its certification of the December 16 vote, Lafayette abandoned its conversion plan.\(^{59}\)

\(^{51}\) Id.
\(^{52}\) Id.
\(^{53}\) See id.
\(^{55}\) See Mullins, Conversion Notice, supra note 35.
\(^{56}\) Carol Anne Burger, Lafayette Sends Disclosures To Members, Awaiting Vote, CREDIT UNION J., Sept. 25, 2006.
\(^{58}\) Id.
\(^{59}\) Mullins, Lafayette Retreat, supra note 54.
c. Marcy to Be Converted and Sold to Beacon Federal

Marcy Federal Credit Union (Marcy) has followed Lafayette and Sunshine State in their plans to switch charters. On June 29, 2006, Marcy, with $23 million in assets, filed an application with the OTS to convert to a mutual savings bank and then sell itself to Beacon Federal. While some banks acquire other banks in order to expand, Beacon Federal persuades credit unions to convert to thrifts and then acquires them as soon as the conversions are completed. The $539 million-asset Beacon, which was a $170 million-asset credit union before it converted to a mutual savings bank in 1999, has completed three such acquisitions since 2000.

d. Countrywide Financial Bank to Become a Thrift

Countrywide Financial Corp. plans to leave its national bank charter and move $88.9 billion of assets to a federal thrift charter. Countrywide Financial, a $195 billion-asset holding company in Calabasas, California, confirmed the planned charter switch on November 9, 2006. Interestingly, Countrywide's announcement comes on the heels of the OTS’s loss of two of its biggest thrifts – Citigroup and Capital One Financial Corp.

e. Citigroup Moves Assets from Thrift Charter to Bank

Citigroup Inc. decided to move $174 billion of assets from two thrift charters into its national bank. Citigroup kept one thrift

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60 Third CU Files to Convert to Bank, CREDIT UNION J., July 10, 2006; Carol Anne Burger, N.Y. CU Seeking Thrift Status, AM. BANKER, July 12, 2006.
62 Id.
63 Id.
64 Countrywide Is to Drop Bank Charter in Favor of OTS, AM. BANKER, Nov. 10, 2006.
65 Id.
66 Id.
67 Id.
f. Capital One Financial Plans to Shift
Assets from Thrift to Bank

Capital One Financial Corp. in McLean, Virginia is planning to move most of its retail banking assets into a nationally chartered bank.69

C. Other Developments

1. Hurricanes

Credit union regulators continue to make adjustments to examination practices for hurricane-affected credit unions.70 “At least 10 credit unions have reported significant problems arising from the storms.”71 The federal banking, thrift and credit union regulatory agencies, along with the state supervisory authorities in Alabama, Louisiana and Mississippi, came up with guidance for their examiners outlining the supervisory practices to be followed in assessing the financial condition of hurricane-hit financial institutions.72 In the joint-issued statement, the agencies outlined the potential problems that may confront credit unions in the devastated areas, including “loan quality issues caused by business failures, interruptions of borrowers’ income streams, increases in borrowers’ operating costs, the loss of jobs as well as uninsured or under insured collateral damage.”73 In devising the “supervisory response,” if any, to the resulting lower CAMEL ratings, the examiners were urged to consider the degree to which credit unions’ poor performance was caused by external factors.74
2. **OTS Alters Its Risk Rate Model**

The OTS has announced the first of many changes to come to its interest rate model.\textsuperscript{75} The model promises to give thrifts “greater transparency and accessibility, expanded interest rate risk reports, and greater accuracy in pricing routines for single-family mortgages and financial derivatives.”\textsuperscript{76}

3. **Security**

Hundreds of credit unions are rushing to meet “a year-end deadline for implementation of a multi-factor security system for authentication of online users.”\textsuperscript{77} Under a directive passed by all bank, thrift and credit union regulators, “federally insured institutions must institute a multi-factor authentication system for all high-risk online transactions.”\textsuperscript{78}

D. **Conclusion**

The most significant event of 2006 in the world of thrifts and credit unions was the passage of the Financial Services Regulatory Relief Act. The bill outlined a number of beneficial provisions for credit unions and thrifts, as well as vital issues which Congress is set to address in the future. The year was also notable for a growing number of credit union conversions to mutual savings organizations and banks and for the controversy surrounding this issue.

Anna Nazarenko\textsuperscript{79}

\textsuperscript{76} Id.
\textsuperscript{78} Id.
\textsuperscript{79} Student, Boston University School of Law (J.D. 2008).
XVI. BUSINESS BANKRUPTCIES

While analysts predicted that 2006 would see an increase in bankruptcies, the number of U.S. corporate filings was down significantly.\(^1\) In the first quarter, filings dropped 15% from 2005 levels.\(^2\) However, there were a number of large asset bankruptcies. This article will discuss the factors surrounding those bankruptcies and the possible fate of the debtors while in bankruptcy.

The only company that filed for bankruptcy claiming over $1 billion in assets was Dana Corporation.\(^3\) Their bankruptcy added to the list of auto parts suppliers in chapter 11, which also includes Delphi, Tower Automotive, Collins & Aikman and, as of October 30, Dura.\(^4\) Tower Records, filing once again for chapter 11 bankruptcy, will be liquidated by Great American Group – the highest bidder.\(^5\) The international bankruptcy which captured the world’s attention in 2006 was Russian oil company Yukos, the company formerly run by Mikhail Khodorkovsky, who is now in jail on tax evasion charges.\(^6\) Other notable companies entering bankruptcy this year are liberal radio station Air America, hardware maker Silicon Graphics, bottled water company Le-Nature, shipping company Sea Containers Limited, Mexican space operations company SatMex and OCA, a dental supply company.

A. Tower Records

Tower Records filed for bankruptcy for the second time on August 20, 2006.\(^7\) The first time was in 2004, when the company successfully persuaded bondholders to forgive much of their debt in


\(^3\) Johnson, supra note 1.


exchange for an 85% stake in the company. But in 2005, revenue decreased by $46.1 million due to competition from online retailers and discount chains. The parent company MTS declared a goal to sell the company on October 5, 2006. MTS hired bankruptcy specialist James D’Amico as the CEO and set the course for restructuring. While MTS initially didn’t want to close any of the 89 stores, management decided to sell out to the highest bidder. On October 5, Great American Group bought the company, planning to liquidate it. A Delaware bankruptcy court approved the sale despite a bid by Trans World of only $500,000 less, which would have kept the company up and running. There was, however, some doubt regarding the extent of the business that Trans World would keep open since they refused to be specific about the fate of specific stores. Three thousand jobs will be lost, and all 89 stores closed due to the liquidation.

B. Dana Corporation

On March 3, 2006, the auto parts supplier Dana Corp. filed for bankruptcy. The company had assets of $7.9 billion and liabilities of $6.8 billion. The bankruptcy’s causes are largely attributed to the cuts at GM and Ford, their major customers, due to the increased competition from overseas carmakers.

The Dana bankruptcy proceedings have yielded an answer to a lingering question about the new bankruptcy code that went into effect last October. The new code put severe restrictions on key employee retention programs (KERPs). KERPs are payments made to management in order to induce them to stay with the company.

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8 Chase, supra note 5.
9 Schweitzer, supra note 7.
10 id.
11 id.
12 Yuki Noguchi, A Broken Record Store, WASH. POST, Aug. 23, 2006, at D01.
13 Chase, supra note 5
14 id.
15 id.
16 id.
17 id.
19 Hines, supra note 4.
20 id.
21 Floyd Norris, Pay Plan at Dana Ruled Illegal, N.Y. TIMES, Sept. 6, 2006, at C1.
22 id.
company through bankruptcy, but their sometimes extravagant amounts convinced Congress that they should be capped, and only be available when there is a legitimate job offer from another corporation.\textsuperscript{23} Dana’s chapter 11 plan attempted to get around this provision by creating an incentive bonus plan rather than making flat out payments.\textsuperscript{24} However, the targets were set so low that they were effectively KERPs. The judge, saying that Dana’s incentive plan “walks like a duck (KERP) and quacks like a duck (KERP),” shot down incentive bonus plans with extremely low thresholds.\textsuperscript{25} The judge went on to say, however, that just because payments may have a positive effect on retention does not mean that they are contrary to Congress’s intent.\textsuperscript{26} This ruling is contrary to that on a similar payment plan in the Calpine bankruptcy (Calpine also filed under the new bankruptcy code)\textsuperscript{27} but the opinion distinguishes the two in that Calpine’s retention payment plan was undisputed by the creditors.\textsuperscript{28}

Carl Icahn, a private investor, acquired over $100 million of Dana’s unsecured debt.\textsuperscript{29} It is believed that he did so because of the influence that unsecured debt can have on a creditor’s committee, therefore assuring that the debt is a high priority repayment even though the shares themselves rarely have much value.\textsuperscript{30}

\section*{C. Dura}

Another auto parts supplier that filed for bankruptcy in 2006 was Dura automotive systems.\textsuperscript{31} It was suspected Dura would file for bankruptcy when it hired the same restructuring firm in August of 2006 that Dana hired one month before it filed for bankruptcy.\textsuperscript{32} Dura filed on October 30, 2006 with $1.2 billion in revenue for the

\begin{footnotes}
\item[24] Norris, \textit{supra} note 21.
\item[25] In re Dana Corp., 351 B.R. at 102.
\item[26] Id. at 103.
\item[27] Id.
\item[28] Id.
\item[30] Id.
\end{footnotes}
first half of the year and a corresponding loss of $138 million. The company arranged for $300 million in debtor-in-possession financing. Management said that it did not want to restructure the corporation’s debt with trade creditors. Hedge funds which own $225 million of Dura’s debt stated that the new loan impinges upon their rights as creditors, because the approximately $175 million of new debtor-in-possession financing is to be secured by the company’s assets, thus giving the new loan a higher priority than the hedge fund’s debt.

D. Yukos

The international bankruptcy of Yukos, the Russian oil giant, was steeped in political controversy. Creditors, led by Societe General Bank, brought the involuntary bankruptcy petition in Russia on March 10, 2006. The other creditors include Rosneft, the state run oil giant, and the Russian federal tax service. The Russian bankruptcy came on the heels of a refusal by American bankruptcy courts to take jurisdiction over Yukos’s bankruptcy in 2005. The earlier voluntary petition was denied because the U.S. courts decided that Russian courts would be best suited to handle the Yukos bankruptcy due to the location of most of their operations. The Yukos bankruptcy, underway in Russia, is a liquidation bankruptcy (similar to a Chapter 7 bankruptcy in the United States), in which the business’ assets are liquidated and no attempt at restructuring is made.

33 Dura Files, supra note 31.
35 McCracken & Kosdrovsky, supra note 32.
37 Catherine Belton, Yukos Bankruptcy Case To Kick Off, MOSCOW TIMES, March 28, 2006, at 5.
40 Id.
41 Torbakov, supra note 38.
Since oil prices were at all time highs when Yukos went into bankruptcy, it is considered likely that some corruption on behalf of the Russian government led to its downfall.\textsuperscript{42} Khodorkovsky was a major political rival of Vladimir Putin, the Russian leader.\textsuperscript{43} Many now fear that the assets of Yukos will be significantly discounted and sold off to government owned companies such as Rosneft, which has already tripled its output by acquiring a former Yukos subsidiary.\textsuperscript{44} Rosneft is on track to become the largest oil supplier in Russia if they acquire more of Yukos’ former assets, which will further expand the power of the Kremlin in the world energy markets.\textsuperscript{45}

E. Air America

On October 13, 2006, Air America, the self-proclaimed liberal radio station, filed for Chapter 11 bankruptcy.\textsuperscript{46} The company claimed assets of only $4 million and liabilities of $20 million.\textsuperscript{47} The announcement came after talks with major creditor, MultiCultural Radio Broadcasting, ended with Air America’s bank accounts being frozen.\textsuperscript{48} Air America posted losses of $19.6 million in 2005 and $13.1 million as of their filing in 2006.\textsuperscript{49} Al Franken, who was the best known voice of the station, is among the creditors.\textsuperscript{50} Air America will reportedly remain on the air during chapter 11.\textsuperscript{51}

F. Silicon Graphics

On May 8, 2006, Silicon Graphics ("SGI"), which manufactures servers and workstations for the graphics industry,
including graphics for Hollywood,\textsuperscript{52} announced that it had reached agreements with its creditors that will reduce its debt by $250 million.\textsuperscript{53} The Wall Street Journal reported that “a group of bondholders agreed to trade their debt for a stake in the company.”\textsuperscript{54} The plan still requires approval, but the bondholders are set to acquire 25\% of the company with the option of buying the remaining 75\% after restructuring.\textsuperscript{55} The bondholders will also dedicate another $70 million of financing during the bankruptcy.\textsuperscript{56} The Chapter 11 filing reports assets of $369.4 million and liabilities of $664.3 million.\textsuperscript{57}

SGI plans on emerging from bankruptcy within six months.\textsuperscript{58} The bankruptcy has only affected the U.S. arm of the company and not the foreign subsidiaries.\textsuperscript{59} SGI assembled a new management team and implemented cost cutting measures\textsuperscript{60} that allowed them to save $100 million annually.\textsuperscript{61} This is the company’s third restructuring attempt.\textsuperscript{62} In 2000, the company planned to move away from the supercomputers market and deeper into the more focused area of digital content creation for technical and scientific projects, such as the Lord of the Rings movie.\textsuperscript{63} The company has continued to experience losses, however, and its stock was delisted by the NYSE in 2005.\textsuperscript{64} Upon the announcement of this most recent bankruptcy, SGI’s shares dropped 81\%,\textsuperscript{65} sinking its market

\textsuperscript{55} \textit{id.}
\textsuperscript{56} \textit{id.}
\textsuperscript{57} \textit{id.}
\textsuperscript{58} SGI Press Release, \textit{supra} note 53.
\textsuperscript{59} \textit{id.}
\textsuperscript{60} \textit{id.}
\textsuperscript{61} \textit{id.}
\textsuperscript{62} Kawamoto, \textit{supra} note 52.
\textsuperscript{63} \textit{id.}
\textsuperscript{64} \textit{id.}
\textsuperscript{65} Fitzgerald, \textit{supra} note 54.
capitalization to only $16.6 million. This may present a ripe takeover opportunity. But interest in keeping the company afloat is unlikely because the third quarter sales this year were down 32%. One of the reasons for the bankruptcy seems to be that companies are no longer willing to pay for large super computers, and competition from other manufacturers has limited SGI’s ability to break into the smaller server market.

G. Le-Nature

One shocking bankruptcy threatens to send a chill through debt markets and the high profit world of private equity. Le-Nature Inc., a bottled water company, was forced into bankruptcy by its creditors on November 1, 2006 after revelations that a massive fraud may have been taking place. The court appointed custodian, Kroll Zolfo Cooper, discovered two different sets of books. Kroll Zolfo Cooper also discovered, as reported in their affidavit, that while reported annual revenue was $275 million, it may have been as low as $32 million. Le-Nature has $428 million of debt outstanding. Its creditors include AIG, CIT Group and Pitney Bowes. Le-Nature’s $150 million in bonds were down 85% as of November 7, 2006 since the custodian took charge on October 27. The discovery came when AIG, which was providing equipment financing to Le-Nature, sent a representative to the equipment manufacturer in Germany. Although $26 million had already been sent to the factory, little equipment had been prepared for Le-Nature. Paperwork allegedly shown to AIG revealed that the

68 Burt, supra note 66.
70 Id.
71 Id.
72 Id.
73 Id.
74 Id.
75 Id.
76 Id.
equipment manufacturer had been funneling most of the money to Le-Nature.\textsuperscript{77}

This apparent fraud spotlights the easy access to debt markets, and the corresponding lack of due diligence which may accompany that easy access.\textsuperscript{78} Wachovia, which doesn’t answer questions about client matters, is Le-Nature’s investment bank.\textsuperscript{79} Relying largely on a memorandum prepared by Wachovia, a $1.2 billion sale of Le-Nature almost went through in 2005 on a bid by a different private equity firm.\textsuperscript{80} Forty five percent of Le-Nature is currently owned by two private equity firms, which were apparently unaware of the fraud taking place. The man suspected to be behind the alleged fraud is CEO Gregory Podlucky, who founded the company in 1989.\textsuperscript{81}

The massive reduction in the price of Le-Nature’s credit has prompted some to buy in. Le-Nature does own a large amount of real property and equipment.\textsuperscript{82} There are also speculators buying debt for the sole purpose of future litigation—planning to accuse Le-Nature of failing to disclose material information.\textsuperscript{83}

\section*{H. Sea Containers Limited}

On October 16, 2006, Sea Containers limited filed for bankruptcy.\textsuperscript{84} This follows its delisting from the NYSE after failing to keep current reports.\textsuperscript{85} Its immediate reason for filing for bankruptcy was the failure to pay a $115 million bond.\textsuperscript{86} The United Kingdom, where Sea Containers has substantial operations and pension obligations, issued a warning through its pension regulator that it may force the company to pay into U.K. pension funds.\textsuperscript{87}

\begin{thebibliography}{999}
\bibitem{77} Id.
\bibitem{78} Id.
\bibitem{79} Id.
\bibitem{80} Id.
\bibitem{81} Id.
\bibitem{82} Id.
\bibitem{83} Id.
\bibitem{84} Sea Containers Files for Bankruptcy, BigNewsNetwork.com, Oct. 16, 2006, available at http://www.hongkongnews.net/story/a9bc34ed1d13f1f4f.
\bibitem{86} Sea Containers Files, supra note 84.
\end{thebibliography}
Containers responded by saying that there was no reason for the warning because they are in the process of negotiation and restructuring.\textsuperscript{88} The announcement by the U.K.’s pension regulator has signaled that it may be willing to use its power to force companies to pay pensions.\textsuperscript{89} It also shows that the regulator is not afraid to enforce its rights against a foreign corporation, in this case a Bermuda corporation.

\section{SatMex}

On February 7, 2006, the creditors of SatMex reached an agreement that would allow the company to carry on its operations while repaying its debt.\textsuperscript{91} On June 29, 2005, the Mexican company SatMex filed for bankruptcy under Mexican law.\textsuperscript{92} SatMex is a satellite fleet operator attempting to raise money to launch a satellite which has already been built.\textsuperscript{93} U.S. creditors, who are willing to put an additional $55 million into the company to launch the new satellite, are trying to involuntarily force SatMex into bankruptcy in the U.S. under chapter 11. The creditors desire U.S. bankruptcy law because it is unclear whether the $55 million in debtor-in-possession financing is allowable under Mexican law.\textsuperscript{94} It is also unclear whether U.S. courts will be willing to exercise jurisdiction over the bankruptcy when proceedings are already underway in Mexico, seemingly at the preference of the debtor.\textsuperscript{95} The Mexican government, a major creditor of SatMex, has allegedly pressured the company to remain in bankruptcy in Mexican courts so that their claims remain a priority.\textsuperscript{96} American creditors were puzzled about such pressure since it came after creditors agreed to give the Mexican government first priority as creditor and inject new money into the company.\textsuperscript{97} In February 2006, an agreement was reached to give

\begin{thebibliography}{97}
\bibitem{88} Id.
\bibitem{89} Id.
\bibitem{90} Id.
\bibitem{93} Id.
\bibitem{94} Id.
\bibitem{95} Id.
\bibitem{96} Id.
\bibitem{97} Id.
\end{thebibliography}
debt holders collateral in the company, thereby allowing SatMex to temporarily forego its debt repayment and launch the satellite. The launch, however, was not enough to keep the creditors from filing for bankruptcy once again on September 19, 2006, this time in U.S. court.

J. OCA

On March 15, 2006 the orthodontic services company OCA filed for chapter 11 protection. They are facing lawsuits from orthodontists who say OCA failed to live up to their business agreements. The company will receive $15 million of financing from Silver Point Capital to carry it through bankruptcy. There will be no disruption of benefit obligations, nor will the company attempt to break any commitments to customers.

Mike Levin

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98 SatMex Bankruptcy, supra note 91.
101 Id.
102 Id.
103 Id.
104 Student, Boston University School of Law (J.D. 2008).
XVII. BANKRUPTCY REFORM IMPLEMENTATION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (‘‘BAPCPA’’)\(^1\) was signed into law on April 20, 2005.\(^2\) Most of the significant portions of the Act became effective on or after October 17, 2005.\(^3\) Therefore, decisions interpreting these important provisions of BAPCPA were generally rendered in 2006. Two heavily litigated areas of interest to practitioners included cases involving constitutional and legal challenges to certain provisions of the BAPCA\(^4\) and cases concerning the implementation of the Credit Counseling Requirements now contained in § 109(h) of the Bankruptcy Code.\(^5\)

A. Significant Constitutional and Legal Challenges to the BAPCPA

1. Section 526(a)(4) – Prohibiting Advice to Incur More Debt in Contemplation of Bankruptcy

The provisions of § 526 of the Bankruptcy Code were added as part of the BAPCPA in an attempt to regulate the conduct of attorneys and others who assist potential debtors in filing for

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\(^3\) Id.

\(^4\) See In re Hedquist, 342 B.R. 295 (B.A.P. 8th Cir. 2006) (holding that provisions requiring credit counseling only for individual debtors do not violate equal protection); Zelotes v. Martini, 352 B.R. 17 (D. Conn. 2006) (holding that Attorneys are subject to § 526(a)(4) and therefore § 526(a)(4) is facially unconstitutional because it chills attorney free speech within the attorney client relationship); Olsen v. Gonzales, 350 B.R. 906 (D. Or. 2006); Hersh v. United States, 347 B.R. 19 (N.D. Tex. 2006) (same); Geisenberger v. Gonzales, 346 B.R. 678 (D. Pa. 2006) (holding that Attorneys lack standing to challenge constitutionally of § 526(a)(4) until there is an enforcement action against them); In re Tomco, 339 B.R. 145 (Bankr. W.D. Pa. 2006) (holding the Credit Counseling requirements meet rational basis test); In re McKittrick, 349 B.R. 569 (Bankr. W.D. Wis. 2006) (holding change in length between allowed discharges from 6 to 8 years is constitutional, even if previous discharge was obtained between 6 and 8 years ago before change in law).

bankruptcy protection. Specifically, § 526(a)(4) provides that no debt relief agency may advise a client to take on additional debt, including the payment of legal fees to an attorney or petition preparer, if the agency is aware that the client is contemplating becoming a debtor under the bankruptcy code.

In several cases, attorneys practicing in the bankruptcy field have challenged the constitutionality of this provision, arguing that it chills protected speech between attorney and client and is both over and under inclusive. Two clear lines of cases have emerged. One line holds that attorneys lack standing to raise a facial challenge to § 526(a)(4). However, a majority of the courts considering the issue have found that practicing bankruptcy attorneys do have standing and that § 526(a)(4) is unconstitutional on its face. Further, it should also be noted that at least one early decision from late 2005 concluded that bankruptcy attorneys are not debt relief agencies and therefore § 526(a)(4) is inapplicable to their conduct. This conclusion has been almost universally rejected by other courts considering the issue.

Those courts holding that attorneys lacked standing have generally looked to the lack of threatened enforcement. One court noted:

"Quite simply, the threat of enforcement against the plaintiff must be "real and immediate." Here, the complaint fails to satisfy even the first requirement because there is no reference to a "feared future event." Additionally, Geisenberger did not allege he sustained or is in imminent danger of suffering an economic loss from the enactment of the BAPCPA..."
provisions he requests this Court declare unconstitutional.\textsuperscript{14}

Therefore the Court dismissed the complaint, holding that there was no Article III case or controversy and the plaintiff attorney was merely seeking an advisory opinion.\textsuperscript{15}

As noted above, however, a majority of the courts considering similar challenges have rejected this argument and found that standing does in fact exist.\textsuperscript{16} Challenges to § 526(a)(4) have been grounded on the theory that the provisions of § 526(a)(4) chill attorney speech to their clients and therefore § 526(a)(4) violates the First Amendment.\textsuperscript{17} In \textit{Hersh v. U.S.}, the U.S. District Court for the Northern District of Texas noted that the threatened suppression of speech itself was sufficient to give the challenging attorney standing.\textsuperscript{18} The U.S. District Court for the District Oregon in \textit{Olsen v. Gonzales} found that the plaintiff had standing to challenging § 526(a)(4) because of the “asserted chilling effect.”\textsuperscript{19}

Those courts which have found standing exists have been unanimous in concluding that § 526(a)(4) is unconstitutional.\textsuperscript{20} Another threshold question, concerning the proper standard of review, has also confronted these courts.\textsuperscript{21} The plaintiffs have argued for strict scrutiny, while the government has argued that the less onerous balancing standard announced by the Supreme Court in \textit{Gentile v. State Bar of Nevada}\textsuperscript{22} for First Amendment questions involving attorney ethical principles should apply.\textsuperscript{23} To only one court has this mattered. In \textit{Milavetz, Gallop & Milavetz, P.A. v. U.S.}, the U.S. District Court for the District of Minnesota rejected the \textit{Gentile} balancing test as the proper standard of review on the

\textsuperscript{14} Id.
\textsuperscript{15} Id. at 683.
\textsuperscript{16} See \textit{Olsen}, 350 B.R. at 913-16.
\textsuperscript{17} \textit{Id. See also} \textit{Hersh v. United States}, 347 B.R. 19, 22 n. 3 (N.D. Tex. 2006); \textit{Zelotes v. Martini}, 352 B.R. 17, 21-22 (D. Conn. 2006)
\textsuperscript{18} \textit{Hersh}, 347 B.R. at 22 n. 3 (citing Center for Individual Freedom v. Carmouche, 449 F.3d 655, 659-660 (5th Cir.2006)).
\textsuperscript{19} \textit{Olsen}, 350 B.R. at 915 (the Court dismissed the remaining claims for lack of standing).
\textsuperscript{21} Id.
\textsuperscript{23} See \textit{Milavetz}, 2006 WL 3524399 at *3.
grounds that no discernible ethical principle was evident from the face of the statute.\footnote{Id.}

The remaining courts have held that the statute fails constitutional muster even under the more lenient \textit{Gentile} balancing test.\footnote{See, e.g., \textit{Zelotes}, 352 B.R. at 22.}

The \textit{Hersh} court held:

\begin{quote}
Section 526(a)(4), therefore, is over-inclusive in at least two respects: (1) it prevents lawyers from advising clients to take lawful actions; and (2) it extends beyond abuse to prevent advice to take prudent actions. Thus, section 526(a)(4) of the BAPCPA imposes limitations on speech beyond what is “narrow and necessary.”\footnote{\textit{Hersh} v. United States, 347 B.R. 19, 25 (N.D. Tex. 2006).}
\end{quote}

Further, at least one court has suggested that Section 526(a)(4) is not only over-inclusive, but under-inclusive as well, because it permits non-profits to give the same advice the statute prohibits for-profits to give.\footnote{\textit{Olsen} v. Gonzales, 350 B.R. 906, 916 (D. Oregon 2006).}

2. \textbf{Section 527 – Disclosure Requirements}

Several attorneys challenging § 526(a)(4) have also challenged § 527’s new disclosure requirements.\footnote{\textit{Hersh}, 347 B.R. at 25-27; \textit{Olsen}, 350 B.R. at 917-19.}

In summary, § 527 requires that “debt relief agencies” provide a detailed statutory notice, setting forth the responsibilities of the debtor in each chapter of bankruptcy, including the information needed to file a bankruptcy case, and the rights of the debtor to represent themselves or seek assistance from an attorney or a non-attorney bankruptcy petition preparer.\footnote{11 U.S.C. § 527 (Supp. 2006). § 527(b) sets forth the required notice in detail.}

Challenges to this provision have centered on whether the statute impermissively compels speech.\footnote{\textit{Hersh}, 347 B.R. at 25-27; \textit{Olsen}, 350 B.R. at 917-19.}

The leading opinion in the matter rejected this claim, holding:

\begin{quote}
In the case at hand, section 527 advances a sufficiently compelling government interest and does
not unduly burden either the attorney-client relationship or the ability of a client to seek bankruptcy. The government clearly has a legitimate interest in attempting to ensure that a client is informed of certain basic information before he or she commences a case in bankruptcy. The amount of debt discharged by bankruptcy in a given year can be tens of billions of dollars, and as among consumer creditors, attorneys, and their debtor clients, the consumer debtor is often at an informational disadvantage. Thus, the government interest is significant. Given that significant interest, the compelled speech of section 527 is a reasonable burden. 31

Therefore, courts have found that § 527 is narrowly tailored to achieve a compelling government interest and the section survives even strict scrutiny. 32

3. Amendments to Section 727(a)(8) – Extending the Period Between Discharges to Eight Years

Prior to the adoption of the BAPCA, § 727(a)(8) provided that a debtor may not obtain a discharge if he had previously obtained a discharge within the past six years. 33 The BAPCA extended this period to eight years. 34 At least one challenge has arisen to this change, arguing that change retroactively impairs a substantive right. 35 However, that challenge was rejected. 36 The court in In re McKittrick held that while the change implicated past conduct, the statute operated prospectively only to future bankruptcy filings. 37 In reaching this conclusion, the Bankruptcy Court for the Western District of Wisconsin noted:

Legislative enactments frequently alter the expectations of various parties. When she received

31 Hersh, 347 B.R. at 27 (internal citations omitted).
33 See In re McKittrick, 349 B.R. 569, 570 (Bankr. W.D. Wis. 2006).
34 Id. at 570-71; See also 11 U.S.C. § 727(a)(8) (Supp. 2006).
35 McKittrick, 349 B.R. at 571.
36 Id. at 571-72.
37 Id. at 572.
her discharge in 1999, the debtor may well have known that § 727(a)(8), as written at the time, provided that she could not receive another chapter 7 discharge for six years. That does not mean she suddenly obtained the absolute right to file such a case, or that Congress was incapable of modifying her ability to do so. . . Congress is free to prospectively modify her ability to receive a subsequent bankruptcy discharge at some future point, even if that modification is based upon her prior conduct. Just as the taxpayer who faces the loss of a tax deduction for future years when Congress passes legislation which eliminates it, the debtor in the present case must accept Congress's power to prospectively modify her ability to file future bankruptcy cases.38

Therefore, previous filers cannot prospectively rely on a previous version of the statute.39

4. Section 109(h) – Credit Counseling Requirements

With certain exceptions, § 109(h), added as part of the BAPCA amendments to the Bankruptcy Code, requires that:

[A]n individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.40

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38 Id. at 571-72
39 Id.
The statute provides that those persons who have an exigent circumstance satisfactory to the court and who have not been able to receive the required counseling within five days of a request may still file a petition, and shall have an additional thirty days to complete the counseling (or 45 days if an additional extension is granted by the court). Further, persons serving in an active combat zone, or suffering from a disability or incapacity are exempt. Finally, those persons living in a judicial district where the United States Trustee has determined that credit counseling services are not adequately available are exempted from compliance prior to filing.

Several constitutional challenges have been raised to enforcement of the credit counseling provisions. However, these challenges have been consistently rebuffed by the courts, including at least one Bankruptcy Appellate Panel (BAP).

At least one complaint alleged that § 109(h) violated equal protection by singling out the individual debtor as opposed to corporate debtors, who are not included within § 109(h)’s reach. But as the Eighth Circuit’s BAP noted, corporate and individual debtors are not similarly situated, and therefore, there is no equal protection question to be raised. Further, the BAP held that individual debtors are not a suspect class, and therefore the statute need only pass the rational basis test. The Court in In re Tomco found the following argument compelling for why the credit counseling requirement meets the rational basis standard:

The rational basis for the 2005 Act's credit counseling provision is Congress' expectation that debtors be proactive with their financial problems. The new provisions to the Bankruptcy Code are thus intended to force individuals to obtain education and counseling regarding both the consequences of filing.

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46 Hedquist, 342 B.R. at 299-300.
47 Id. at 299.
48 Id.
49 Id. at 300.
for bankruptcy and the non-bankruptcy alternatives available to the debtor to rebuild his or her financial health. Ms. Tomco has not come forward with any evidence to suggest that the Congressional justifications for the credit counseling provisions of the 2005 Act are irrational. This Court therefore determines that there is a rational legislative basis for the 2005 Act's credit counseling provisions, and such provisions do not violate the Constitution.  

For this reason, courts have upheld the credit counseling requirement against constitutional challenges. However, other issues have arisen in the implementation of the credit counseling requirements as discussed below.

B. Issues in the Implementation of the Credit Counseling Requirement

1. Remedy for Failure to Comply

As noted in the prior section on the constitutionality of the credit counseling requirements contained in § 109(h), the changes made by the BAPCA have mandated that all but a few individual debtors must obtain pre-filing credit counseling. While the credit counseling requirement appears straightforward on its face, the remedy for failing to comply is apparently not so straightforward. At the outset, it appears courts disagree with the nature of the requirement, with some holding that the requirement is a jurisdictional prerequisite, and others finding it to be only a condition of eligibility. The nature of the requirement in turns affects the remedy chosen for a failure to meet the requirement. A majority of the courts, including both appellate panels considering the issue, have held that § 109(h) is an eligibility requirement, and the failure to meet the credit counseling

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50 Tomco, 339 B.R. at 157.
51 Id.; Hedquist, 342 B.R. at 300.
54 See Id.
requirement requires a dismissal of the petition.\textsuperscript{55} Those courts holding that § 109(h) is an eligibility, rather than jurisdiction prerequisite, have looked at the practical problems with striking the petition as void, such as the effect on the automatic stay,\textsuperscript{56} and actions by the trustee prior to the court's determination of the ineligibility of the debtor.\textsuperscript{57} These courts have been concerned with the uncertainty created by a later declaration that the petition is void:

Treating an ineligible debtor's case as filed and dismissing it avoids serious problems that treating a petition as void \textit{ab initio} or as failing to establish jurisdiction creates. Laying aside the question of whether an ineligible debtor should be able to rely on the facial validity of a petition filed to initiate a bankruptcy case, creditors and other parties in interest have a considerable interest in being able to rely on the existence of a case, the bankruptcy court's jurisdiction, and the validity of actions taken in the case.

If every case is subject to being dismissed as void \textit{ab initio} at a later time, creditors and other parties will face enormous uncertainty. They will not know whether a valid case exists without investigation. Even after review of the record reveals the absence of any proof of compliance with § 109(h), they still will not be sure that the debtor is ineligible, because the debtor may in fact have met the requirements but not perfected the record. Conversely, they will not know that the debtor is eligible even if the record on its face shows compliance with § 109(h); under the void \textit{ab initio} result, the petition of an ineligible debtor must be stricken if the debtor in fact was not eligible but had erroneously shown that she was.\textsuperscript{58}

\textsuperscript{55} Hedquist, 342 B.R. 300-01; In re Dixon, 338 B.R. 383, 389 (B.A.P. 8th Cir. 2006) (although noting that the exact remedy was not put at issue by the parties); In re Seaman, 340 B.R. 698, 707-08 (Bankr. E.D.N.Y. 2006); Ross, 338 B.R. at 136-38.
\textsuperscript{56} Seaman, 340 B.R. at 707.
\textsuperscript{57} Ross, 338 B.R. 140-41.
\textsuperscript{58} Id. at 141 (emphasis in the original).
These courts, have, however, noted the harsh results a dismissal may cause under the new amendments, which may treat with disfavor a second petition filed following a prior dismissal. At least one court has noted that the debtors whose prior case was dismissed are not without relief, as a good faith debtor may be able to seek relief from certain provisions affecting a second filing.

Some courts have found that § 109(h) imposes a jurisdictional prerequisite, the failure of which to be met requires the petition to be struck. One of these courts has argued that the automatic stay is in fact triggered and remains effective even though the petition may later be stricken, because the petition is not void, rather it fails to create a proper case:

This Court holds that petitions filed by ineligible § 109(h) debtors are not void ab initio, but in fact trigger the imposition of the automatic stay and the stay remains in place until it is later modified or the proceeding is closed. By so finding, the “substantial uncertainty” for creditors and debtors alike is minimized. Given the typically short lapse of time between filing and closing in this district, few acts have the opportunity to transpire so as to cause “substantial uncertainty”. However, a "case" has not “commenced” until it is determined that the debtor filing the petition is eligible for bankruptcy relief under § 109(h). In the event the debtor is determined to be ineligible under § 109(h), the petition is stricken; there was no “case” to “dismiss”. And, if there was no “case” to “dismiss”, then there could not have been a “pending case”.

Nonetheless, striking the petition doesn't render it a nullity; rather, the petition retains its assigned cause number and remains on the Court's records. The petition merely fails to develop into a full, pending case, at least for purposes of §§ 362(c)(3) and (4). If the Debtors here file a

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59 See Hedquist, 342 B.R. at 301; Seaman, 340 B.R. at 709 (noting that the automatic stay may terminate after only 30 days if the petitioner has had a prior case dismissed within the previous year).
60 Seaman, 340 B.R. at 709.
61 In re Thompson, 344 B.R. 899, 906-07 (Bankr. S.D. Ind. 2006); In re Carey, 341 B.R. 798, 803-04 (Bankr. M.D. Fla. 2006).
subsequent petition within a year and meet the §
109(h) criteria, the petition filed under this cause
number will not count as a “case pending and
dismissed” for §§ 362(c)(3) and (4) purposes.

Of those courts determining that credit counseling is a
jurisdictional prerequisite, the approach of the Bankruptcy Court for
the District of Columbia appears unique. In considering the nature of
the credit counseling requirement, the Court concluded that the
requirement is of a jurisdictional nature. However, the Court
determined that a petitioner must only make a “colorable” showing
of jurisdiction in order to invoke the Bankruptcy Court’s subject
matter jurisdiction. Should a party later discover that the
petitioner’s “colorable” showing was in error or not correct, then a
motion to dismiss would in fact be proper. This too would
apparently allay concerns about the effectiveness of the automatic
stay.

2. What Constitutes Exigent Circumstances
Triggering the 30-day Waiver?

As noted under Section B(4) above, the statute provides that
those persons who have an exigent circumstance satisfactory to the
court and who have not been able to receive the required counseling
within five days of a request may still file a petition and shall have an
additional 30 days to complete the counseling (or 45 days if an
additional extension is granted by the court). Therefore, it is of no
surprise that what constitutes an exigent circumstance has also been
the subject of litigation.

Several courts have held that an impending foreclosure is not
an exigent circumstance that would trigger the 30 day delay in
obtaining credit counseling, but one court has found that impending

62 Thompson, 344 B.R. at 907-08 (emphasis in the original) (footnotes omitted).
64 Id. at 647-48.
65 Id. at 648.
67 In re Hedquist, 342 B.R. 295, 298 (B.A.P. 8th Cir. 2006); In re Dixon, 338 B.R.
383, 388-89 (B.A.P. 8'h Cir. 2006).
creditor action is in fact an exigent circumstance. 68 An attorney’s mistake is generally not an exigency, however, a medical emergency on the part of the debtor’s counsel which necessitates a premature filing before the credit counseling can be completed has been found to constitute an exigent circumstance. 69 In addition, the debtor’s counseling by a regular credit counseling agency has been found to be exigent circumstance if the agency failed to inform the debtor that they could not produce the required certificate because they were not certified as a bankruptcy counselor by the local United State Trustee. 70

Adam Eric Miller 71

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68 In re Cleaver, 333 B.R. 430, 435 (“Consequently, the immediacy of the foreclosure sale in this case appears to be exactly the sort of exigent circumstance contemplated by the statute.”).


70 Id. at 498-99 (finding that the debtor was not at fault where credit counselor failed to inform debtor he was in wrong counseling and that the counselor could not produce the certificate, and the circumstance therefore could be exigent because debtor made good faith effort to comply and minimum requirements were met).

71 Student, Morin Center for Banking and Financial Law, Boston University School of Law (LL.M. 2007); J.D., summa cum laude, Oklahoma City University (2006). Member of the Bar of the State of Oklahoma.
XVIII. FHLB CAPITAL REQUIREMENTS & SEC FILINGS

Established by the Federal Home Loan Bank Act of 1932, the Federal Home Loan Bank System (hereinafter “FHLBanks”) assumed a stated mission “to provide cost-effective funding to members for use in housing, community, and economic development; to provide regional affordable housing programs, which create housing opportunities for low- and moderate-income families; to support housing finance through advances and mortgage programs; and to serve as a reliable source of liquidity for its membership.”¹ The FHLBanks member institutions, including federally insured savings associations, commercial banks, credit unions and insurance companies, rely on loans from the FHLBanks, known as advances, to support the mortgage lending and auxiliary credit needs of their customers.² If not for the FHLBanks, an environment of diminishing cash deposits would lead to a drought of medium and long-term sources of funding for a majority of the nation’s depository institutions.³

Federally chartered but privately capitalized and managed, FHLBanks, like Fannie Mae and Freddie Mac, are considered government-sponsored enterprises.⁴ The system’s federal regulator, the Federal Housing Finance Board (hereinafter “FHFB”), appoints directors to govern each of the twelve regional FHLBanks.⁵ The FHFB’s mission is “to ensure that the FHLBanks operate in a safe and sound manner, carry out their housing and community-development finance missions, and remain solidly capitalized.”⁶ Presently, two salient issues continue to impact the FHLBanks in profound ways: capital requirements and Securities Exchange Commission (hereinafter “SEC”) filings.

² Id.
³ Id.
⁵ Id.
⁶ Id.
⁷ Id.
A. Capital Requirements

The Gramm-Leach-Bliley Act of 1999 (hereinafter “GLB Act”) ushered in not only a new era of risk-based capital standards for FHLBanks, but unwittingly launched a tumultuous chapter in the FHLBanks’ seventy-year history. To ease fears of possible runs on the FHLBanks’ capital during economic down-swings, the GLB Act sought to change the system’s capital structure to achieve “the toughest and strongest capital requirements of any of the housing [government-sponsored entities] . . . , [to] have a higher minimum leverage ratio, higher weighted leverage ratio, and . . . the highest risk-based capital requirements.” Fundamentally, the GLB Act gave the FHLBanks the flexibility to become “more effective and efficient by developing a capital plan that aligns the size of the FHLBanks’ [system] with the size of and risks on the balance sheets of the FHLBanks.” To successfully implement this policy, an important mission of the FHFB was to create a system where the twelve FHLBanks’ capital structures were similar to such a degree that shopping around the system for a better deal would constitute an act of futility. Opponents of the rule focused on the fact that it reduced the FHLBanks’ ability to use retained earnings to pay dividends to Class A stockholders, and also barred the FHLBanks from selling stock to nonmembers. As stated at the time by Peter E. Gutzmer, senior vice president of the Chicago Home Loan Bank, “the final rule grossly overestimates the risks attendant to [FHLBanks’] business and requires risk-based capital that is both excessive and which will place the Home Loan Banks in a disadvantageous competitive position . . . .” Despite such strong criticism, by July of 2002, the FHFB had approved the new risk-based capital plans for all twelve FHLBanks.

March of 2006 delivered another major adjustment to the FHLBanks’ capital structure when the FHFB announced a plan to

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8 Id.
10 Community Banks Await Reform of FHLB System, supra note 7.
12 Id.
drastically overhaul the capital requirements through a process that could take as long as two and a half years.\textsuperscript{14} Expressly stating that some of the FHLBanks “fell short” when specifically urged to increase their retained earnings in 2003, the new proposal would cut the FHLBanks’ dividend payments to their members in half, until retained earnings reached the mandatory level ($50 million plus 1% of nonadvance assets).\textsuperscript{15}

Losses at the New York Home Loan Bank in 2003, coupled with enforcement actions against the Seattle and Chicago counterparts in 2004, prompted the FHFB to follow this novel course requiring the FHLBanks to hold approximately $4.4 billion in retained earnings – a 76% increase from the 2005 year end level.\textsuperscript{16} Richard Rosenfeld, head of the FHFB, opined that a major reason for the proposal was the FHLBanks’ “unique capital structure . . . where the majority of capital is held in stock that is fixed at $100 par value and is redeemable by member institutions.”\textsuperscript{17} As a result of this structure, FHLBanks “do not hold enough in retained earnings to cushion against losses, they could be forced to dip into their capital – and effectively reduce the par value.”\textsuperscript{18} A reduction of par value, said Rosenfeld, could have disastrous effects on the willingness of members to initiate new advances, especially if the likelihood existed that they could not recapture the par value paid for the stock upon redemption.\textsuperscript{19} The regulators said that this inability to redeem stock at the full face value “could shake confidence in the home-loan bank system, with unpredictable results.”\textsuperscript{20}

Along with the possibility of decreased dividends, the FHFB’s concern for safety and soundness led to provisions in the proposal “which would stop banks from issuing excess stock, limit such stock to 1% of assets, and eliminate stock dividends altogether. The possible effects include hampering the banks’ mortgage programs, curtailing their charitable activities, and removing the flexibility that stock dividends provide member institutions.”\textsuperscript{21} At

\textsuperscript{15} \textit{id.}
\textsuperscript{17} \textit{id.}
\textsuperscript{18} \textit{id.}
\textsuperscript{19} \textit{id.}
the time the FHFB’s plan was declared, four banks were over the Board’s proposed 1% limit: the Home Loan Bank of Chicago with about 2.73% of its assets in excess stock, the Cincinnati bank with 1.93%, the Indianapolis bank with 1.43%, and the Seattle bank with 1.07%.\footnote{Id.} As an immediate reaction, a number of FHLBanks cut back on charitable initiatives – including those for Hurricane Katrina victims – because as Charles “Bud” Koch, the chairman of the Cincinnati bank, stated, “[g]ood corporate governance will not allow us to continue funding the multimillion-dollar voluntary housing programs until we are in a position to know the full extent of our retained-earnings shortfall and the negative impact this proposed regulation would have on our business model.”\footnote{Id.} Koch estimated that the Home Loan Bank of Cincinnati would be forced to raise at least $109 million of additional retained earnings and buy back $421 million of excess stock because of the plan.\footnote{Id.}

As early as May of 2006, the twelve FHLBanks, through the Council of Federal Home Loan Banks (hereinafter “the Council”), took a “rare united stand against [the FHFB].”\footnote{Rob Blackwell & Patrick Rucker, FHFB Plan Unites Home Loan Banks – Against It, AM. BANKER, May 4, 2006.} The Council, via a comment letter signed by the chairmen and vice chairmen of each bank, declared that the proposal “may have substantial and significant unintended consequences and ramifications for the Home Loan banks, our members, and their communities . . . , [w]e therefore urge that the Finance Board withdraw the current proposed regulation, and instead issue an advance notice of proposed rulemaking.”\footnote{Patrick Rucker, In Brief: Home Loan Banks: Ditch the Proposal, AM. BANKER, May 5, 2006.} This united front followed closely behind Bud Koch’s April 28\textsuperscript{th} comment letter to the FHFB stating that:

We believe the end result of the proposed rule for the Cincinnati bank will be to lower capital levels, lower liquidity, and lower profitability. The board believes that the proposed regulation will result in a significant deterioration in the value of FHLBank membership. [Furthermore, in that members would have to] carry more liquidity of their own . . . , [t]his will in turn reduce their ability to cost-effectively
provide services to their own retail customers, decreasing their earnings and ultimately threatening the viability of the United States community banking system.27

The Cincinnati board’s letter was accompanied by one from outside counsel, which called into doubt the legal foundation for affecting the plan. Melvin S. Shotten, a lawyer with Taft, Stettinius & Hollister LLP in Cincinnati wrote, “[f]rom a legal perspective, the proposed rule appears to reach beyond the reforms intended to be imposed by Congress on the FHLBanks by the GLB Act, to exceed the authority granted to the Finance Board and to erode the powers specifically delegated to, or reserved for, the individual FHLBanks.”28 By July 13, 2006, when the comment acceptance period closed, the FHFB had received over 1000 letters asking it to withdraw the proposal,29 including comments from the Credit Union National Association,30 as well as from six financial services trade groups.31

In a move that seems to heighten opponents’ fears, Washington Mutual, Inc., the FHLBanks’ single largest customer, has taken actions to diversify away from the system, in light of the impending dividend reductions.32 Having already cut its stake in the Federal Home Loan Bank of San Francisco to 25% of outstanding stock, from 38%, Wamu’s assistant treasurer, Peter Freilinger said, “[I]f the dividend policy is changed as currently contemplated, the attractiveness of the Home Loan Bank financing system would change pretty radically.”33

On June 30, 2006, the abundance of criticism directed at the FHFB’s plan led House Financial Services Committee (hereinafter “the Committee”) Chairman Michael G. Oxley and Rep. Barney Frank to openly question the proposal: “The fact that the proposal has been

27 Blackwell, supra note 25.
28 Id.
29 Id.
31 FHLBs Score New Plan on Dividend Payouts, CREDIT UNION J., May 15, 2006 (“The healthy dividends paid by FHLBs are the main reason credit unions join the system, already having access to low-cost capital to fund mortgage lending through the corporates.”); Ed Roberts, CU’s Join Banks in Fighting Plan To Limit FHLB Dividends, CREDIT UNION J., July 3, 2006.
32 Cole, supra at note 29.
33 Id.
criticized by the leadership of all twelve banks and key industry trade
groups indicates to us a need for a pause. We are concerned that the
proposed changes may go too far and actually harm the Bank system
more than protect it.” 34 The elected officials also raised questions
about the legality of the proposal in light of the GLB Act. 35 In a
letter sent to Rosenfeld, the Committee notified the FHFB that top
representatives should plan to testify on the issue after Congress
returns from its August recess, and that a public accounting of the
reasons for the new capital proposal will be expected. 36

On September 7, 2006, the Committee convened for a
hearing entitled “A Review of the Federal Home Loan Bank
System,” with the proposal serving as the main talking point. 37 The
new capital proposal received sharp criticism from key lawmakers,
including Rep. Frank, the future chairman of the Committee.
Arguing for a withdrawal of the proposal, Frank stated, “[o]bviously,
we want to protect the safety and soundness of the system, but this
does not appear to be justified by any negative circumstances.” 38

The lawmakers, echoing the opinions of the main critics of the
proposal, said, “that lower dividends paid by the FHLBs in order to
meet the new retained earnings requirement will cause members to
withdraw or to look elsewhere for investment opportunities, eroding
the base of the system. This would not only diminish the system as a
whole, but also the $100 million a year in affordable housing grants
the FHLBs award to their members.” 39

Despite the barrage of criticism, the FHFB seemed ready to
move ahead with its proposal. However, Rosenfeld has
acknowledged that the financial routine of any one FHLBank would
not be expected to change overnight. 40 Rosenfeld wrote, “Our
regulation should recognize that where a bank has engaged in prior
conduct that was permissible under the then-existing rules, any
change in those rules should afford the bank a reasonable time to

35 Id.
38 Ed Roberts, FHLBs Capital Rule in Jeopardy, Key Reps Seek Withdrawal, CREDIT
39 Id.
40 Steven Sloan, FHFB Sticks by Proposal, Says Rollout to be Phased, AM. BANKER, July 28, 2006.
adjust its business strategies.” Accordingly, amendments by the FHFB to the initial rule appeared possible following Rosenfeld’s concession “that a final rule might give the FHLBanks more time to build up their retained earnings so they won’t have to cut stock dividends by 50%.” Though Rosenfeld insisted that the September 7, 2006 Committee hearing had failed to persuade him to withdraw the proposal, when the FHFB met for the final time in 2006 the capital plan was “shelved indefinitely,” due to a lack of consensus on the board.

B. SEC Filings

On June 9, 2006, the Home Loan Bank of Pittsburgh became the last of the FHLBanks to file a Form 10 with the SEC, bringing to a close a four-year struggle between the Securities and Exchange Commission (hereinafter “the SEC”), the Treasury Department and the FHFB. The lack of compliance with accounting standards forced a time frame extension, with only two of the twelve banks meeting the initial August 2005 deadline to complete registration. An incentive to readily comply with the registration process was provided on August 23, 2005, when the FHFB announced that “no Federal Home Loan Bank may pay a dividend without prior approval from the agency until it has registered with the Securities and Exchange Commission.”

In July of 2002, on the heels of Fannie Mae and Freddie Mac agreeing to register with the SEC, the FHFB commenced negotiations with the SEC and the Treasury Department to propose similar disclosure for the FHLBanks. John Korsmo, chairman of the Finance Board at the time, began this uphill battle with the goal of bringing “transparency” to the system. Two prominent arguments against disclosure soon materialized. First, it was evident

41 Id.
43 Roberts, supra note 38.
46 Id.
47 Regulatory Roundup, AM. BANKER, Sept. 8, 2005.
49 Id.
that unlike Fannie Mae and Freddie Mac who have publicly traded stock, the FHLBanks are cooperatives, and where the Securities and Exchange Act of 1934 required disclosures for the benefit of the stockholding public, in the case of the FHLBanks, no public exists. Second, SEC disclosure would disrupt the Finance Board’s safety-and-soundness jurisdiction. Following this logic, the FHLBanks claimed “that the Finance Board [was] in a better position to accept and evaluate the disclosures. [T]he banks would work with the Finance Board and the SEC to develop disclosure requirements that virtually mirror those the SEC applies to publicly traded companies. But the banks would make those disclosures directly to the Finance Board.” The Treasury Department strongly disagreed with that compromise, and instead called for all government-sponsored entities to register their stock with the SEC and submit to financial disclosures like those required of publicly traded companies.

By September of 2003, as the SEC registration became inevitable, many FHLBanks’ directors called upon the FHFB to craft a regulation protecting the directors from liability in the event of a loss to the bank stemming from said disclosure. As described by New York FHLBank president Alfred DelliBovi, “A regulation has the force of law, therefore assuming that the rule-making process is done correctly, it will relieve the District Bank Boards of a need to make a decision about whether to register at the SEC.” In June 2004, the FHFB unanimously approved a final rule requiring the twelve FHLBanks to register their stock with the SEC. Korsmo’s successor as Finance Board Chairwoman, Alicia Castaneda, wrote:

[T]he final decision for SEC registration was heavily influenced by the central issue of comparability. Federal Home Loan Bank disclosures should be fully comparable to other entities with whom they compete for funds in the market, especially the two other housing GSEs. Just as important, investors

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54 *Id.*
must accept these disclosures as comparable. And where is that comparability to be found? At the SEC. [I]f disclosures are not comparable . . . you’ve lost confidence. As an issuer, your spread widens, you find yourself chasing the market, and your cost of funds will rise.\textsuperscript{56}

Two months after the rule was approved, the FHFB issued guidelines to help the FHLBanks register their equity securities with the SEC; one of the most relevant being that the board would retain jurisdiction over the banks’ capital structure.\textsuperscript{57}

C. Conclusion

The year 2006 brought closure to a four-year struggle between regulators and the FHLBanks, but a new proposal, involving a controversial capital requirement, appears to be even more polarizing than the forced SEC registration which preceded it. Although the Federal Housing Finance Board’s final meeting of 2006 resulted in shelving the capital proposal, Chairman Rosenfeld’s strongly held view that capital plays a crucial role in the FHLBank system will likely lead to him back to the drawing board, intent on attacking the issue from a fresh standpoint. Whether a newly devised capital proposal will meet with the same opposition from banking trade groups and the FHLBank community, as the 2006 proposal did, is a question that will likely influence any new strategy that Rosenfeld endorses.

Cole Barry\textsuperscript{58}

\footnotesize{\textsuperscript{56} Alice Castaneda, Disclosure Helps FHLB System, NAT’L MORTGAGE NEWS, Oct. 4, 2004.\textsuperscript{57} Damian Paletta, Guidelines on Registering FHLB Equities, AM. BANKER, Nov. 1, 2004.\textsuperscript{58} Student, Boston University School of Law (J.D. 2008).}
XIX. BASEL II

The Basel Committee on Banking and Supervision (hereafter “BCBS”) released a final version of its revised International Convergence of Capital Measurements and Capital Standards\(^1\) (hereafter “Basel II”) in June 2004.\(^2\) Basel II is part of the BCBS’ Core Principles for Banking Supervision,\(^3\) and is reflective of the general trend toward applying international law to international markets.\(^4\) This trend is especially apparent in the banking industry.\(^5\)

The new Basel II revises its predecessor, Basel I,\(^6\) primarily in three ways, referred to as “Pillars.” Under Pillar I, minimum capital holding levels are set based on more risk-sensitive asset categories\(^7\) and “operational risk.” Optional risk refers to “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk.”\(^8\) The capital holding levels may be calculated under the Basic Indicator Approach (based on a percentage of prior-year income),\(^9\) the Standardized Approach (based on a percentage of income by


\(^4\) Molloy, supra note 2 at 330.


\(^8\) BASEL II, supra note 1, at 137.

business line), or the Internal Risk-Based Approach (based on an internal risk assessment).

The Basel II framework attempts to manage the risk of all a bank’s assets; therefore, assets will be categorized based on either credit risk (e.g. loans), or market risk (e.g. trading assets). Pillar II institutes a supervisory review process to ensure proper capital levels and “encourage banks to develop and use better risk management techniques in monitoring and managing their risks.” This process requires banks to establish systems of internal controls commensurate with the institutions’ risk profiles. Pillar II also requires supervisory controls to include plans to accommodate prospective changes in the banking environment (e.g. ensuring proper capital holdings under Pillar I during an economic downturn). Finally, Pillar III focuses on “market discipline,” targeting information disclosure. The disclosure requirements in Pillar III are designed to provide market participants with relevant information concerning bank risk and internal controls.

A. United States Regulatory Adoption

In recent years, banking regulators became increasingly concerned that bank capital holdings did not accurately reflect the risk presented by bank assets. In July 2003, the Federal Reserve and Federal Deposit Insurance Corporation began discussing incorporating Basel II in the U.S. banking regulatory system to deal

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10 Id.
13 BASEL II, supra note 1, at 158.
16 BASEL II, supra note 1, at 175.
with these concerns. The agencies released a draft of the Basel II Notice of Proposed Rulemaking (hereinafter “Basel II NPR”) in March 2006, and a final version in September 2006. The Basel II NPR was open for comment until January 23, 2007. The comment period for those parts of the document dealing with the continued use of the existing risk-based capital framework was extended until March 26, 2007.

The final version revised the March draft in several ways: “[f]or example, the agencies have responded to certain requests from the industry to seek comment on alternative risk-based capital approaches and have clarified that in evaluating credit risk, banking organizations should not rely on the possibility of U.S. government financial assistance.” Objectives of the Basel II NPR include strengthening the safety and soundness of banks subject to the rule, and “provid[ing] better incentives for institutions to improve risk measurement and management.” A three year transition to Basel II in the U.S. will begin on January 1, 2009, though certain parts of the Basel II NPR could be implemented sooner. The transitional period will create a time safeguard beyond that for which Basel II provides, and allow regulators a chance to find and correct

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18 Molloy, supra note 2, at 341.
21 Id.
26 Chris Dammers, US regulators give ground: In the face of fierce lobbying by American banks and under pressure from state regulators and politicians, the US federal regulators have softened their stance on key issues in their latest consultation on Basle [sic] II, Structured Fin. Int’l, Sept. 1, 2006, at 62(1).
27 See Petrou, supra note 12.
deficiencies in the Basel II NPR prior to full implementation. The U.S. implementation will lag the European Union’s implementation of Basel II by a brief period, with full EU compliance expected in 2008.

The drafters of the Basel II NPR modified the original Basel II framework as a result of two Quantitative Impact Studies (hereafter “QIS”), one of which was conducted in 2004, and the other in 2005. QIS-4, from 2004, showed that adoption of the Basel II NPR by the studied banks would lead to a median decrease in minimum risk-based capital requirements of 26%, with an average decrease of 15.5%. The Basel II NPR modified Basel II to expand the lower risk-weighted assets categories, with the potential for further modification if agencies find that aggregate minimum risk-based capital requirements drop by more than 10% as a result of the move to Basel II.

The Basel II NPR also modifies Pillar I of Basel II. Under Pillar I, the Basel II framework attempts to classify all bank assets based on credit risk or market risk. One particular focus of the Basel II NPR’s implementation of Pillar I is to “reduce the incidence of arbitrage between the banking book and the trading book.” U.S. regulators apparently drafted this section of the Basel II NPR with the intention of moving more bank assets from the “trading” (market

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29 A Battle over Basel II, ECONOMIST, Nov. 10, 2006
30 Addressing Challenges, supra note 7.
36 Steven Sloan, Basel II Robs Attention from Crucial Risk Plan, AM. BANKER, Dec. 22, 2006, at Washington; Pg. 3.
risk) category to the “banking” (credit risk) category, thus increasing overall bank capital holding requirements.  

The Basel II NPR will only apply to the largest internationally active U.S. banks, about twenty-six in all. These largest, or “core,” banks have at least $250 billion of consolidated assets, or at least $10 billion of consolidated “foreign exposure.” The Basel II NPR also applies to certain savings associations. Banks not subject to Basel II may be subject to Basel 1A, according to a draft Notice of Proposed Rulemaking issued December 5, 2006.

One piece of the Basel II NPR, however, may apply to institutions other than just core banks. The market risk segment of the Basel II NPR could apply to banks and savings associations with substantial trading activities, that is banks where trading accounts for 10% of total assets, as well as banks with more than $1 billion worth of trading activity.

B. Concerns with Basel II NPR

1. Cost v. Benefit

Banks which would be subject to the Basel II NPR have opposed the Internal Ratings Based (“IRB”) approach to assessing credit risk, the method which regulators have insisted upon using. In particular, the banks have contended that the additional costs of compliance with the complex IRB approach will exceed its benefits, and this contention has contributed to the delay of the Basel II NPR implementation until 2009. Federal Reserve Chairman Benjamin Bernanke told Congress he favors the IRB approach, and that the

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38 Sloan, supra note 36.
39 Addressing Challenges, supra note 7.
40 A Battle over Basel II, supra note 29.
42 Joint Press Release, supra note 23.
44 Petrou, supra note 12.
45 Dammers, supra note 26.
46 Id.
standardized approach, which certain banks want to use, does not accurately assess risk.\textsuperscript{47} House Financial Services Committee Chairman Barney Frank, however, suggested that he favors deference to the banks’ expertise.\textsuperscript{48}

2. Limited Application

Another concern involves the limited application of the Basel II NPR. Smaller banks, those not subject to the Basel II NPR, may be subject to regulations which place them at a competitive disadvantage to the larger banks.\textsuperscript{49} This problem has been made more apparent since regulators have proposed that Basel 1A apply to banks not required to comply with Basel II.\textsuperscript{50}

3. Ability to Equally Address all of Basel II’s Goals

Basel II also has several objectives, including establishing minimum risk-based capital levels and promoting sensitivity to risk and fair international competition among banks.\textsuperscript{51} However, there is concern that regulators will focus too heavily on setting minimum capital levels, to the detriment of other goals.\textsuperscript{52}

4. Reduced International Competitiveness

Under the current enactment schedule, certain parts of the Basel II NPR may be implemented sooner than others.\textsuperscript{53} For example, under the Basel II NPR, rules relating to market risk categorization of assets are scheduled to be implemented prior to the credit and operational risk portions of the minimum risk-based capital calculation, and this could amplify competitive differences between U.S. and foreign banks (since Basel II has already been adopted abroad).\textsuperscript{54} Director of the Office of Thrift Supervision John

\textsuperscript{47} Id.
\textsuperscript{49} Steven Sloan, Small Banks Gain a Bit in Basel 1A Plan, \textit{AM. BANKER}, Dec. 6, 2006, at Washington; 1.
\textsuperscript{50} Id.
\textsuperscript{51} Id.
\textsuperscript{52} Id.
\textsuperscript{53} Petrou, supra note 12.
\textsuperscript{54} Id.
Reich even believes Basel IA could be adopted before the final Basel II,55 further complicating U.S. banks’ ability to maintain competitiveness domestically and internationally, since banks will have to make adjustment for differences in regulatory treatments during the transitional period.

5. Political Interests

In addition, strong political interests are involved in the adoption of the Basel II NPR. Memories of bank failings from the 1980s prompted regulators to place a floor on Basel II minimum capital requirements.56 The banking lobby can also be expected to weigh-in heavily as congressional committees evaluate the impact on banks subject to the Basel II NPR.

C. Conclusion

The U.S. implementation of Basel II faces substantial revision if bank capital holdings drop significantly. Regulators will carefully monitor banks during the transitional implementation period to ensure safety and soundness. The framework detailed in the Basel II NPR offers a more critical assessment of the risk in a bank’s assets. The proposals have been a long time coming, and many of the changes are welcomed by U.S. regulatory agencies. The focus of Basel II on an internal assessment of risk also fits well with current corporate trends toward internally evaluating, addressing, and managing business risks. In implementing Basel II, U.S. banking regulators must be careful not to sacrifice core banks’ international competitiveness for more nuanced risk-based capital minimums. Since one focus of Basel II is to place internationally competing banks on somewhat equal regulatory footing, significant deviation from Basel II’s Pillars could severely affect U.S. banks’ ability to maintain a strong global presence.

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XX. BANK SECRECY ACT & ANTI-MONEY LAUNDERING REGULATION

The Bank Secrecy Act ("BSA") imposes recordkeeping and reporting requirements on financial institutions and other businesses to assist law enforcement agencies in detecting and deterring money laundering and related activities.\(^1\) Since the terrorist attacks of September 11, 2001, the compliance burden associated with the BSA and related anti-money laundering ("AML") regulations, together with the threat of costly enforcement actions for BSA/AML deficiencies, have made the topic an industry focal point. Significant BSA/AML developments during 2006 included: the expanding scope of suspicious activity reporting; increased focus on the money services business; institutional and policy changes at the Financial Crimes Enforcement Network; interagency publication of a revised BSA Examination Manual; and the issuance of several noteworthy BSA/AML enforcement actions.

A. Suspicious Activity Reporting

According to the Financial Crimes Enforcement Network ("FinCEN"), banks, thrifts, and credit unions filed more Suspicious Activity Reports ("SARs") than ever in 2005, leading many to conclude that the "defensive filing" of SARs remains a problem.\(^2\) The volume of SAR filings has increased significantly since 2004, when regulators fined Riggs National Corp. $41 million and AmSouth Bancorp $50 million for SAR program deficiencies and related violations.\(^3\) Moreover, the number of SARs filed during the first six months of 2006 represented an increase of 11% over the same period a year earlier, with suspected violations of BSA and AML laws continuing to be the most frequently reported basis for filing.\(^4\) Industry representatives argue that many financial institutions, forced to rely on vague regulatory guidance, have chosen to file defensive SARs that provide little value to regulators rather

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\(^3\) Id.
than incur the risks associated with failure to file.\textsuperscript{5} Specific aspects of the SAR guidelines that have come under fire include the designation of 43 U.S. states and territories, including every major population center, as high risk regions; designation of electronic banking and credit card lending as high risk products; and designation of convenience stores, restaurants, retail stores, attorneys, accountants, doctors, and domestic charities as risky customers.\textsuperscript{6}

In May 2006 the Financial Services Roundtable, a trade association comprised of 100 of the industry’s largest firms, proposed to the Treasury Department two regulatory changes it argued would help reduce the flow of defensive SARs: (i) codifying a “good faith” standard that would shield a financial institution from regulatory action over an individual SAR filing decision, provided that the institution followed appropriate policies, procedures, and processes in arriving at the decision, and (ii) undertaking an “effectiveness” study to determine whether existing monitoring and reporting requirements, including the SAR requirements, effectively deter criminal activity and lead to prosecutions.\textsuperscript{7} Other industry representatives called for elimination of the requirement that financial institutions file a SAR whenever a customer has structured a transaction to avoid currency transaction reporting requirements, even where the underlying funds are plainly legitimate.\textsuperscript{8} On the other hand, the Financial Action Task Force, an international policy-making body that helps coordinate global action against money laundering and terrorist finance, stated in June that the existing $5,000 SAR reporting threshold applicable in the U.S. should actually be lowered to capture more activity because the current threshold could allow small-dollar terrorist financing transactions to go unreported.\textsuperscript{9} Others also sought to impress upon the industry the vital nature of suspicious activity reporting, such as AML expert

\textsuperscript{5} Reginald J. Brown and Stephen R. Heifetz, \emph{Vague Guidance Still Invites Defensive SARs}, \textsc{Am. Banker}, Jan. 6, 2006, at 11.
\textsuperscript{6} Id.
\textsuperscript{7} Letter from Steve Bartlett, President and CEO, Financial Services Roundtable, to Stuart Levey, Under Secretary for Terrorism and Fin. Intelligence, Department of the Treasury (May 18, 2006), http://www.fsround.org/policy/regulatory/pdfs/2006StuartLeveyFollowupLetter.pdf.
\textsuperscript{8} Robert B. Serino, \emph{SARs Are Useful Only When Activity Is Illegal}, \textsc{Am. Banker}, Oct. 6, 2006, at 9.
Dennis Lormel, who told a conference of the American Bankers Association in June that law enforcement officials had used SAR information to track funds gained through fraud in the United States that were being funneled to Abu Musab al-Zarqawi’s terrorist network in Iraq.\textsuperscript{10}

Despite issues raised by the industry, FinCEN has stated that the rapid increase in SAR filings may be attributable not to rampant defensive filing, but rather to improved systems and more robust monitoring of activity that are allowing institutions to recognize activity they previously might have missed.\textsuperscript{11} The agency did provide additional guidance in 2006 to assist financial institutions with SAR compliance, touching on issues such as proper documentation of a decision not to file a SAR; dealing with the target of a SAR; continued suspicious activity reporting where law enforcement has taken no action on an initial SAR; and the prohibition on SAR disclosures in civil litigation.\textsuperscript{12} FinCEN and the bank regulatory agencies also confirmed in January that financial institutions could share confidential information contained in a SAR with their parent companies and headquarters overseas.\textsuperscript{13}

On May 4, 2006, FinCEN issued a final rule requiring that mutual funds file SARs in a manner consistent with other financial institutions.\textsuperscript{14} The rule identified four categories of transactions that require reporting: (i) “transactions involving funds derived from illegal activity, or intended or conducted in order to hide or disguise funds derived from such illegal activity as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;” (ii) “transactions designed, whether through structuring or other means, to evade the requirements of the Bank Secrecy Act;” (iii) “transactions that appear to serve no business or apparent lawful purposes, and for which the mutual fund knows of no reasonable

\textsuperscript{10} Richard Cowden, \textit{Terrorism Finance Expert Says SARs Helped Link U.S. Fraud Probe to Zarqawi’s Network}, \textit{Banking Daily}, June 14, 2006, at D8.
\textsuperscript{11} Paletta, \textit{supra} note 2.
explanation after examining the available facts relating to the transaction and the parties;” and (iv) “transactions that involve the use of the mutual fund to facilitate criminal activity.” In March, the Federal Reserve Board (the “Board”) issued a final rule requiring U.S. branches of foreign banks, as well as Edge and Agreement corporations to establish similar monitoring and reporting procedures to ensure compliance with BSA/AML regulations, including SAR requirements. In issuing the rule, however, the Board stated that the measure would impose little burden on those institutions because the Board had already demanded in its capacity as safety and soundness supervisor that such entities meet BSA requirements.

B. Money Services Businesses

Money services businesses (“MSBs”) including check cashers, money transmitters, and related businesses, were a major focus of regulatory and congressional attention in 2006, as it became clear that the trend among financial institutions of closing MSB accounts rather than incur the risks associated with them would continue. Since enactment of the USA Patriot Act of 2001, MSBs have been required to follow BSA/AML regulations in a manner consistent with other financial institutions, and federal regulators have placed the burden on banks to ensure their MSB customers are in compliance with the law – a burden many have avoided by dropping MSB customers. Continuing efforts begun in 2005 to facilitate access to banking services for MSBs, FinCEN in March requested comment from both the banking and MSB industries on what measures might be taken to improve the situation. FinCEN

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15 Id. at 26,216.
18 Stacy Kaper, Banks and MSBs Offer FinCen Ways to Fix Problems, AM. BANKER, June 2, 2006, at 3.
19 Id.
received a range of suggestions, including that banks be rewarded with Community Reinvestment Act credit for keeping MSBs as customers; that state regulation of MSBs be replaced with a federal regulatory framework; that small check cashers be exempt from the BSA; and that MSBs be permitted to borrow directly from the Federal Reserve when traditional banks reject them.21

Frustrated with the inability of MSBs to maintain U.S. accounts, the House Financial Services Committee in June challenged bank regulators to prove that MSBs carry a significant risk of money laundering and said the agencies were not doing enough to stop banks from severing relationships with the businesses.22 While acknowledging the problem facing the MSB industry, regulators maintained that they have not required financial institutions to close MSB accounts and that banks should not consider themselves de facto regulators of their MSB customers.23 Representatives from the MSB industry argued that the banking regulators, in particular the Office of the Comptroller of the Currency (“OCC”), created a problem where none existed and called on Congress to provide a legislative solution such as a “self-certification” program that would remove from banks any responsibility for determining the BSA compliance of their MSB customers.24 Despite pressure from Congress and the MSB lobby, the list of large banks ending relationships with MSB customers continued to grow throughout the year.25 SunTrust Banks Inc. began severing its ties with MSB customers in May, joining other major institutions such as JPMorgan Chase, AmSouth Bancorp, and PNC Financial Services Group, each of which had already closed most or all MSB customer accounts.26 In August, Bank of America Corp., the nation’s largest retail bank, cut its ties with the nation’s top two

FinCEN and the federal banking agencies with respect to MSB customer accounts and stating that banking organizations would not be held responsible for their MSB customers’ BSA compliance).

21 Kaper, supra note 18.
26 Id.
remittance companies, Western Union Financial Services Inc. and MoneyGram International Inc.27

C. Institutional and Policy Changes at the Financial Crimes Enforcement Network

Under new director Robert Werner, FinCEN sparked controversy in the banking industry on several fronts in 2006, most notably by reversing the agency's longstanding support for reducing the AML reporting burden associated with Currency Transaction Reports (“CTRs”).28 In 2005, FinCEN had endorsed a House proposal to eliminate the CTR requirement for “seasoned business customers,” an exemption that would have reduced banks’ currency transaction reporting burden by as much as 75%.29 In 2006, however, FinCEN’s new director testified before the House Financial Services Committee that the agency no longer supported legislation implementing the seasoned customer exemption, but rather would encourage further study of the issue.30 FinCEN’s reversal on CTRs followed a pushback by federal law enforcement officials, who testified before Congress that the reports, which banks are required to file under the BSA for all cash transaction over $10,000, are a vital tool in fighting money laundering.31 FinCEN’s reversal of position caused frustration among some Committee members, who expressed skepticism about law enforcement claims that CTRs were particularly valuable in policing financial crimes.32 Ultimately, the seasoned customer exemption was not included in regulatory relief legislation signed by the President in October, although the

legislation did commission a study on the volume of CTRs filed with Treasury including recommendations for changes.  

FinCEN in March launched a feasibility and impact study of implementing a cross-border wire transfer reporting requirement under the BSA. The proposed reporting requirement met with immediate opposition from many in the industry, who argued that such a requirement would be burdensome, expensive, and of little value to law enforcement. Mr. Werner was reportedly less enthusiastic about the proposal than his predecessor, William Fox, who had been a vocal proponent of a wire transfer reporting system and had already earmarked $10 million to set up such a program. FinCEN was expected to publish its feasibility study on the proposed international wire transfer reporting system in June, but postponed publication as it sought further input from bank regulators, including the Federal Reserve Board, which was reported early on to have opposed such a system. The bank regulators, led by the Federal Reserve, formally responded to the proposal in June with an interagency letter to Director Werner, raising concerns about privacy issues, regulatory burden, and usefulness of the information, though the agencies stopped short of outright opposition.

One problem facing FinCEN throughout the year was a perception among many in the industry that the agency was incapable of properly handling the information it was already receiving. A report issued in May by the Treasury Department’s Office of Inspector General, for example, concluded that FinCEN was suffering from data management weaknesses and internal control issues. The agency suffered another setback in July when it

36 Id.
37 Rob Blackwell, Fincen Wire Plan Moves to Slow Lane, AM. BANKER, June 1, 2006, at 1.
39 Kaper, supra note 35.
abandoned its BSA Direct initiative, a program designed to help analyze data from the millions of SARs filed each year, after spending more than $14 million on the project.41 Mr. Werner, who had taken over as director of FinCEN in March, announced in November that he was leaving the agency for a position in the private sector.42 The announcement reportedly caught many in the industry off guard, coming just before the expected release of FinCEN’s study on the international wire transfer reporting proposal and as the organization continued to face substantial problems related to MSBs.43

D. Revised Bank Secrecy Act Manual

The Government Accountability Office (“GAO”) in April 2006 issued a report highlighting the need for the federal bank and thrift regulatory agencies to improve collaboration on BSA/AML issues.44 The GAO noted that the regulatory agencies had begun making progress in this area in 2005 by discarding their separately developed examination procedures to assess BSA compliance and adopting for the first time on an interagency basis a jointly developed BSA examination procedures manual.45 The bank regulatory agencies then announced in July 2006 that they had updated their interagency BSA examination manual, building upon the effort to provide “consistent guidance on risk-based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing.”46 Regulators added that the revisions were not intended to impose new burdens, but rather to provide a compilation of

45 Id. at 6.
existing requirements, supervisory expectations, and sound practices in the BSA/AML area.\textsuperscript{47}

Substantial revisions to the manual addressed topics including the risk assessment process; Automated Clearing House transactions; trade finance activities; and updated regulatory and supervisory guidance on suspicious activity reporting, foreign correspondent accounts, and private banking programs.\textsuperscript{48} Industry representatives reacting to the revised manual identified several noteworthy changes, including (i) a relaxation in the recommended frequency of independent audits of an institution’s BSA/AML compliance program and (ii) the elimination of an express recommendation in the previous manual that an institution provide for “dual controls and segregation of duties” in its compliance program.\textsuperscript{49}

E. BSA/AML Enforcement Actions

During the first six months of 2006, the federal bank regulatory actions took a total of 27 enforcement actions against financial institutions for BSA/AML violations.\textsuperscript{50} The BSA/AML cases during the year revealed that violations in the area are increasingly prone to criminal as well as civil penalties.\textsuperscript{51} In April, for example, the Justice Department, FinCEN, and the Office of Thrift Supervision brought one of the year’s most substantial actions against BankAtlantic of Fort Lauderdale, FL for failure to report millions of dollars of suspicious transactions.\textsuperscript{52} FinCEN assessed a $10 million penalty against the institution, and the Justice Department entered a deferred prosecution agreement with the bank, which agreed to forfeit $10 million of illegal deposits.\textsuperscript{53} In October, federal and state regulators assessed a $12 million fine against Israel Discount Bank of New York for inadequate BSA compliance, less

\textsuperscript{50} Vartanian & Nelson, supra note 12.
\textsuperscript{51} Id.
\textsuperscript{52} Id.
\textsuperscript{53} Id.
than a year after the bank was forced to pay $8.5 million in penalties to the New York State District Attorney’s Office for similar violations. The Vice President and BSA compliance officer at Gulf Bank of Miami, FL was not only subject to a Federal Reserve Board enforcement action but also pled guilty in February to 19 criminal counts for failing to file more than 2,000 CTRs.

Despite the range of enforcement actions and steep fines levied for BSA/AML deficiencies, a GAO report in April criticized the regulatory agencies for relying too heavily on the examination framework and informal oral agreements with financial institutions in combating BSA deficiencies. Moreover, the OCC in particular became the subject of criticism in August over its failure to take formal enforcement action against Wells Fargo last year after examiners had identified significant deficiencies in the bank’s BSA/AML compliance program. A report issued in August by the Treasury Department’s Office of Inspector General criticized the national bank regulator for departing from its normal procedures in the matter. The report went on to criticize the OCC for failing to properly notify FinCEN of the full extent of the violations at Wells Fargo. Some observers felt the report would renew debate over whether BSA supervision and enforcement should be consolidated into a single agency.

Donald Waack

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56 *Id.*
59 *Id.* at 6.
60 Bruce, *supra* note 57.
61 Student, Boston University School of Law (J.D. 2008).
XXI. FEDERAL INSURANCE CHARTER

The regulatory scheme of the insurance industry was established by the McCarran-Ferguson Act. The Act went into effect in March of 1945 and mandates that insurance regulation will be “subject to the laws of the several States,” as long as Congress does not pass insurance-related acts. Although the Act has resulted in a functional insurance industry, there is widespread dissatisfaction with current regulatory policies and procedures. One of the main criticisms of the current insurance regulatory scheme is that regulations are overly demanding, expensive and contain serious shortcomings. Further, because insurance companies have to deal with a different set of rules and regulations for every state in which they offer a product, “companies are…[becoming] exasperated.” They are forced to expend significant amounts of effort and resources to take on such a task. The difficulty imposed causes an allocation of money away from investments and deters companies from entering markets. Thus, barriers imposed by the current regulatory scheme of the insurance industry prevent the “true solutions desired by customers.”

To make matters more troubling, the “magnitude and scope of risks [to Americans] is constantly increasing.” In recent years, there have been extraordinary ordeals such as global climate changes, terrorist attacks, hurricanes and other environmental catastrophes, some of which have been completely unpredictable. It is no secret that customers’ needs are becoming more “diverse and complex.”

Due to the changing and unprecedented needs of customers coupled with the delay and costs of offering products to multiple

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2 Id.
5 Raymond J. Lehmann, Federal Insurance Charter’s Supporters Say They’ll Foot the Bill for Uniformity, BestWire, Apr., 06, 2006.
7 Id.
8 Id.
9 Id.
10 See id.
11 Id.
states, the industry’s products are “fall[ing] further behind…rather than… [providing] a safety net for individuals, their families and the economy as a whole.”12 In addition, regulations increasingly become insufficient since they are ill-suited to handle new insurance products targeted to these changes.13 The end result to the consumers will be inadequate and improperly-tailored insurance products.14

With existing problems becoming worse and new troubles with current regulations arising, insurance trade associations, insurance companies and agencies, and politicians are aggressively pushing for reform.15 The many regulatory proposals that exist have sparked intense debate among those involved in the industry.16 Debate looms among those who propose to keep the insurance industry regulated at the state level about how to modernize and improve existing regulations.17 Several proposals include “gutting” state regulation or “federally prodded” reform, which would allow for levels of federal involvement.18 Another side of the debate would see the states lose their sole right to regulate the insurance industry, thus allowing for the creation of an optional national insurance charter.19

In the most general sense, the development of an optional national insurance charter would result in an insurance industry that resembles the current American banking system’s dual format.20 Insurance companies would be able to choose whether they are regulated by the national insurance charter or subscribe to regulations at the state level.21 Previous attempts at passing an optional national insurance charter have failed, leading to the introduction of the newest proposal, the National Insurance Act of 2006, which was put forward by Senators John Sununu and Tim Johnson.22

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12 Id.
14 See Beneducci, supra note 6, at 58.
15 See Lafferty LTD., supra, note 4, at 1.
16 See Id.
18 Lafferty LTD., supra note 4, at 1.
19 Id.
20 See Postal, supra note 3, at 7.
21 Beneducci, supra note 6, at 58.
22 Lehmann, supra note 5.
The National Insurance Act would create a self-governing federal office of National Insurance within the U.S. Treasury Department.23 The office would have several divisions such as insurance fraud and consumer affairs.24 In addition, there would be an ombudsman and a National Insurance Guaranty Corp.25 A presidentially-appointed commissioner would be in charge of running this office.26 In terms of capital, the office would obtain its funding from filing fees, user fees, examination fees, and assessments on insurance agencies.27

This Act would still permit the states to maintain significant control over federally regulated insurance companies.28 For example, states could levy taxes on insurance premiums.29 In addition, insurance companies would be forced to comply with state-mandated assigned risk and residual-market plans and to contribute to appropriate state guaranty funds.30 While this Act addresses some of the concerns that skeptics and critics of an optional national insurance charter may have, there are still very strong arguments against the passing of the charter.

This article will briefly highlight the main arguments for and against the establishment of an optional national insurance charter.

A. Why Keep the Insurance Industry at State Level?

Advocates of the current insurance regulatory system argue that instituting an optional national charter is "special interest legislation of the worst kind."31 They argue that the idea of this charter is being pushed by larger securities firms, big banks, and several large insurance companies as a means of obtaining increasing amounts of market share.32 In addition, these firms are accused of trying to maximize profitability by attempting to override existing security measures for consumers, lessen restrictive regulations, and "essentially...decide what insurance regulation, if any, they will

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23 Id.
24 Id.
25 Id.
26 Id.
27 Id.
28 Id.
29 Id.
30 Id.
31 PR NewsWire Association LLC, supra note 17.
32 Id.
Those opposing the optional national insurance charter predict there will be negative effects on important consumer protections, the stability of insurance markets, the availability of insurance coverage, as well as a drastic increases in the amount of insurance litigation.34

Opponents of the optional national charter argue that keeping insurance charters at the state level is extremely important for consumer protection.35 In the insurance industry, complaints need to be dealt with swiftly.36 Complaints deal with extremely demanding social issues and have rose to over 500,000 per year.37 However, it is the state regulators who “are at the forefront of [these] major social debates,” and have adapted to handling these problems, including AIDS, infertility drugs, and generic testing.38 The states have historically been able to protect insurance customers, according to one official.39 Looking at natural catastrophes that have taken place in the past two years, the industry was able to answer its claims, and on top of that remain an extremely “strong…and…profitable pillar…of the American economy.”40 Thus, opponents of the optional national insurance charter believe that the state’s ability to handle the customer’s increasing social problems best serves insurance customers41

In addition, the best way to ensure fundamental changes for the consumer take place as soon as possible, while simultaneously preserving consumer protection at the state level, is for states to make recommendations to Congress of conditions and problems in the insurance industry.42 The existing system allows modernization to take place because Congress can react to states’ requests.43

It has also been argued that the passing of an optional national insurance charter will negatively effect product availability and market stability.44 An effect of the charter will be that large
financial service entities with insurance divisions can enter or exit various insurance markets “solely at their whim.”\textsuperscript{45} Further, with the passing of an optional national insurance charter, federally-chartered insurance companies will be able to easily do so in markets throughout the country.\textsuperscript{46} The result of this behavior on the insurance industry will lessen options to the consumer and their ability to access coverage.\textsuperscript{47} It is claimed that another consequence of this behavior will be the disruption of markets, causing severe instability.\textsuperscript{48} 

Instituting a charter has been called “a prescription for...chaos in insurance marketplace.”\textsuperscript{49}

It has been predicted many other consequences will plague the insurance industry with the passing of an optional national charter.\textsuperscript{50} Opponents of the charter believe instituting the charter will result in confusion in the marketplace among customers and in interpretation of regulations by corporations.\textsuperscript{51} The result of this confusion will be exorbitant amounts of litigation by insurance companies and its consumers, inhibiting growth of the insurance industry.\textsuperscript{52}

B. Why Allow an Optional National Insurance Charter?

For those companies and insurance member groups desperately trying to upgrade existing insurance regulations, many believe simply modernizing and improving them will not allow the industry to alleviate its main problems.\textsuperscript{53} They believe the optional national insurance charter will result in a minimal “intrusion into the business of insurance,” which is necessary to fix industry problems.\textsuperscript{54} In addition to the insurance industry itself, there will be positive changes for the consumer and the stability of the economy.\textsuperscript{55}

Proponents of an optional national insurance charter predict the charter will shape the development of the industry in several

\textsuperscript{45} Id.
\textsuperscript{46} Id.
\textsuperscript{47} See PR NewsWire US, supra note 17; Beneducci, supra note 6, at 58.
\textsuperscript{48} See PR NewsWire US, supra note 17.
\textsuperscript{49} Id.
\textsuperscript{50} Id.
\textsuperscript{51} See id.
\textsuperscript{52} See id.
\textsuperscript{53} Beneducci, supra note 6, at 58.
\textsuperscript{54} Lehmann, supra note 5.
\textsuperscript{55} See Beneducci, supra note 6, at 58.
ways. First, the institution of an optional national insurance charter “would encourage state regulators to be more responsive.” In order to ensure that insurance corporations elect to be regulated by the states, they would need to keep up with the growth of the industry. Second, an optional national insurance charter would help instill laws that are said to be combative to industry scandals such as “bid-rigging, price-fixing and hidden-commission” schemes. Third, the charter would divert its attention and resources to important aspects of the insurance industry such as insurance solvency and market conduct; state regulators currently focus attention to product forms and pricing. Finally, because of the rise in innovation, which will be discussed below, the industry as a whole will move forward.

The optional national charter is also supposed to have beneficial effects for the consumer, including a greater array of product choice, faster introduction of product to the marketplace, and a lower cost of product. Federally chartered insurance companies will not have to deal with 50 different state regulators. The result of this change will be that regulators can bring products to the market quicker because they will not have to tailor and change them to meet many jurisdictional requirements. Currently, it takes months or possibly years to gain approval for new products, and approval must be received in each jurisdiction where the product is offered. Thus, in some cases companies just opt not to enter various markets. With more companies entering more markets, there will be an increase in the amount of existing products offered.

In addition, there will be significant resources left over from not having to deal with the compliance and paperwork of every

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56 See generally id.
58 See generally id.
59 Lafferty LTD., supra note 4, at 1.
60 Beneducci, supra note 6, at 58.
61 See id.
62 Id.
63 Lafferty LTD., supra note 4, at 1.
64 Beneducci, supra note 6, at 58.
65 Id.
66 Id.
67 Id.
market that an insurance company enters.\textsuperscript{68} This money can now be reinvested and allocated towards research and development.\textsuperscript{69} The benefit of this will be innovative products “to keep pace with ever-changing risks faced by insurance consumers.”\textsuperscript{70}

C. Conclusion

Due to many problems that plague the insurance industry, it is clear that change and reform is needed. “A growing number in Congress are coming to the conclusion that the current patchwork regulatory system is unacceptable for both consumers and the economy;” however, it remains to be seen whether Congress will elect to pass the National Insurance Act of 2006 in order to combat these problems.\textsuperscript{71} Even if the Act is vetoed, debate will continue as to whether or not an optional national insurance charter could be a solution to the problems of the insurance industry. Both sides continue to make strong arguments and well-supported predictions concerning the effects the charter could have on the consumer and the industry. However, it will take the creation of an optional national insurance charter to allow its effects on the insurance industry and markets to be witnessed. Until then, the debating will continue.

Harley Brown\textsuperscript{72}

\textsuperscript{68} Id.
\textsuperscript{69} Id.
\textsuperscript{70} Id.
\textsuperscript{71} Lafferty LTD., supra note 4, at 1.
\textsuperscript{72} Student, Boston University School of Law (J.D. 2008).
XXII. FINANCIAL EFFECTS OF DISASTERS

Recent natural disasters have had a major impact on the insurance industry, as companies paid out on far more policy claims than anticipated due to the unexpected recent events. Chief among these natural disasters was Hurricane Katrina, which prompted an unprecedented number of claims in the Gulf Coast region in August 2005. In addition to homeowner’s insurance policies, there were also an increased number of claims in the energy and marine insurance industries. In 2005, the insurance and reinsurance industry paid out a record $80 billion to settle claims filed as a result of natural disasters. This has impacted the way that insurance companies do business, which has in turn affected the reinsurance industry, hedge fund investors, consumers, and the government at both local and national levels. Natural disasters have had both positive and negative effects on insurers, investors, and the insured.

A. Insurers and the Insured

Recent natural disasters have prompted some insurance companies to stop offering coverage in natural disaster-prone areas, such as Florida, Texas, and California, to avoid the possibility of expensive payouts in the future. Other insurance companies have struggled to meet payout obligations, either declaring bankruptcy or dissolving. Still other companies have remained in disaster-prone areas but have increased the premiums for policies in those areas. In some instances, companies have considered increasing premiums

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2 Id.
4 Id.
6 Julia C. Mead, Flood Insurance Often Insufficient, N.Y. TIMES, July 30, 2006 at 14NJ 3; for a discussion of local efforts to block insurance companies’ attempts to move out of their area, see infra text accompanying notes 51-54.
8 Mead, supra note 6.
nationwide, thereby dispersing the cost of recent natural disasters across all consumers.9

Consumer advocates have criticized insurance companies’ increased premiums, equating the practice with price gouging.10 These advocates argue that the industry prospectively sets premiums based on risk, and it is unfair to raise future premiums to recoup losses that resulted from bad risk estimates in the past.11 Insurance companies disagree, arguing that there has been a general trend toward increasing frequency and intensity of natural disasters; therefore, the increased risk of large payouts justifies higher premiums.12

Insurance companies have also begun to rely heavily upon internally generated catastrophe models, which now include worst-case scenarios far more damaging than those previously used.13 This is particularly salient because some analysts blame the increasing frequency and intensity of natural disasters on global climate change and therefore argue that the trend toward more frequent, more devastating natural disasters will continue.14

Consumer advocates further criticize insurance companies’ payouts to policyholders, saying that insurance companies have failed to appropriately compensate their customers for damages.15 Insurance companies concede that they have been unable to go to some affected regions to assess damage and provide payouts precisely because the damage is so severe, but they deny any intentional wrongdoing.16 Consumer advocates disagree, alleging that insurance companies have deliberately classified losses as the result of uncovered activities such as flooding rather than covered activities such as wind.17 In November 2005, the Mississippi Attorney General filed suit to force insurance companies to cover water damage caused by hurricanes.18

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9 O’Connor & Pilla, supra note 3.
10 Brady, supra note 1.
11 Id.
12 O’Connor & Pilla, supra note 3.
13 Id.
15 Brady, supra note 1.
16 Id.
17 Id.
While the immediate impact on insurance companies has been negative due to higher payouts, some speculate that insurance companies will actually benefit from recent natural disasters in the long run.\textsuperscript{19} This is particularly true given that many insurance companies have enjoyed high profits on a national scale, despite having suffered losses in regions of the country impacted by recent natural disasters.\textsuperscript{20} Insurance companies that have exited disaster-prone areas face less potential for catastrophic liability in the future.\textsuperscript{21} Increased premiums may also drive greater profits.\textsuperscript{22} Consumers directly bear the cost of companies raising premiums and indirectly bear the cost of decreased competition when companies exit particular markets, which also results in increased premiums.\textsuperscript{23}

In addition, Hurricane Katrina and other highly visible natural disasters like the December 2004 Indonesian tsunami have increased awareness about the need for comprehensive homeowners’ insurance policies, which may drive increased policy sales.\textsuperscript{24} Furthermore, natural disasters often create a positive perception of the insurance industry and provide free publicity for insurance companies who appear on the news visiting hurricane ravaged areas.\textsuperscript{25}

B. Reinsurers and Hedge Fund Investors

The reinsurance industry is a major component of insurance companies’ financial plans.\textsuperscript{26} Reinsurers absorb some of the risk that insurance companies underwrite.\textsuperscript{27} In cases of catastrophic events such as natural disasters, reinsurers often end up reimbursing insurers for the majority of any given consumer’s claim.\textsuperscript{28} Reinsurers can disperse some of their risk onto other reinsurance companies, known as retrocessionaires.\textsuperscript{29} Because of Hurricane Katrina and other

\begin{thebibliography}{9}
\bibitem{19} Stewart, \textit{supra} note 5.
\bibitem{20} Tom Zucco, \textit{Lawyers vs. Insurers a Stormy Battle, St. Petersburg Times}, Aug. 23, 2006, at 1D.
\bibitem{21} \textit{See supra} note 6.
\bibitem{22} \textit{See supra} notes 8, 9.
\bibitem{23} \textit{Id}.
\bibitem{24} Stewart, \textit{supra} note 5.
\bibitem{25} \textit{Id}.
\bibitem{26} Anderson, \textit{supra} note 1.
\bibitem{27} O’Connor & Pilla, \textit{supra} note 3.
\bibitem{28} \textit{See id}.
\bibitem{29} Anderson, \textit{supra} note 1; Reinsurers can end up inadvertently underwriting their own risk, undermining the financial solvency of the entire scheme (e.g., insurance
\end{thebibliography}
natural disasters, many reinsurers have been called upon to reimburse primary insurers. Thus, the reinsurance industry has suffered greater financial losses than the insurance industry itself, shouldering $50 billion of the insurance industry’s $80 billion total payout in 2005.

Hedge funds are among the largest investors in the reinsurance industry. Since reinsurers typically require investors to provide collateral up front, there is little concern about hedge fund insolvency or inability to reimburse reinsurers. As Charles P.T. Cantlay, deputy chairman of international reinsurance company Aon Re U.K., said of recent losses, “this was substantially an earnings event, not a capital event.” Given these recent losses, some analysts and hedge fund managers question whether hedge funds will continue to invest aggressively in reinsurance. Nonetheless, reinsurers, like insurers, have raised their premiums. Therefore, many hedge funds have continued to seek out investments in reinsurance based on the potential for higher profits. In addition, recent natural disasters have fueled an increase in insurance companies’ demand for reinsurance. Thus, the negative impact of recent natural disasters on hedge funds’ investment in reinsurance may be limited to short-term losses.

Since Hurricane Katrina, investors have raised $23 billion in capital to support either existing reinsurance companies or to create new companies. Of that amount, hedge funds and private equity firms were the biggest contributors, providing $7.3 billion of capital to start-up reinsurance companies. With premiums in the Gulf Coast region up 100 to 200 percent, many hedge funds are scrambling to invest in the reinsurance industry based on the

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30 O’Connor & Pilla, supra note 3.
31 Id.
32 Anderson, supra note 1.
33 Richard Beales and Andrea Felsted, Hurricane Losses Test for Hedge Funds Investments, FIN. TIMES LONDON ED., Sept. 12, 2005, at 28.
34 O’Connor & Pilla, supra note 3.
35 Anderson, supra note 1; Beales & Felsted, supra note 33.
36 Anderson, supra note 1.
37 Id.
38 Id.
39 Id.
40 Id.
41 Id.
perceived unlikelihood of another Katrina-like storm (at least in the near future). In addition, hedge fund investors are attracted to the fact that profits in the insurance and reinsurance industry, unlike other investments, are not tied to general market trends.

Hedge funds have also taken advantage of other vehicles for investing in the reinsurance industry. For example, hedge funds are the primary investors in reinsurance sidecars, which are investment vehicles that allow existing reinsurers to raise capital to cover past losses and invest in future growth. Since Katrina, hedge funds and private equity firms have contributed $3.6 billion to reinsurance sidecars of existing reinsurance companies.

Hedge funds also represent the largest pool of investors in catastrophe bonds. Insurance and reinsurance companies issue bonds that pay five to fifteen percent interest on the investment. If there is no catastrophic natural disaster, investors receive a return on their principal in addition to the five to fifteen percent interest rate. In 2005, the insurance and reinsurance industries issued $1.5 billion worth of catastrophe bonds. As of August 2006, $2.5 billion worth of catastrophe bonds had been issued. Since Hurricane Katrina, ten new reinsurance companies have been created, ten reinsurance sidecars have come into existence, and existing reinsurance companies have raised an additional $12 billion in capital.

C. Local Government

Whereas investors, insurers, and reinsurers worry about losing money on large payouts, local government officials in disaster-prone areas worry about insurance companies leaving their states. There is some history of states successfully preventing insurance companies from leaving. For example, the Texas

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42 Id.
43 Id.
44 Id.
45 Id.
46 Id.
47 Id.
48 Id.
49 Id.
50 Id.
52 Home Insurer Reaches Deal with Texas, Ending Suit, supra note 51.
Attorney General brought a suit against Farmers Insurance for deceptive pricing practices in 2002. As part of a settlement agreement, Farmers agreed to retain its 700,000 existing Texas homeowners' insurance customers rather than leave the state completely.

Surveys of Florida voters leading up to the November 2006 election indicated that hurricane insurance was the second most important issue to voters, behind only education. During the 2006 Florida gubernatorial campaigns, both Democratic candidate Jim Davis and Republican candidate Charlie Crist proposed plans to increase the availability and decrease the cost of property insurance. Davis proposed eliminating Citizens Insurance, a state owned and operated insurer. In addition, he proposed eliminating the state fund that subsidizes insurance companies in case of default. Davis suggested using the money saved by eliminating these two programs to provide state-sponsored insurance of homes and condominiums up to $500,000; private insurance companies would cover any damage beyond this amount.

Crist, who was ultimately elected, proposed that insurance carriers that sell automobile and life insurance in Florida be required to sell property insurance to Florida residents if they sell property insurance in other parts of the country. In addition, Crist proposed eliminating Florida-only subsidiaries of national insurance companies. Crist voiced concern that national insurance companies only create these subsidiaries to limit their liability in the case of a major catastrophe. It remains to be seen what solutions, if any, local officials will be able to successfully implement.

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53 Id.
54 Id.
55 Mary Ellen Klas and Beth Reinhard, Crist Holds Comfortable Lead in Governor’s Race, MIAMI HERALD, Nov. 5, 2006.
56 Id.
57 Id.
58 Id.
59 Id.
60 Id.
62 Id.
D. Federal Government

Areas disproportionately affected by natural disasters have lobbied for a federal solution to the problem of insurance availability and affordability. However, it is often difficult to garner national support for such reforms. Many of the proposed reforms force areas minimally affected by natural disasters to bear additional financial burdens by subsidizing funds for disaster-prone areas, even though those minimally affected areas reap little or no benefit from these increased costs. The lack of incentive to produce results is particularly apparent when representatives from unaffected areas are appointed to lead Congressional committees on insurance reform. For example, Bob Ney, a Representative from relatively natural disaster-free Ohio, headed the House Subcommittee on Housing and Community Opportunity, which held hearings in the summer of 2006 on the prohibitive cost of insurance in natural disaster-prone areas.

Proposed federal regulation has taken many forms. Some have suggested the creation of a national catastrophe fund that would either subsidize the insurance industry in cases of major national disasters, or provide funds to those who were uninsured or underinsured. In addition, the Internal Revenue Service tax structure could be changed to encourage insurance company solvency. Insurance companies could make tax-exempt contributions to a fund reserved for payouts of national disaster claims.

Based on the perceived instability of the reinsurance market, other representatives have suggested the creation of a standardized process for the resale of reinsurance contracts to replace the current system, where companies can freely buy or sell reinsurance.
Under the proposed system, companies would resell reinsurance contracts at designated regional auctions. The federal government would set minimum prices for the reinsurance contracts according to their relative risks. Despite the multitude of possible solutions and the fact that Hurricane Katrina hit the Gulf Coast over a year ago in August 2005, the federal government has taken little regulatory action thus far.

E. International Governments

In other countries, the threat of regulation has created enough of an incentive for insurance companies to voluntarily undertake reform. In the United Kingdom, the Financial Services Authority (FSA), a non-governmental body authorized by statute to regulate the insurance industry, had concerns about the ability of insurers to pay claims in the case of a major natural disaster. As a result of voicing those concerns to the insurance industry in December 2004, the insurance industry took action to make the financial stability of insurance contracts more certain. In March 2006, the United Kingdom insurance industry estimated that the solvency of 65 percent of insurance contracts was certain, and it ultimately aspires to an 85 percent certainty rate. Because of this industry self-reform, the FSA has responded by postponing—perhaps indefinitely—plans to regulate the certainty of insurance contracts.

Ironically, the impact of the December 2004 Indonesian tsunami on the insurance industry was minimized by the fact that many of the resort homes that were destroyed did not have insurance policies. In contrast, Mexican insurance companies were forced to deal with an unusually large number of claims related to damage

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71 Id. (discussing H.R. 846).
72 Id.
73 Id.
75 See, e.g., Peter Thal Larsen, FSA Shelves Plans to Intervene in Insurance Contracts, FIN. TIMES LONDON ED., Mar. 21, 2006, at 3.
76 Larsen, supra note 75.
77 Id.
78 Id.
79 Id.
from Hurricanes Emily, Stan, and Wilma, which hit Mexico in 2005.81 While their magnitude does not compare to that of Katrina, Mexico nonetheless experienced record levels of insurance claims and payouts.82 This has international implications, as 70 percent of Mexico’s insurance policies are reinsured by companies outside of Mexico, primarily the United States and London.83 In the short term, the Mexican federal government relaxed its liquidity requirements for insurance companies to allow faster payouts on claims.84 In the long term, Mexico hopes to strengthen insurance regulations and create a national insurance pool to disperse the losses associated with natural disasters among both affected and unaffected geographic areas.85

**F. Conclusion**

Severe natural disasters have historically had a significant impact on the insurance industry, and there have been other periods during which increasing frequency and severity of natural disasters affected the insurance industry.86 For example, many insurance companies left coastal areas in the United States following an unusually severe storm season in the early 1990s.87 Insurance companies’ three years of profitable operations from 2002 through 2004 tempered the 2005 damage to industry profits.88 Only time will tell whether the recent trend in natural disasters’ increasing frequency and severity will continue or dissipate, which will dictate the ultimate long-term effect on the insurance industry.

Geoffrey Klimas89

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82 Id.
83 Id.
84 Id.
85 Id.
87 See id.
88 O’Connor & Pilla, supra note 3 (comparing the relative health of the insurance market leading up to recent natural disasters to the relative market struggles preceding the World Trade Center attack in 2001).
89 Student, Boston University School of Law (J.D. 2008).
XXIII. IRS RULES ON ABUSIVE TAX SHELTERS

Although the Internal Revenue Service (“IRS”) does not have an official definition of abusive tax shelters, they are usually defined as complex transactions through which taxpayers manipulate the tax code to create large, unintended reductions in their taxable income.1 The IRS has accumulated evidence regarding the extent of these abusive shelters and has developed a multi-prong strategy addressing the perceived abuses of the system.2 This strategy involves pursuing tax professionals who promote abusive transactions, placing an emphasis on detecting and deterring abusive tax shelters, and providing incentives to disclose abusive transactions.3

In 2006, the IRS took three steps in accordance with this general strategy to combat abusive tax shelters. First, Congress enacted the Tax Increase Prevention and Reconciliation Act of 2006 (“TIPRA”), which imposed excise taxes and additional disclosure requirements on organizations and their managers that use prohibited tax shelters.4 Next, the IRS extended the M-3 disclosure schedule to include insurance companies, S corps, and partnerships.5 Finally, the IRS allowed taxpayers until January 23, 2006 to take advantage of the lenient settlement terms of the Abusive Transaction Settlement Initiative.6

A. Tax Increase Prevention and Reconciliation Act of 2005

1. Excise Tax

TIPRA created section 4965 of the Internal Revenue Code and amended several other sections.7 The new section created an excise tax intended to dissuade tax-exempt organizations from

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2 Id. at 3.
3 Id.
5 George G. Jones & Mark A. Luscombe, M-3: Evaluating One Round While Rolling out the Next, ACCT. TODAY, Sept. 4, 2006, at 10.
participating in prohibited tax shelter transactions.\textsuperscript{8} Prohibited tax shelter transactions include "listed" transactions, reportable confidential transactions, and transactions with contractual protection.\textsuperscript{9} Listed transactions are specific transactions identified by the Secretary as a tax avoidance transaction, or any transaction substantially similar to a listed transaction.\textsuperscript{10} Confidential transactions are transactions in which disclosure limitations protect an advisor’s tax strategy.\textsuperscript{11} Transactions with contractual protections are transactions in which advisor fees are refundable if the taxpayer does not realize the intended tax benefits.\textsuperscript{12}

The tax-exempt organizations subject to this excise tax include specified tax-favored investment plans ("plan entities") as well as specified physical organizations such as churches and hospitals ("non-plan entities").\textsuperscript{13} Section 4965 imposes the excise tax on the organization itself in the case of non-plan entities, as well as on the managers of both plan and non-plan entities.\textsuperscript{14} The entity level tax is imposed if the entity becomes a party to a prohibited transaction but is also retroactively imposed on transactions that are listed subsequent to the entity taking part in them.\textsuperscript{15} The manager level tax is imposed on the person with authority over the organization in the case of non-plan entities, and, in the case of plan entities, on the person who either approves the prohibited tax shelter or has broad investment authority under the plan.\textsuperscript{16}

The manager level penalty is $20,000 for each prohibited tax shelter.\textsuperscript{17} The entity-level excise tax depends on the entity’s knowledge at the time they entered into the transaction.\textsuperscript{18} Notice 2006-65 delineates the penalty:

If the tax-exempt entity did not know (and did not have reason to know) that the transaction was a prohibited tax shelter transaction at the time the

\begin{footnotes}
\footnote{\textit{Id.}}
\footnote{I.R.S. Notice 2006-65, 2006-31 I.R.B. 102, 102.}
\footnote{\textit{Id.} at 103.}
\footnote{Treas. Reg. § 1.6011-4(b)(3) (as amended in 2006).}
\footnote{Treas. Reg. § 1.6011-4(b)(4) (as amended in 2006).}
\footnote{I.R.S. Notice 2006-65, 2006-31 I.R.B. 102, 102-03.}
\footnote{Serota, \textit{supra} note 7.}
\footnote{Alison L. Mcconnell, \textit{Issuers, Counsel Urge Treasury to Change TIPRA Excise Tax}, BOND BUYER, Sept. 18, 2006, at 1.}
\footnote{Serota, \textit{supra} note 7.}
\footnote{I.R.S. Notice 2006-65, 2006-31 I.R.B. 102, 104.}
\footnote{\textit{Id.} at 103.}
\end{footnotes}
entity became a party to the transaction, the tax is the highest rate of tax under § 11 . . . multiplied by the greater of: (i) the entity’s net income with respect to the prohibited tax shelter transaction . . . for the taxable year or (ii) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction . . . . If the tax-exempt entity knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity became a party to the transaction, the tax is the greater of (i) 100 percent of the entity’s net income with respect to the transaction . . . for the taxable year or (ii) 75 percent of the proceeds received by the entity for the taxable year that are attributable to such transaction . . . .

2. Retroactive Nature of Excise Tax

The retroactive nature of the excise tax could expose many non-plan organizations to liability for transactions they entered into before the transaction was listed as abusive. In fact, TIPRA could expose taxpayers to liability for transactions previously favored by the government. In the 1990s, the federal government encouraged lease-in/lease-out (LILO) deals in which a tax-exempt entity leased an asset to a private company which then immediately leased the asset back to the issuer and received a tax benefit. The IRS subsequently listed LILOS as abusive transactions. TIPRA does not take into account when the tax-exempt entity entered into the LILO deal, and the result could expose many of these entities to substantial penalties for deals that took place when the transaction was promoted as a capital funding method.

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19 Id.
20 McConnell, supra note 15.
21 Id.
22 Id.
24 McConnell, supra note 15.
3. New Disclosure Rules

Every tax exempt organization subject to the excise tax must disclose that it is party to the tax shelter and also any other known parties to the tax shelter.25 The penalty for non-disclosure is $100 per day, but the penalty for any one non-disclosure cannot exceed $50,000.26 A party to a prohibited tax shelter is also subject to a $10,000 to $200,000 penalty for failure to disclose to any other tax-exempt participant that the transaction is prohibited.27 The disclosure requirements became effective on May 17, 2006.28

B. Extension of the M-3 Disclosure Schedule

1. Large Book/Tax Differences Are No Longer a Reportable Transaction

As of 2006, large book/tax differences are no longer reportable transactions, because the IRS believes the expanded information requirements of schedule M-3 are comprehensive enough to render the filing of both redundant.29 Large book/tax differences occur when “the amount for tax purposes . . . differs by more than $10 million on a gross basis from the amount of the item or items for book purposes . . . .”30 Previously, companies had to file a reportable transaction disclosure statement for large book/tax differences; however, beginning with 2004 tax returns the IRS introduced schedule M-3 for companies with assets equal to or greater than $10 million.31 Due to schedule M-3 these companies no longer have to disclose transactions with a large book/tax differences as reportable transactions under § 1.6011-4.32 The IRS introduced schedule M-3 to more accurately guide examiners to transactions that should be audited by requiring more information about book/tax differences than the reportable transaction disclosure.33 However,

26 Id.
27 Serota, supra note 7.
29 Jones, supra note 5.
31 Jones, supra note 5.
33 Jones, supra note 5.
analysis of the 2004 tax returns shows a large non-compliance problem that undercuts the effectiveness of the new schedule.34

2. Schedule M-3 Extended to Include Insurance Companies, S Corps, and Partnerships

In 2006, schedule M-3 was extended to insurance companies, S corps, and partnerships.35 The filing requirements for insurance companies and S corps are similar to the $10 million in asset test for corporations.36 For partnerships, the IRS determined that the $10 million asset test was not adequate because the economic impact of partnerships can be far greater than their total assets imply; therefore, partnership filing requirements include four tests with the partnership only required to meet one in order to file the schedule.37 The first test is the same as the $10 million asset test of corporations.38 The second test is a modified version of the $10 million asset test based on assets before any adjustments that would reduce total capital.39 The third test requires the partnership to file an M-3 if its total receipts equal or exceed $35 million.40 Finally, if a partner owns at least 50% of the partnership and was required to file a schedule M-3 on their most recently filed federal tax return then the partnership must file a schedule M-3.41 The schedule for the three new entities is similar to the schedule for corporations, which allows methods for evaluating and identifying possible abusive transactions in corporations to be readily applied to the new entities.42

3. Schedule M-3 Provides a Starting Point for Book/Tax Reconciliation

Unlike previous attempts to reconcile book/tax differences, Part I of schedule M-3 provides a clear basis for reporting book

34 Id.
35 Id.
37 Id.
38 Id.
40 Id. at 2.
41 Id.
42 Boynton, supra note 36, at 10.
income by ranking financial statements on a scale of reliability, with Securities and Exchange Commission filings being the most reliable and unaudited corporation-produced financial statements being the least reliable.\textsuperscript{43} Due to this change, schedule M-3 increased the potential of using book/tax analysis to identify potentially abusive tax shelters.\textsuperscript{44}

C. Abusive Transaction Settlement Initiative

The IRS offered taxpayers who gained a tax-benefit from a listed transaction or a transaction substantially similar to a listed transaction until January 23, 2006, the opportunity to settle their abusive transactions.\textsuperscript{45} The settlement initiative specifically excluded several classes of people from eligibility, primarily promoters of the transactions and taxpayers who were in litigation to determine the tax treatment of a listed transaction.\textsuperscript{46} Under the settlement terms, taxpayers gave up all benefits derived from abusive transactions for all taxable periods allowed by law.\textsuperscript{47}

The settlement terms took different forms depending on the nature of the transaction. In some cases, the IRS denied all benefits from the transaction and computed the tax owed as if the abusive transaction never occurred; however, in other cases the settlement terms simply required recalculating the benefits of a transaction to remove the abusive elements.\textsuperscript{48} The settlement initiative also required the participant in an abusive tax shelter to pay the interest on the taxes owed as well as a fraction of the penalty the IRS would have required but for the settlement.\textsuperscript{49}

The Gulf Opportunity Zone Act of 2005 created additional incentives for taxpayers to participate in this settlement initiative. Before the Gulf Act, a taxpayer was not liable for the interest on unpaid tax liabilities for a period beginning 18 months after filing the return until October 3, 2004.\textsuperscript{50} The Gulf Act changed the interest

\textsuperscript{43} Id. at 4-5.
\textsuperscript{44} See id. at 5.
\textsuperscript{47} Id. at 969.
\textsuperscript{48} Id.
\textsuperscript{50} New Tax Law Affects Settlement Initiative, supra note 45.
calculation for abusive transactions and stipulated that interest accrued from the tax filing date until the taxpayer settled their unpaid liabilities. However, the taxpayers that settled under the settlement initiative were exempt from this new method of income calculation.

D. Conclusion

The government took several steps in 2006 to combat abusive transactions. First, Congress imposed excise taxes and additional disclosure requirements on organizations and their managers that use prohibited tax shelters. The IRS increased its ability to analyze returns for abusive elements by extending the M-3 disclosure schedule to include insurance companies, S corps, and partnerships. Finally, the IRS allowed taxpayers until January 23, 2006 to take advantage of the lenient settlement terms of the Abusive Transaction Settlement Initiative.

David Karasko

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51 Id.
52 Id.
54 Jones, supra note 5.
56 Student, Boston University School of Law (J.D. 2008).
XXIV. KPMG TAX SHELTER SCANDAL

A. The Thompson Memorandum

The United States Department of Justice memorandum entitled “Principles of Federal Prosecution of Business Organizations” (commonly referred to as the “Thompson Memorandum”) was issued by Deputy Attorney General Larry D. Thompson in 2003. The memorandum set forth revised guidelines for United States attorneys’ decisions as to whether or not to “seek charges against a business organization” itself, rather than just the alleged wrongdoers, in an effort to “enhance [the Department of Justice’s] efforts against corporate fraud.” One of the factors to be considered “in reaching a decision as to the proper treatment of a corporate target” is the corporation’s “willingness to cooperate.” In turn, two of the key factors in determining whether a corporation is cooperating is whether it has waived attorney-client privilege and work product protection, and whether it is “protecting…culpable employees.” In assessing whether a corporation is protecting culpable employees, the United States attorney is to consider whether they have advanced attorneys fees, retained the employees without sanction, provided information on the government’s investigation pursuant to a joint defense agreement, or any combination thereof.

The memorandum makes it clear that a corporation who wishes to genuinely cooperate should not “advance legal fees…to employees…[whom the government] deem[s] ‘culpable’” unless it is legally required to do so.

The Thompson Memorandum would take a significant role in the KPMG Tax Shelter Case in the wake of the Arthur Andersen scandal. Arthur Andersen served as Enron’s auditor throughout the

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2 Id.
3 Id.
4 Id.
5 Id.
Enron fraud. In 2002, Arthur Andersen was convicted of obstruction of justice for shredding Enron-related documents. This conviction was later reversed by the Supreme Court in 2005. However, by the time this conviction was reversed, Arthur Andersen was a shadow of its former self. In the wake of the collapse of Arthur Anderson, an indictment serves as a “virtual death knell for many companies.” It is in this type of environment that the KPMG tax shelter scandal developed.

B. KPMG Tax Shelter Scandal

In 2005, KPMG struck a deal with prosecutors and admitted to helping other individually-named defendants conspire to “defraud the IRS by designing, marketing and implementing illegal tax shelters” from 1996 through 2003. KPMG admitted “that it engaged in a fraud that generated $11 billion dollars in phony tax losses which, according to court papers, cost the United States at least $2.5 billion in evaded taxes.” The individually-named defendants were accused of distributing opinion letters claiming the tax shelters would more likely than not survive scrutiny by the Internal Revenue Service, while actually not believing the shelters would survive a challenge by the tax agency. At the core of the tax shelters were allegedly “fake loans and investments.”

The agreement KPMG reached with prosecutors mandated that prosecution of the criminal charge against KPMG would “be deferred until December 31, 2006 if specified conditions – including payment of $456 million in fines, restitutions, and penalties – are met.” If KPMG “has fully complied with all the terms of the

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8 Id.
9 Id.
11 Id.
13 Id.
15 Id.
16 Dep’t of Justice, supra note 12.
deferred prosecution agreement at the end of the deferral period, the
government will dismiss the criminal information.”17 Pointedly, “prosecutors…question[ed] KPMG in 2004 over whether the firm
intended to pay legal fees of indicted employees.”18 It was revealed
that at this time, a senior KPMG executive, former federal judge
Sven Erik Holmes, stated that “it was critical that the firm be in full
compliance with Thompson guidelines’ regarding its treatment of
employees whom it suspected of wrongdoing.”19 In what “many
legal scholars” see as a “textbook case of what happens when a
company follows the guidelines in the Thompson Memorandum,”
KPMG at first limited legal fees to $400,000 per defendant and then
“cut them off entirely.”20

C. Federal Judges Begin to Question Cutting Off of Legal Fees

Federal judges began to “question why companies are cutting
off legal fees to their executives when they become caught up in
criminal investigations.”21 “A federal judge in New Hampshire
granted five former executives of Enterasys Networks a three-month
reprieve in their trial after he questioned whether there was undue
influence to cut off their legal payments.”22 Judge Kaplan, the
presiding judge in the KPMG tax shelter case at the United States
District Court in Manhattan, went so far as to “order…a hearing to
determine whether prosecutors had improperly put pressure
on…[KPMG] to stop paying defendants’ legal bills.”23

The degree of adherence by the Department of Justice to the
Thompson Memorandum was becoming a contentious issue.24 While
prosecutors describe the Thompson Memorandum as “simply
factors…[they] must consider in evaluating a company’s cooperation
and are not ironclad requirements,” defense and corporate lawyers
say that “the memorandum is being used as a club to bludgeon
companies into . . . cutting off legal fees . . . to avoid being

17 Id.
18 Browning, supra note 10, at C1.
19 Lynnley Browning, U.S. Tactic on KPMG Questioned, N.Y. TIMES, June 28, 2006,
at C1.
20 Id.
21 See generally id.; Browning, supra, note 10, at C1.
22 Browning, supra note 10, at C1.
23 Id.
24 See id.
indicted.”  Corporate counsel have complained that the Thompson Memorandum puts the company in question “at the mercy of the Department of Justice” and creates a “culture of waiver…[where a company is] expect[ed]…to disclose private legal communications.”

D. Judge Kaplan’s Decision

“Judge Kaplan’s factual findings, made after a 2-day evidentiary hearing, show[ed] prosecutorial [mis]conduct specifically intended to coerce KPMG to cut-off fees.” He found that “before the criminal tax shelter investigation, KPMG’s longstanding practice always was to advance fees to its partners and employees to defend any civil or criminal case.” As recently as 2002, KPMG had paid $20 million in legal fees defending four partners in a criminal investigation relating to KPMG’s audit of Xerox. Judge Kaplan additionally found that the “government raised the fee issue at its first meeting with KPMG’s counsel at the very start of the investigation.” The prosecutors indicated that if KPMG had discretion over fees, the government would “‘look at that under a microscope.’” It was shortly after this meeting that KPMG first departed from its long established practice and began capping legal fees at $400,000.

Judge Kaplan ultimately found that “[t]he government’s interference in KPMG’s decision whether to advance fees violated the defendants’ rights to due process and assistance of counsel.” Judge Kaplan recognized a fundamental due process right, and particularly the urgent need for counsel in a case like this that involved “the government…producing millions of documents in discovery.” Judge Kaplan applied strict scrutiny to his decision, and determined that the government’s conduct was not “narrowly tailored to achieve a compelling government interest.”

25 Browning, supra note 18, at C1.
26 Id.
27 Margolis, supra note 6.
28 Id.
29 See id.
30 Id.
31 Id.
32 See id.
33 Id.
34 Id.
35 Id.
Judge Kaplan rejected the government’s argument that the Thompson Memorandum “punishes those whom prosecutors deem culpable.” Judge Kaplan found that “[t]he imposition of economic punishment by prosecutors, before anyone has been found guilty of anything, is not a legitimate government interest – it is an abuse of power.” “The government’s other justifications that its policy helps gauge the sincerity of corporate cooperation and encourages companies to pressure employees to cooperate as well both were found wanting.” The Court found that the “Thompson Memo [random] is not limited to corporations that ‘circle the wagons,’ but applies to all companies (however sincere their cooperation) to coerce them to refuse to advance fees.” The court further found that “[t]here is no language in the [Thompson Memorandum] limiting it to companies that engage in obstructive conduct or whose cooperation is otherwise lacking.”

In terms of public policy, Judge Kaplan found that the Thompson Memorandum went against the public policy of virtually all states, “including Delaware, which encourages companies to advance fees to officers and employees as an incentive to corporate service, so that employees can be free from the fear that they might later be ‘left out to dry’ in the event of a lawsuit or investigation.”

Judge Kaplan found that even though “the challenged conduct occurred before indictment,” this still did not “prevent a successful Sixth Amendment claim.” He further found that “the government’s pre-indictment coercion of KPMG was calculated to deprive the defendants of resources after they were indicted.” The KPMG decision came as a “necessary corollary” to a United States Supreme Court decision that “found in the Sixth Amendment context that defendants have the right to use their personal resources to defend themselves.” Judge Kaplan found further support “from the Supreme Court decision this Term in United States v. Gonzalez-Lopez.” In that case, “the Court found that wrongful deprivation of

36 Id.
38 Margolis, supra note 6.
39 Id.
40 Id.
41 Id.
42 Id.
43 Id.
44 Id.
45 Id.
retained counsel-of-choice was a structural error requiring automatic reversal of a conviction without any need to show prejudice.”46 Commentators speculated that it was “no leap of logic to apply that principle to the government’s wrongful interference with a defendant’s ability to fund his retained attorney through resources that would otherwise be available is a constitutional wrong.”47 On August 7, 2006, Judge Kaplan ordered a trial to “determine whether…former employees had an implied contract that required KPMG to pay legal fees.”48

E. Implications of Judge Kaplan’s Ruling

One commentator stated that Judge Kaplan’s ruling was “certain to be groundbreaking.”49 Indeed, the “Justice Department has already taken steps to insure that prosecutors are not being overly aggressive with the guidelines” by, for one, requiring all United States attorneys “to obtain approval from supervising prosecutors before requesting the privilege waivers.”50 No matter what the effect, a determined group has begun a multi-objective lobbying effort to curb government regulation of business, and one of their proposals is to “recommend that the Justice Department sharply curtail its policy of forcing companies under investigation to withhold paying the legal fees of executives suspected of violating the law.”51

F. The McNulty Memorandum

On December 12, 2006, the new Deputy Attorney General Paul McNulty announced the issuance of a new memorandum revising the guidelines for charging of corporations.52 Two of the most significant changes were those regarding obtaining privileged attorney-client communications from a corporation and the taking

46 Id.
47 Id.
49 Margolis, supra note 6.
50 Browning, supra note 18, at C1.
51 Labaton, supra note 7.
into account of a corporation providing attorneys’ fees to their employees in the decision to charge a corporation. The new memorandum, the “McNulty Memo,” provides that when a United States Attorney wishes to obtain privileged attorney-client communications from a corporation, the request must be approved by the Deputy Attorney General. The new memorandum “also instructs prosecutors that they cannot consider a corporation’s advancement of attorneys’ fees to employees when making a charging decision.” There is an exception, however, “for…extraordinary instances where the advancement of fees, combined with other significant facts, shows that it was intended to impede the government’s investigation.”

One critic hailed the new memorandum as a victory for big business, commenting that it was a demonstration of corporations’ political power. The critic also commented that this new memo has corporations “smell[ing] blood” and looking for a legislative bill that would prohibit waivers altogether. The impact of the new McNulty Memo remains to be seen.

Gerald Derevyanny

53 See id.
54 Id.
55 Id.
56 Id.
58 Id.
59 Student, Boston University School of Law (J.D. 2008).
XXV. CORPORATE GOVERNANCE

Numerous corporate scandals in 2002, the most notorious being Enron and WorldCom, created an atmosphere of distrust and skepticism in United States capital markets.\(^1\) Congress quickly reacted by passing the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").\(^2\) The main goals of Sarbanes-Oxley were to strengthen the protections offered to investors and increase the transparency and accuracy in corporate accounting and financial reporting.\(^3\) Through its regulatory changes, Sarbanes-Oxley was intended to decrease the risk of investment, create incentives for good corporate governance and re-instill faith in the economy as a whole.\(^4\)

Section 404\(^5\) is among the most controversial and highly criticized aspects of Sarbanes-Oxley.\(^6\) The biggest criticisms are that it encourages excessive caution, applies to non-material corporate functions, and does not provide adequate guidelines to either the internal management or the auditors.\(^7\) Although the sweeping reforms "rightly [punish] the managers who violated the rules... [they] may also punish innocent parties – employees, shareholders and the many firms who had conducted legitimate and profitable business relations with the now defunct enterprise."\(^8\) As a result, too many companies are burdened with spending many hours and millions of dollars to document details that have a minimal effect on the corporation’s financial status.\(^9\)

A particular focus of criticism has dealt with the burden faced by small public companies. Although there has been a

\(^2\) See id.
\(^3\) Hubbard & Thornton, *supra* note 1.
\(^5\) Schuman, *supra* note 4; Rob Garver, *SEC 404 Decision Leads to Tough Choice*, AM. BANKER, May 24, 2006. (Section 404 requires top executives of all publicly traded companies to review their internal controls over financial reporting and attest to their accuracy. It also requires that independent auditors then certify the firm’s internal controls.)
\(^6\) Hubbard & Thornton, *supra* note 1; Schuman, *supra* note 4.
\(^8\) Hubbard & Thornton, *supra* note 1.
significant amount of debate on the future of small firm compliance with section 404, the most substantial changes made in 2007 affected filing deadlines, rather than altering the requirements for compliance.10

A. Section 404 Places Large Burden on Small Firms

A small business is defined as a public company “with market capitalization of less than $700 million and revenues of less than $250 million.”11 Although certain integrated software systems can automatically set up many of the controls, the problem is that small companies can’t afford such systems.12 Thus, when Sarbanes-Oxley was first enacted, there was significant speculation that smaller companies would be driven from the public market altogether.13 This is a significant concern because public capital markets not only offer a means for growing firms to finance investment, but also allow risk-sharing to lower firms’ capital costs and provide investors with opportunities to fund promising business opportunities.14 Despite the fear expressed in 2002, small public companies continue to operate into 2007.15 The sustained presence of small firms in U.S. capital markets, however, is not as much a testament to the ability of these businesses to successfully implement section 404 requirements as it is a result of the SEC’s continued lenience in granting delays to small corporations.16

While larger public corporations had been dealing with the burden of Sarbanes-Oxley compliance by 2004, the SEC extended the filing deadline for small public companies until 2005.17

12 John Cunningham, Regulatory Burdens on Smaller Public Companies Could Decrease, LAW. WEEKLY USA, Apr. 24, 2006.
15 Gibeaut, supra note 13.
17 Gibeaut, supra note 13; McCann, supra note 16.
Nevertheless, there were no significant changes to the status of small firm compliance with section 404 at the close of 2005. At the end of 2004, the Securities and Exchange Commission (“SEC”) announced the formation of the SEC Advisory Committee on Smaller Public Companies (“Advisory Committee”), comprised of securities lawyers, small business executives, investment bankers and accountants. The committee was created to study the effects of Sarbanes-Oxley on small public companies.  

Thirteen months after its creation, the Advisory Committee issued a report that, once again, criticized section 404 as being over inclusive.

One of the Advisory Committee’s main criticisms, however, was that small companies were disproportionately burdened with the costs of complying with section 404. The American Electronics Association released a study that described section 404 compliance costs as a “regressive tax on small businesses.” According to the study, small companies are forced to spend a much larger percentage of their revenues on compliance, and thus, carry a much heavier load than the large public companies. By the end of 2005, the question was not if the SEC would make changes to the requirements of small companies complying with section 404, but to what extent.

B. No Exemption for Small Firms from Section 404

In early 2006 it appeared that the Advisory Committee would recommend to the SEC that small public companies be completely exempt from compliance with section 404. In April of 2006, the Advisory Committee voted to do just that. On May 17, 2006, however, the SEC rejected the Advisory Committee’s recommendation. While the SEC did, once again, extend the deadline for small firm compliance with section 404, it announced that “no U.S. Sarbanes-Oxley company will be exempt from section 404.

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19 McCann, supra note 16.
20 Id.
21 Kerrigan, supra note 18.
22 Id.
24 Id.
25 Id.
Unlike the hasty implementation of Sarbanes-Oxley itself, this decision was made with adequate consideration of both the benefits of section 404 and the concerns voiced by the Advisory Committee. The SEC’s decision reflected a number of concerns. First, it stressed the importance of protecting shareholders from fraudulent practices and improving the integrity of U.S. capital markets. Proponents of section 404 also argue that an implication of the SEC’s decision is that investors of small public companies deserve the same protections and assurances as those of large corporations. This decision, therefore, reemphasized the importance and necessity of Sarbanes-Oxley in the protection of U.S. investors and capital economy.

C. SEC Solution: Extensions and Guidance for Small Companies

The SEC does acknowledge that there are some shortcomings to section 404 with respect to small public companies. Although compliance is required for all public companies, there is room for improvement in the requirements and the SEC is committed to making the transition process for small companies as efficient as possible. The years following the enactment of Sarbanes-Oxley have shed some light on the types of problems firms will face in meeting their compliance requirements. The main source of problems is a lack of clarity. In 1992, the Committee of Sponsoring Organizations (“COSO”) declared that “internal controls encompass a set of policies, rules and procedures enacted by management to provide reasonable assurance that 1) financial reporting is reliable, 2) its operations are effective and efficient, and
3) its activities comply with applicable laws and regulations."  

The Public Company Accounting Oversight Board (PCOAB), created by Sarbanes-Oxley to oversee auditors of public companies, expanded the definition to include a system of checks and balances for all corporate operations.  

Managers and auditors, however, remain unclear as to what exactly they are certifying and attesting to.  

The result is high costs for small firms that need to put in place controls for many non-material elements.  

Following its May 17 announcement, the SEC declared that it would provide small businesses with better guidelines for section 404 implementation before the new July 2007 deadline.  

SEC Chairman Christopher Cox stated that the SEC is making a positive step towards more efficient section 404 compliance “[by] providing practical guidance to companies, by working with PCAOB on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost-effectiveness of the audit process.”  

The commission expects that comprehensible guidance will alleviate some of the high costs facing small firms.  

In July 2006, COSO issued guidelines for more cost effective implementation of internal controls, which may benefit many of the smaller public companies.  

The suggestions included creating a comprehensive project plan, outlining financial reporting objectives and conducting testing and evaluations.  

In its effort to further the “next steps for Sarbanes-Oxley implementation,” the SEC issued a release on August 9, 2006 granting further relief from compliance to small public companies.  

The SEC is continuing its “efforts to be sensitive and responsive to the particular needs of smaller public companies . . . and to minimize the burdens that section 404 will
impose on them.” The proposed rules would postpone the deadline to the fiscal year ending on or after December 15, 2007 for accelerated filers, and December 15, 2008 for non-accelerated filers. According to the SEC, the delay would serve two important objectives. First, the deadline extension clearly benefits small companies by allowing them more time to implement programs in compliance with section 404. The second and perhaps more significant implication of the extension is that the SEC and PCAOB will use the time to “redesign section 404 implementation in a way that is efficient and cost effective for investors.” Thus, while small firms were required to comply with Sarbanes-Oxley in general, their temporary exemption from section 404 continued into 2006.

D. As Complaints Continue, Independent Committee Formed

Despite the SEC’s attempt to ease the burden on small public companies through delays and better guidance, complaints that section 404 was still being interpreted too broadly continued. Consequently, various groups were formed to analyze the current situation in the U.S. markets and provide advice to the SEC regarding possible regulatory changes. As a reaction to both difficulties faced by U.S public companies and to the declining popularity of the U.S. capital markets, one such group, the Committee on Capital Markets, announced its formation on September 12, 2006. The committee is “an independent and nonpartisan group of academic, business, financial and corporate governance leaders,” that recognizes both the costs and benefits of Sarbanes-Oxley and was not created as a way to convince the SEC to repeal Sarbanes-Oxley completely. Instead, the committee will focus on researching the competitiveness of U.S. capital markets, measuring the costs of regulatory changes against their benefits, and

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44 Id.
45 Id.
46 Id.
47 Id.
48 Id.
49 Hubbard & Thornton, supra note 1.
50 Id.
51 Id.
52 Id.
evaluating possible alternatives. In late November 2006, the committee issued a statement that the implementation approach taken by the SEC and PCAOB does not strike the right cost-benefit balance. The committee’s November report highlighted several possible changes to Sarbanes-Oxley implementation that could improve the competitiveness of U.S. capital markets, including suggestions regarding more cost-effective implementation of section 404. In addition to revising the materiality standards and providing greater clarity to internal controllers and outside auditors, the committee suggested that “the SEC and PCAOB should give guidance to management and auditors to allow multiyear cycling of testing where appropriate.” Most importantly for small-firms, the committee suggested that small businesses be subject to a revised section 404, or that Congress should consider reshaping this section altogether and eliminate the requirement for auditor attestation. The report was issued in time for consideration by the SEC and PCAOB in the public meetings held December 13, 2006 and December 19, 2005 for the two groups, respectively.

E. Following the 2006 Congressional Elections

The congressional elections in early November 2006 also created a stir among the “nation’s business lobby.” Sarbanes-Oxley critics, however, feared that any change that could ease the burden on public companies would be less likely. It is unlikely that a Democrat-controlled Congress, however, will act in a way that is unfavorable to the U.S. financial markets. By November 17, Christopher Cox, Chairman of the SEC, announced that significant changes to Sarbanes-Oxley would be revealed at a public meeting on December 13, 2006. These changes, not surprisingly, would

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53 Hubbard & Thornton, supra note 1.
54 Hubbard & Thornton, supra note 14.
55 Id.
56 Id.
57 Id.
58 Id.
60 Scannell & Solomon, supra note 7.
61 Id.
62 Id.
mostly revamp section 404. Particularly, they were anticipated to fix the materiality problem of section 404 and help focus internal audits on financially relevant information.

F. No Significant Changes in Small Firm Compliance at the End of 2006

On December 13, 2006, the SEC voted to propose interpretive guidance to section 404. According to the Chief Accountant, Conrad Hewitt, the focus would be on risk and materiality and, “in particular, the top-down, risk based guidance would allow for effective, and, importantly, efficient, methods and procedures for control over the process by providing management with its own guidance—without the need to look to auditing standards—for evaluating internal control over financial reporting.”

The proposal provides a specific set of procedures for management to follow to satisfy the requirements of section 404. While this announcement helps curb the costs of section 404 implementation in general, it does little to relieve small businesses of the disproportionate burden placed on them versus large firms. The SEC did, however, once again extend the deadline for compliance for small public companies. The July 15, 2007 deadline for management’s assessment was extended until December 15, 2007, while auditor attestation will not be required until the fiscal year ending on December 15, 2008. In the interim, PCAOB will continue to conduct a cost-benefit analysis of the auditing demands to ensure that the costs to smaller companies are not disproportionate to the benefits.

Much like the end of 2005, small firms have taken few steps to comply with section 404. Many of the same criticisms, including the disproportionate costs to small firms continue, and the permanent exemption of small public corporations from auditing requirements

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64 Id.; David Reilly, Regulator Says Accounting Rules May Ease but Will Stay in Place, WALL ST. J., Nov. 18, 2006, at B5.
65 Burns & Scannell, supra note 63.
67 Id.
68 Id.
70 Id.
remains a heavily advocated for solution.\textsuperscript{72} So far, SEC and PCAOB actions have resulted in increased guidance, and the most recent proposed changes attempt to fix the problem of materiality.\textsuperscript{73} Continued delays provide Congress, the SEC, PCAOB and small public companies with more time to target the problem of disproportionate costs. It is possible that the periodic changes will result in looser restrictions on management, and the continued cost-benefit analysis will help ensure that the changes are not enacted at the expense of the integrity of financial markets.\textsuperscript{74} The final effect section 404 will have on small public companies in the U.S. capital markets remains to be determined.

Bella Zaslavsky\textsuperscript{75}

\textsuperscript{72} See Tucci, supra note 69.
\textsuperscript{73} Kay, supra note 11.
\textsuperscript{74} See id.
\textsuperscript{75} Student, Boston University School of Law (J.D. 2008).
XXVI: REGULATORS AT THE GATE\textsuperscript{1}: THE FUTURE OF PRIVATE EQUITY INVESTMENT

A. Introduction

In the 1980s, investment firms acquired companies by loading the target with huge amounts of debt, or leverage, and then broke the conglomerates apart to sell the pieces for profit.\textsuperscript{2} These takeovers became known as leveraged buyouts due to the excessive debt used to finance the transactions.\textsuperscript{3} In such a transaction, the acquirer purchases the company with a cash payment of twenty to thirty percent of the total value and the remainder of the acquisition is financed through bank loans and bond sales.\textsuperscript{4} In the 1980s, acquirers financed leveraged buyouts primarily through junk bonds, but buyouts became less prevalent as the junk bond market dried up.\textsuperscript{5} Leveraged buyouts became a hot investment vehicle again in the technology boom of the 1990s; however, when the stock market bubble burst in 2000, so did the opportunity for leveraged buyouts.\textsuperscript{6}

The past few years have witnessed a resurgence in leveraged buyouts, which are now commonly classified as private equity investments.\textsuperscript{7} Private equity investment firms “[a]cquire undervalued companies, load them with debt, overhaul operations and then return them to the stock exchanges,” giving investors potentially great returns and collecting massive fees throughout the

\footnotesize{\textsuperscript{1} Derived from Bryan Burrough and John Helyar’s probative book Barbarians at the Gate, chronicling the leveraged buyout of RJR Nabisco. BRYAN BURROUGH & JOHN HElyAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO, Perennial (HarperCollins) (1991).}

\footnotesize{\textsuperscript{2} Barbara Kiviat, The Big Deals Wheel Again, TIME, Aug. 7, 2006, at 50; see also Matthew Monks, Private-Equity Stars Play Name Game, WALL ST. J., Oct. 4, 2006.}

\footnotesize{\textsuperscript{3} Brandt v. Wand Partners, 242 F.3d 6, 10 n.2 (1st Cir. 2001) (defining a leveraged buyout as “[a] transaction to acquire a corporation ‘in which a substantial portion of the purchase price paid for the stock of a target corporation is borrowed and where the loan is secured by the target corporation’s assets.’”) (quoting Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 645 (3d Cir. 1991), cert. denied, 503 U.S. 937 (1992)).}

\footnotesize{\textsuperscript{4} Randall Smith, Dennis K. Berman & Gautam Naik, HCA Is in Talks On Buyout Offer Worth $21 Billion – Deal for Company Would Be Among Largest of Its Kind; A Frist Family Connection, WALL ST. J., July 24, 2006, at A1.}

\footnotesize{\textsuperscript{5} Kiviat, supra note 3.}

\footnotesize{\textsuperscript{6} Id.}

\footnotesize{\textsuperscript{7} Id.; see also Monks, supra note 3.}
In 2006, private equity boomed, due in part to a poorly performing stock market and historically low interest rates. The private equity takeovers in 2006 reached all-time highs as private investment firms banded together in so-called “club deals” to target larger public companies.

Kohlberg Kravis Roberts & Co. (“KKR”) long held the record for the largest leveraged buyout, winning a bidding war for RJR Nabisco in 1989 at a legendary price tag of $31 billion. This record has been continuously challenged in recent years. In 2006, pipeline operator Kinder Morgan announced it would be taken private for $22 billion. And, on July 24, 2006, a consortium of private equity investors, including KKR, surpassed the RJR Nabisco record by closing a deal to acquire hospital chain HCA for $33 billion. Of the top twenty buyout deals on record, fifteen have been announced since 2005.

Part I of this note will examine the HCA and Kinder Morgan transactions, some of the largest buyouts in 2006, and address the specific conflicts and issues that arose from those investments. Part IIA will address the general concerns surrounding private equity, including the inherent conflicts of interest that arise in private equity investments.
investment. Lastly, Part IIB will examine recent regulatory backlash and speculate as to the future of private equity investment.

B. The Deals

1. HCA: Only $33 Billion?\(^\text{15}\)

In the summer of 2006, KKR, alongside Bain & Co. and Merrill Lynch, announced a $33 billion deal to purchase the HCA hospital chain.\(^\text{16}\) The HCA deal surpassed the RJR Nabisco buyout as the largest private-equity deal of all-time.\(^\text{17}\) The investors in the HCA deal financed the acquisition with the biggest loan package ever floated and the largest high-yield debt ever sold to back a leveraged buyout.\(^\text{18}\)

Rumors circulated in mid-July, 2006 that the buyout would fall through because the debt market had tightened, making funding the deal more difficult.\(^\text{19}\) However, HCA confirmed that it was being taken private on July 24, 2006.\(^\text{20}\) The HCA deal may be different in some respects from the leveraged buyouts of the 1980s, which focused on cutting costs and streamlining business operations. Analysts speculated that HCA investors bought into the idea of growing with the chain in the future rather than stripping the business down to sell it for profit.\(^\text{21}\)

a. Advisor to Investor

Parties to a private equity investment may take on multiple roles throughout the process. For example, in the case of a management-backed buyout, the board members of the target company itself become investors taking the entity private.\(^\text{22}\) In this
deal, Merrill Lynch, a longtime advisor to HCA, also took on the role of investor.\footnote{23 Randall Smith, \textit{Barbarians at the Bedside – How Wall Street Securities Firms Plan to Profit in HCA Hospitals; Juggling Many Roles in Buyout}, \textit{WALL ST. J.} July 25, 2006, at C1.} With investment banks functioning as investors, advisors, and, in some instances, lenders, various investment banks have scaled back their involvement in private equity to avoid allegations of unfair competition.\footnote{24 Id.} Some investment bankers have admitted that taking on multiple roles could lead to inevitable conflicts.\footnote{25 Id.} Merrill Lynch, acting as both advisor and investor, sought to avoid such conflicts in its dealings with HCA.

Since May 2001, Merrill Lynch had advised HCA on asset sales, a one billion dollar acquisition, and four billion dollars worth of stock buybacks.\footnote{26 Id.} Yet in closing the HCA deal, Merrill Lynch did not serve as HCA’s advisor. Merrill Lynch instead served as advisor to KKR and Bain & Co., the club taking HCA private.\footnote{27 Id.} Merrill Lynch, along with Bank of America, Citigroup and JPMorgan, also provided debt to finance the buyout.\footnote{28 Id.} Compounding these potential conflicts, Merrill Lynch invested more than $1 billion in the club deal.\footnote{29 Id.} Thus, Merrill Lynch’s roles included advisor to parties on both sides of the deal, financier, and investor, albeit at different times. To insulate itself from these potential conflicts, Merrill Lynch took three steps to isolate its former role as advisor from its new role as investor.

First, when HCA management broached the idea of going private, Merrill Lynch bankers stepped down as HCA’s formal advisors and introduced HCA to the Merrill Lynch private equity investment group.\footnote{30 Id.} As HCA’s advisor, Merrill Lynch would have had the obligation to seek out the highest price for HCA shares.\footnote{31 Id.} However, Merrill Lynch envisioned the possibility of investing in the HCA deal.\footnote{32 Id.} As an investor, Merrill Lynch would want to acquire HCA at the lowest cost. Thus, Merrill Lynch’s investor and advisor
roles would necessarily conflict. As a result, Merrill Lynch attempted to eradicate this potential conflict by removing itself as HCA’s formal advisor.33

Second, Merrill Lynch invested with its own money rather than that of its institutional investors.34 This practice differs from other buyout-fund investment groups which raise funds from institutional investors, such as pension funds, and then owe the investors a fiduciary duty to seek investments at the best price.35 Although Merrill Lynch did not serve as a formal advisor to HCA in the transaction, Merrill Lynch still had a history with HCA and likely recognized that investing at the lowest price could pit itself against a former client. Merrill Lynch’s president of global-markets and investment-banking division claimed that investing with Merrill Lynch’s own money would avoid a fiduciary duty to its institutional investors to invest at the lowest price.36 Merrill Lynch’s tactic may have minimized the actual fiduciary duty to invest at a low price, but the incentive to obtain the lowest price was unavoidable because as a public company Merrill Lynch has duties to its shareholders.37 Merrill Lynch’s own shareholders would still be subject to some residual unfairness if Merrill Lynch did not seek the lowest price for its investment.

Third, Merrill Lynch screened the bankers participating in the HCA private equity investment.38 Although no longer serving as formal advisor to HCA, Merrill Lynch likely had extensive knowledge and previous access to HCA’s company records. Merrill Lynch recognized that certain bankers would have had access to HCA company information and disclosing that information to bankers investing in HCA could have harmed HCA shareholders being bought out of the company.39 For that reason, Merrill Lynch screened the bankers who worked directly with HCA over the years from participation in the buyout.40 While there is currently no

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33 Id.
34 Id.
35 Smith, Berman & Naik, supra note 5.
36 Id.
37 Since Merrill Lynch invested with its own funds, this technically eliminated the fiduciary duty to invest at the lowest price; however, it is arguable that Merrill Lynch would still have an incentive to invest in the lowest price absent this fiduciary duty.
38 Smith, supra note 24.
39 See discussion infra Part I.B.
40 Smith, supra note 24.
regulation mandating that such an action take place, Merrill Lynch likely screened its bankers to avoid HCA shareholder dissent or a future shareholder lawsuit.\(^41\) Threat of shareholder dissent can be a powerful incentive for dealmakers to regulate their own conduct.\(^42\)

Merrill Lynch’s involvement in the HCA buyout demonstrated useful tactics an advisor may utilize when simultaneously assuming the roles of advisor and investor. Merrill Lynch stepped down as formal advisor to the company to remove the obvious conflict; Merrill Lynch invested with its own money to minimize the conflict its fiduciary duty might pose against its former client; and lastly, Merrill Lynch screened the bankers participating in the private equity transaction to ensure that they had not previously worked with HCA in an advisory capacity.

b. Is the Deal Fair to Shareholders?

With Merrill Lynch no longer acting as an advisor, HCA’s board obtained outside advice from Credit Suisse and Morgan Stanley to protect the interests of HCA shareholders and to determine whether the deal would be fair to shareholders.\(^43\) The structure of the HCA deal also left open a fifty-day period during which other investors could submit an alternative offer to maximize shareholder value.\(^44\) However, competing offers for the hospital chain were never made.

One explanation for the absence of competing claims could have been the size of the deal.\(^45\) While it was reported that the Blackstone Group would compete for the deal; Blackstone would have needed investment help from other firms. Major Wall Street players such as Goldman Sachs stayed far away from the HCA deal.\(^46\) With a consortium of investors already assembled, it may have been difficult to assemble a competing coalition.

Some have suggested that Wall Street firms stayed away because the terms of the HCA deal were not particularly attractive to

\(^{41}\) Id; see also Model Rules of Prof’l Conduct R. 1.0(k) (defining “screen” within the practice of law).
\(^{42}\) See discussion infra Part I.B.2.
\(^{43}\) Smith, supra note 24; see also Smith, Berman & Naik, supra note 5; see generally Herskowitz v. Nutri/System, 857 F.2d 179 (3d Cir. 1988) (discussing fairness issues).
\(^{44}\) Smith, supra note 24.
\(^{45}\) Berman, Naik & Winslow, supra note 21.
\(^{46}\) Smith, supra note 24.
competitors. Under the terms of the deal, Bain, KKR, and Merrill Lynch had the opportunity to top any counteroffer. Thus, when a competitor exercised its due diligence, which could cost as much as ten to twenty million dollars, it would have done so without any certainty that the competing offer would even be accepted. Further, even if the competing offer were accepted, Bain, KKR and Merrill Lynch would receive a $300 million breakup fee.

2. The In-Crowd: Kinder Morgan Insiders Take the Company Private

In August 2006, petroleum pipeline operator Kinder Morgan, Inc. ("KMI") was taken private in a management-backed buyout for $22 billion. In a management-backed buyout, the company’s managers already own a significant portion of the company’s equity and work together with private equity investors to acquire the remainder of the shares. In this case, Chairman and CEO Richard Kinder, co-founder Bill Morgan, and board members Fayez Sarofim and Mike Morgan owned a significant portion of KMI and took the company private with the help of private equity investors Goldman Sachs Capital Partners, American International Group, the Carlyle Group, and Riverstone Holdings.

Management-backed buyouts inherently breed conflicts of interest because the managers taking the company private want to pay as little as possible for the company, while the shareholders being bought out want the highest price they can get. In these

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47 Henny Sender & Randall Smith, Blackstone May Enter Bid for HCA – Current Agreement Poses Obstacles for New Entrants; A $300 Million Breakup Fee, WALL ST. J., July 26, 2006, at A3.
48 Id.
49 Id. (discussing another explanation for the absence of competition as the generally anti-competitive, “incestuous” nature of private equity investment as it exists today. Some argue that investment firms are less likely to compete for fear that competition will drive prices higher requiring more debt to complete the buyouts). This point is further illustrated by the RJR Nabisco leveraged buyout in which KKR topped a management-backed bid, ultimately leaving RJR Nabisco saddled with high debt and making the deal less profitable. For a detailed examination of the RJR Nabisco leveraged buyout see Barbarians at the Gate, supra note 1.)
50 Purva Patel, Kinder group boosts bid to $22 billion; Investors taking firm private offer 27% more, but some still unhappy, HOUS. CHRON., Aug. 29, 2006, at B1.
51 ROBERT CLARK, CORPORATE LAW 500 (1986).
52 Jad Mouawad, Kinder Morgan Agrees to an Improved Buyout Offer Led by Its Chairman, N.Y. TIMES, Aug. 29, 2006, at C3.
53 See Smith, supra note 24.
circumstances, management will employ certain techniques to assure that the deal is fair to shareholders. 54 One such technique is the formation of a special committee of disinterested independent directors. 55

a. The Special Committee

Special committees are comprised of independent board members whose mission is to negotiate a fair transaction for shareholders and to ensure that shareholders receive the best available price for their shares. 56 A special committee is usually advised by an outside investment banker or law firm. 57 To ensure the propriety and fairness of the rendered opinion, the hired advisor should be independent from the company itself and the board taking the company private. 58

Recognizing these issues, KMI established a special committee comprised of independent board members to evaluate the fairness of the management-backed buyout. 59 The special committee hired Blackstone, Morgan Stanley, and New York law firm Skadden Arps to render a fairness opinion. 60 Ultimately, the special committee determined the $100 share price was too low, and the private equity club subsequently raised the offer price to $107.50 per share, bringing the total deal up to $22 billion. 61 Although the special committee was integral in raising the price to $107.50, some argue that “[s]pecial committees often ask for, and receive, an improved price from potential buyers as a sign there is no sweetheart deal in place.” 62 Thus, this raise in price could have been mere

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55 Id.
56 Id.
57 Id.
58 Id.
59 Tom Fowler, Offer may rise for KMI shares; But analysts say a bidding war is not very likely, HOUS. CHRON., May 31, 2006, at B1.
60 Avital Louria Hahn, A Legal Minefield Awaits MBOs; Without proof of fairness, deals can lead to a flood of shareholder suits, INVESTMENT DEALERS’ DIG., June 19, 2006, at 28.
61 Patel, supra note 51.
62 Dennis Berman & Henny Sender, Kinder Morgan Gets Proposal To Take It Private – Management-Led Buyout, Valued at $13.5 Billion, Would Be Biggest of Its Kind, WALL ST. J., May 30, 2006, at A1; see also ALLEN & KRAAKMAN, supra note 57, at 314 (“Techniques that assure the appearance as well as the reality of a fair deal are useful.”) (emphasis added).
pretense to represent that the special committee was acting independently.63

Indeed, KMI shareholders questioned the independence of the special committee and filed a class action lawsuit on August 28, 2006 in Kansas District Court.64 The shareholders claimed that the original $13 billion deal at $100 per share was unfair.65 The plaintiffs amended their complaint in October, after the buyout price was raised to $107.50, claiming that even this adjusted price was unfair.66

The shareholders’ complaint focused on the nature and structure of the management-backed buyout and whether the special committee was tainted or acted improperly. Specifically, the plaintiff shareholders alleged that KMI directors breached their fiduciary duties by taking part in wrongful self-dealing.67 Additionally, the shareholders alleged that Riverstone Holdings, Goldman Sachs and the Carlyle Group aided and abetted the breaches of fiduciary duty and would “profit from the acquisition of KMI at a grossly inadequate and unfair price.”68 Lastly, the shareholders claimed the process by which the $107.50 share price was approved was “defective and not independent.”69

63 But see Dennis K. Berman & Henny Sender, Backstory of Kinder LBO Underscores Web of Ethical Issues Such Deals Face, WALL ST. J., Sept. 29, 2006, at C1 (noting that “[t]he special committee was able to extract the higher price, said people familiar with the matter, because it was very close to rejecting the offer, in part because it was upset with how the original approach was conducted.”).


65 Id. at 38-40; see also Hahn, supra note 63.

66 In re Kinder Morgan, Consol. Case No. 06 C 801 (Kan. Dist. Ct. Oct. 2, 2006) [hereinafter Amended Kinder Morgan Complaint], at 46 (stating that “[t]he $107.50 share price approved by the special committee and Board does not fairly account for the extraordinary control value of KMI and its assets.”); see also Patel, supra note 53 (quoting Darren Robbins, an attorney representing some of the shareholder plaintiffs stating “[t]here’s no doubt $107.50 is better . . .but it simply doesn’t lend itself to an agreement by the plaintiffs to discontinue the case.”); but see Jad Mouawad, Kinder Morgan Agrees to an Improved Buyout Offer Led by Its Chairman, N.Y. TIMES, Aug. 29, 2006, at C3 (reporting that “Paul Sankey of Deutsche Bank wrote: ‘[t]here are megabulls on Kinder Morgan who valued it at $150, and expected a bump to $120, but this was not reflected by the market, which clearly didn’t see much upside.’”)

67 Amended Kinder Morgan Complaint, supra note 67, at 2.

68 Id. at 11-12.

69 Id. at 46.
b. **Inside the shareholders’ complaint: Is the Kinder Morgan deal unfair?**

Mr. Kinder famously collected a mere $1 salary for his role in managing KMI (as KMI’s largest shareholder, his income was derived from his stock ownership). As a result of Mr. Kinder’s compensation arrangement, his interests were historically aligned with his fellow shareholders since they both profited from increases in KMI’s stock price. In contrast, taking the company private pitted Mr. Kinder’s interests directly against those of KMI’s shareholders.

Shareholders and analysts questioned the timing of the KMI buyout because it was announced when shares were trading at an all-time low. This trading slump seemed like an anomaly because KMI had announced various opportunities for expansion in the near future. Thus, the plaintiff shareholders alleged that KMI insiders were able to benefit from the low trading price, while investing in a growing company set to make hefty profits from expansions in the near future. As a result, the shareholders argued that the KMI directors breached their fiduciary duty because they used their insider “knowledge, judgment and expertise” to maximize their own interests in the leveraged buyout at the expense of the shareholders.

The misalignment between Mr. Kinder’s interests and shareholders’ interests is not unique in a management-backed buyout. By definition, a management-backed buyout is a transaction in which insiders take their company private. These managers-turned-investors will always have superior knowledge derived from running the company and their interests will always be adverse to the shareholders because the investors will want to acquire the company for as little as possible while the shareholders will want to maximize the value of their shares.

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70 Patel, *supra* note 51.
72 *Amended Kinder Morgan Complaint, supra* note 67, at 45.
73 *Id.* at 42-45.
74 *Id.* at 45.
75 *Id.* at 45-46.
76 *CLARK, supra* note 52, at 500; *BLACK’S LAW DICTIONARY* 213 (8th ed. 2004) (defining the term “management buyout”).
Shareholders also argued that the directors breached their fiduciary duty by including unfair deal protections.\textsuperscript{78} For example, if the deal were to fall through, Mr. Kinder and the board would receive a $215 million termination fee and up to $45 million in expense fees.\textsuperscript{79} Shareholders complained that the termination fees were too high “[b]ecause [KMI] was being acquired by insiders who wouldn't have to spend as much as an outsider would in evaluating the company for purchase.”\textsuperscript{80} Although these break-up fees might have dissuaded potential investors from making a counteroffer, such termination fees are routine in private equity transactions, so it will be difficult for shareholders to prove that management was acting improperly unless it is determined that the fees were unreasonably high.\textsuperscript{81}

Shareholders also faulted the special committee appointed to examine the fairness of the deal. The complaint alleged that the special committee was not acting independently and was tainted by high compensation fees and an overbearing CEO.\textsuperscript{82} While each member of the KMI special committee did receive between $125,000 and $250,000 in compensation, there is no evidence that these fees tainted the independence of the committee.\textsuperscript{83} In fact, compensating the special committee members for their service in negotiating a fair deal is a customary practice.\textsuperscript{84} The special committee’s compensation could be likened to a fee paid to an expert witness in a trial. An expert receives a fee for her time spent on the case regardless of how she testifies; likewise, special committee members receive compensation regardless of their opinion. Thus, the

\textsuperscript{78} Amended Kinder Morgan Complaint, supra note 67, at 46.
\textsuperscript{79} Patel, supra note 51 (although the buyout was announced in August 2006, the deal is still pending).
\textsuperscript{80} Id.
\textsuperscript{81} See, e.g., Sender and Smith, supra note 48; see also In re Toys "R" Us, Inc., S’holder Litig., 877 A.2d 975, 1017 (Del.Ch. 2005) (discussing validity and commonality of termination fees in buyout transactions).
\textsuperscript{82} Amended Kinder Morgan Complaint, supra note 67, at 46-47.
\textsuperscript{83} Id. at 39.
\textsuperscript{84} See Kimble Charles Cannon, “Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers After Siliconix, Aguila and Pure Resources”, 2003 COLUM. BUS. L. REV. 191, 222 n.96 (2003) (“It is widely acknowledged that service on a special committee may require additional compensation.”).
shareholders will have difficulty proving that the special committee’s compensation made the committee *per se* tainted.85 

In addition to arguing that high compensation tainted the special committee, the complaint also alleged that the advisors tainted the special committee.86 The committee was advised by Morgan Stanley — a former advisor to KMI.87 In November 2004, Morgan Stanley worked alongside Goldman Sachs, one of the buyout partners, to advise KMI directors in an asset sale.88 Due to Morgan Stanley’s prior involvement with KMI and the buyout partners, the shareholders questioned the propriety of Morgan Stanley’s role in advising the special committee.89

Also, since the KMI buyout was backed by management, the shareholders argued that Richard Kinder himself tainted the special committee. Mr. Kinder reportedly launched the career of one of the board members selected to serve on the special committee.90 Based on this observation, the shareholders alleged that this special committee member likely felt indebted to Mr. Kinder and, therefore, could not have acted disinterestedly.91 The shareholders further alleged that other members of the special committee were tainted merely by the fact that Mr. Kinder held a management role within KMI.92

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85 See id. at 221-222 (discussing procedural requirements necessary to ensure the special committee acted fairly and recognizing that reasonable compensation is permissible); but see In re Tele-Commc’n, Inc. S’holder Litig., 2005 Del. Ch. LEXIS 206, at *49 (Del. Ch. 2005) (recognizing compensation exceeding $1 million may suggest special committee process was flawed).
86 Amended Kinder Morgan Complaint, supra note 67, at 39-40.
87 Id. at 38-39.
88 Id.
89 See Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997) (finding that the special committee did not satisfy their professional obligation to the shareholders due in part to their choosing an outside advisor who had “lucrative past dealings” with the investor). In this case, perhaps Kinder Morgan’s special committee should not have chosen an advisor that had past dealings with Kinder Morgan. See also ALLEN AND KRAAKMAN, supra note 55, at 314.
90 Amended Kinder Morgan Complaint, supra note 65, at 39.
91 Id.
92 Id. (The special committee would be unlikely to oppose Mr. Kinder because the committee members have an interest in keeping their positions after the company is taken private. However, accepting this argument implies that all special committees that assess fairness of insider buyouts are inherently biased because the buyout is led by insiders. In fact, the whole purpose of a special committee is to protect against such a phenomenon. Thus, it will be difficult for the shareholders to prove that Mr. Kinder has improperly influenced the special committee.)
The shareholders also claimed that the terms of the deal failed to maximize the value of their shares. However, two factors could have accounted for the $107.50 share price. First, Mr. Kinder’s role in the buyout could have dissuaded potential bidders from competing for the company. Early on, it was rumored there would be a counteroffer, possibly from TransCanada or Enbridge. However, since Mr. Kinder himself owned nearly 20% of KMI, a counteroffer would have depended on his support, something which Mr. Kinder may have been unwilling to give considering his interest in the initial buyout offer.

Second, KMI’s corporate structure could have dissuaded potential bidders. Kinder Morgan consists of three affiliated, publicly traded companies: KMI, (the arm being taken private), Kinder Morgan Energy Partners (“KMP”) and Kinder Morgan Management (“KMR”). Many of the large players who may have considered a counteroffer were already invested in one of these other affiliated companies. Thus, analysts speculated that those investors would have avoided a bidding war for KMI because driving up the price for KMI could have created a bigger debt load which subsequently would have jeopardized their investments with KMP or KMR.

At the time of publication, the shareholder complaint was still pending in Kansas District Court. While it is uncertain whether the suit will go forward, the shareholders’ dissent could result in an increased buyout offer. For example, in 2005, shareholders of the Tennessee-based regional retailer Goody’s Family Clothing filed a complaint seeking to enjoin Goody’s from a proposed merger.

93 Id. at 2-3.
94 Patel, supra note 51.
96 Tom Fowler, Offer may rise for KMI shares; But analysts say a bidding war is not very likely, HOUS. CHRON., May 31, 2006, at B1 (stating that investors would like Richard Kinder to stay on board since he “[h]elped build the companies from a small collection of former Enron pipeline properties into a massive business with more that 34,000 miles of pipelines and 150 fuel terminals.”).
97 Id.
98 Id.
99 Id.
Goody’s shareholders, like KMI shareholders, alleged that the directors breached their fiduciary duty by accepting an inadequate offer from a private equity firm and alleged that the directors discouraged other acquisition proposals by imposing an excessive termination fee.\textsuperscript{101} It was later revealed that the private equity firm’s bid was not the highest bid so the bidding process was re-opened and a bidding war ensued.\textsuperscript{102} In the end, Goody’s shareholders received an added 20% to the original $327 million buyout price.\textsuperscript{103}

c. \textit{The Federal Trade Commission Takes Notice}

In late January 2007, the Federal Trade Commission (“FTC”) filed a complaint challenging certain terms of the Kinder Morgan private equity transaction.\textsuperscript{104} The FTC expressed antitrust concerns with respect to the investments of the Carlyle Group and Riverstone Holdings.\textsuperscript{105} Carlyle and Riverstone both held significant investments in Magellan Midstream, a chief KMI competitor in the southeastern United States.\textsuperscript{106} The FTC expressed concern that Carlyle and Riverstone’s private equity stake in KMI would threaten competition between KMI and Magellan which could result in higher prices for petroleum products.\textsuperscript{107}

The FTC formally charged Carlyle and Riverstone with violations of section 7 of the Clayton Act and section 5 of the Federal Trade Commission Act.\textsuperscript{108} In order to comply with the Clayton and the FTC Acts, the FTC ordered Carlyle and Riverstone to transform their holdings in Magellan into a passive investment.\textsuperscript{109}

Specifically, the FTC required Carlyle and Riverstone to remove all of their representatives from Magellan’s boards, cede control to Magellan’s other principal investor, and refrain from influencing Magellan’s operations or management.\textsuperscript{110} Additionally,

\begin{footnotes}
\textsuperscript{101} Id.
\textsuperscript{102} Id.
\textsuperscript{103} Id.
\textsuperscript{105} Kristen Hays, \textit{FTC approves Kinder Morgan deal; Caveat is that two investors take passive role at competitor}, HOUS. CHRON., Jan. 26, 2007, at B3.
\textsuperscript{106} FTC Press Release, \textit{supra} note 107.
\textsuperscript{107} Id.
\textsuperscript{109} Id. at *10-18; \textit{see also} FTC Press Release, \textit{supra} note 105.
\textsuperscript{110} In re TC Group, L.L.C., \textit{supra} note 109.
\end{footnotes}
the FTC required Carlyle and Riverstone to establish safeguards ensuring that information relevant to competition not be shared between Magellan and KMI. The FTC’s action could be evidence of the agency’s willingness to regulate private equity investments that may inhibit competition, and thereby adversely affect consumers.

C. Regulators at the Gate

1. What’s Wrong With Private Equity?

Wall Street analysts and media pundits criticize private equity investment on at least three levels. The first level of criticism aims at the dealmakers, primarily for loading acquired companies with excessive debt in order to pay themselves substantial dividends. The second level of criticism focuses on the participating companies for their potential conflicts of interest. The third level of criticism questions the paucity of competition for these lucrative acquisitions. This section examines these attacks on private equity in more detail.

a. Dividends to Default

Standard & Poor’s recently reported that during 2006, private equity firms have loaded their acquisitions with over $25 billion in debt to pay themselves dividends. These large payouts used to be reserved for the true “barbarian” takeover artists, but now premature profits are commonplace. For example, the Carlyle Group led a private-equity buyout of Hertz car rental chain for $15 billion in 2005. Less than six months after the deal closed, the private-equity group paid itself a one billion dollar dividend. Extracting equity in this fashion is referred to as “dividend

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111 Id.
112 See discussion infra Part III.A.1.
113 See discussion infra Part III.A.2.
114 See discussion infra Part III.A.3.
116 Id.
117 Id.
118 Id.
recapitalization." While such recapitalizations are profitable for investors (Carlyle and its private-equity consortium doubled their money after having owned Hertz for less than one year), they leave the acquired company at a greater risk of defaulting on its debt.

Another illustrative example was the leveraged buyout of dental products distributor Healthco. Hicks, Muse & Co., a Dallas-based investment firm, took Healthco private in 1991 and saddled the company with several million dollars worth of debt. Following the buyout, Healthco struggled financially and began defaulting on its loans, including the loan from the bank group which financed the privatization. Healthco was forced to file a petition for Chapter 7 bankruptcy a mere two years after the buyout. William Brandt was appointed Chapter 7 trustee. Brandt brought suit on behalf of Healthco against the parties involved in the buyout. He alleged in part that the leveraged buyout amounted to a fraudulent transfer.

When a private equity transaction is attacked as a fraudulent transfer, the multi-step leveraged buyout must be collapsed into a transfer of the company’s assets to the buyout group. Whether to collapse a transaction is an issue of state law, and the First Circuit found limited precedent to guide its opinion. The First Circuit ultimately refused to decide the issue because it was not properly brought on appeal. However, the Third Circuit ruled that leveraged buyouts are subject to the Uniform Fraudulent Conveyance Act under Pennsylvania law because the broad language of the statute does not per se exclude a transaction such as a leveraged buyout “[s]imply because it is innovative or complicated.”

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119 Id.
120 Id.
121 Brandt v. Wand Partners, 242 F.3d 6, 10-11 (1st Cir. 2001).
122 Id.
123 Id. at 11.
124 Id.
125 Id. at 9.
126 Id.
127 Id. at 11.
128 Id. at 12-13.
129 Id. at 12.
130 Id. at 13.
The Ninth Circuit, interpreting California law, recognized that fraudulent conveyance law could apply to a leveraged buyout if the buyout was specifically designed to defraud creditors, or if evidence of intent to defraud existed. However, the Ninth Circuit determined that fraudulent conveyance law exists to protect creditors from debtors’ secret transactions, and, in most cases, a leveraged buyout is a public transaction. Accordingly, absent actual intent to defraud, the Ninth Circuit decided that a leveraged buyout may not be subject to fraudulent conveyance law.

In sum, private equity investors may be accountable for driving their acquisitions into bankruptcy under a theory of fraudulent conveyance. The availability of this claim is one way to regulate the risky practice of loading an acquisition with debt it cannot service.

b. Multiple Roles Leads to Conflicts of Interest

“Advisor,” “lender,” and “investor” are technical terms used to describe the three different parties to a private-equity transaction. Sometimes, however, one party may wear all of these hats, as evidenced by Merrill Lynch’s role in the HCA transaction. With private equity acquisitions getting bigger, and the stakes getting larger, investment firms find themselves playing multiple roles that were formerly assumed by separate parties. Merrill Lynch pounced on an opportunity to invest by teaming up with other investment firms to take one of its long-time clients private. In fact, clients often request their advisors to take on these multiple roles. Goldman Sachs’ 2006 annual shareholder report identified this as a “key trend” for the coming years.

In a high-stakes environment such as private equity investment, it may be necessary to take on multiple roles since there are a limited number of parties available to participate in the deals. Merrill Lynch sought to manage its conflicts by removing itself as a formal advisor to HCA, investing with its own funds and screening

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133 Id. at 850.
134 Id.
135 Berman & Sender, supra note 65.
136 Id.
the bankers involved in the private equity transaction. However, these techniques may not always insulate investment banks from potential conflict. Additionally, such overlap may not be advantageous for shareholders in particular. Currently, the court system is the chief method of redress for shareholders who believe they have been treated unfairly. In the future, look for shareholders to continue to challenge the propriety of these “advisors” turned “investors” turned “lenders”.

c. An Absence of Competition

Modern private equity transactions commonly involve club deals in which two or more funds combine to take their targets private. Absent these investor clubs, deals in excess of $30 billion would be difficult to assemble. Club deals also signal less competition, which does not necessarily bode well for shareholders. Some analysts are concerned that the limited number of competitors is restricting the potential value of the target companies.137

Theoretically, competition is good for the market because it drives share prices up to market value, or above. However, in the case of private equity, there has been little competition for these acquisitions.138 Bidding wars are especially seldom in the case of a management-backed buyout, such as the KMI deal, because management will have superior knowledge about the future prospects of the company, and thus, will have an advantage over outsiders in the bidding process.139 This advantage could dissuade a rival bid because the rival would not know how much to safely bid against the insiders.140 Additionally, even if the rival won the bidding war, it may have overbid for the company resulting in a bad investment.141

In October 2006, the Justice Department took notice and began an inquiry into the propriety of recent private equity

137 Randall Smith & Kathryn Kranhold, GE Sets Private-Equity Limits – In Auction of Plastics Unit, Restrictions on Team Bids Reflect Antitrust Concerns, WALL ST. J., Jan. 9, 2007, at A3.
138 See id. (“[I]n the past few years no agreed-to private-equity deal has been topped by a higher bid from a rival buyout firm.”).
139 CLARK, supra note 54, at 512.
140 Id.
141 Id.
transactions. Additionally, some target companies have stood up against the private equity clubs. General Electric Co. recently began soliciting bids for its $10 billion plastics business. However, GE reportedly restricted the bidding to private equity firms acting alone. Although such restrictions will not always be feasible, restrictions such as these can help to stimulate competition for smaller private equity acquisitions.

2. The Future of Private Equity

The aforementioned transactions have highlighted some of the issues plaguing private equity investment. State, federal, and international agencies have begun to closely scrutinize these investments.

One such example of state regulation over private equity occurred in Oregon. Portland General Electric ("PGE") is Oregon's largest electrical utility and distributes electricity to some 765,000 customers. In 1997, PGE was owned by Enron; however, when Enron collapsed in 2001 it began to solicit offers from investors interested in acquiring the utility. The city of Portland initially expressed interest in purchasing PGE, reasoning that a government-owned utility could lower costs and lead to rate reductions for consumers. However, the city’s negotiations with Enron were terminated in 2003 when Enron began negotiating the sale of PGE to private equity investment firm Texas Pacific for $2.35 billion.

Similar to many private equity transactions, Texas Pacific’s proposal relied heavily on financing through debt and Texas Pacific likely intended to sell its acquisition as soon as profits were realized. In 2005, state regulators stepped in and blocked the deal. The

143 Smith & Kranhold, supra note 140.
144 Id.
145 Id. ("The HCA board also sought to stimulate competition in the form of a rival bid by barring three initial members of the private-equity bidding group from adding additional members. However, a rival bid didn't materialize.").
147 Id.
Oregon Public Utility Commission (the “Commission”) denied Texas Pacific’s bid because Texas Pacific was merely an investment firm with no utilities experience and the Commission faulted Texas Pacific for its plans to sell PGE for profit. Additionally, the Commission expressed concern with the amount of debt upon which Texas Pacific’s proposal relied.

By statute, Oregon requires any individual or investor interested in acquiring a utility to apply for authorization from the Commission. After reviewing Texas Pacific’s application, the Commission determined, in part, that the “large debt burden and short-term ownership” would be major sources of risk and would serve to put consumers at risk. The Commission worried that the debt would lower PGE’s credit rating which could result in higher utility rates for consumers.

Oregon regulators are not the only entities scrutinizing private equity takeovers. The Bank of England cited private equity takeovers as one of the “six greatest threats to the financial system.” Britain’s Financial Services Authority has begun monitoring private-equity investors suspecting insider trading and possible conflicts of interest. In Germany, private equity investors are likened to “locusts,” and South Korea worries that private equity could “lead to the drain of national wealth.”

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151 Id.
152 See OR. REV. STAT. § 757.511 (1) (2006) (stating that “[n]o person, directly or indirectly, shall acquire the power to exercise any substantial influence over the policies and actions of a public utility which provides heat, light or power without first securing from the Public Utility Commission, upon application, an order authorizing such acquisition if such person is, or by such acquisition would become, an affiliated interest with such public utility as defined in ORS 757.015 (1), (2) or (3).”).
154 OEU Case, supra note 153; see also Public Utility Commission News Release, supra note 156.
155 Roane, supra note 118.
156 The Financial Services Authority is Great Britain’s counterpart to the SEC, FRB and FDIC.
157 Roane, supra note 118.
158 Id.
The United States Justice Department’s inquiry has focused on the propriety of the club deals. Although some proponents of deal-sharing argue that this phenomenon allows for better investment decisions and is beneficial to society as a whole, the Justice Department is concerned that these clubs may be engaging in price fixing or market division to evade true competition.

The private equity community is aware of the Justice Department’s inquiry as well as global criticism. Some of the largest private equity investors have banded together to form the Private Equity Council, a lobbying consortium devoted to giving private equity a friendlier face. The council hopes to ward off future backlash as private equity investment continues to reign.

The HCA deal is a sign that private equity funds are powerful and may seek larger targets in the future. By the end of 2006, private equity funds were expected to surpass the $283 billion they raised in 2005. In 2006, Blackstone amassed a milestone buyout fund at $15.6 billion, the largest ever assembled. Additionally, Lehman Brothers announced that it is raising a $2 billion private equity fund and Citigroup announced the creation of a $3.5 billion fund. These funds were created as an answer to criticism that their investment bank parent companies would be competing for deals with their clients.

HCA’s $33 billion deal may only be a preview of what is to come. In November 2006, Blackstone Group announced it would acquire Equity Office Properties Trust for $36 billion, surpassing

159 Lerner, supra note 145; see also Dennis K. Berman, Merrill Arm Draws U.S. Questions In Informal Probe of Private Equity, WALL ST. J., Nov. 6, 2006, at A9 (discussing fact that Merrill Lynch, the Carlyle Group, Clayton, Dubilier & Rice Inc., Kohlberg Kravis Roberts & Co. and Silver Lake Partners have all received requests for information from the Justice Department).
160 Lerner, supra note 145.
161 Charles Duhigg, Can Private Equity Build a Public Face, N.Y. TIMES, Dec. 24, 2006, at 3; see also Smith & Kranhold, supra note 140 (reporting eleven of the largest funds will become members of the Private Equity Council including the Blackstone Group, the Carlyle Group, Kohlberg Kravis Roberts and the Texas Pacific Group).
162 Roane, supra note 118.
163 Smith, supra note 26.
164 Shearer, supra note 20.
165 Id.
166 Id.
167 Id.
HCA only months after it attained record proportions.\textsuperscript{168} Bain Capital and Thomas H. Lee Partners announced they would take radio giant Clear Channel Communications Inc. private for $27 billion, including debt.\textsuperscript{169} Additionally, there is talk that private equity investors have set their sights on home improvement chain Home Depot, whose shares are worth approximately $79 billion, and Dell computer company, whose shares are valued at approximately $56 billion.\textsuperscript{170} All the while, the Justice Department will continue to examine these escalating deals with concerns that investors are colluding to keep prices unreasonably low.\textsuperscript{171}

In the late 1980s, investors thought “[p]rivate equity was going to become the dominant form of investment.”\textsuperscript{172} But those predictions turned out to be wrong.\textsuperscript{173} Right now, favorable conditions once again exist for private-equity to prevail.\textsuperscript{174} But private equity beware – of the regulators at the gate.\textsuperscript{175}

\begin{footnotesize}
\begin{itemize}
\item[168] Mark A. Stein, \textit{Another Top this Week for the Deal Makers}, N.Y. TIMES, Nov. 25, 2006, at C2.
\item[169] Joseph Weber, \textit{M&A: An Irresistible Urge to Merge; The dealmakers will be working double time in ’07, and in virtually every sector}, BUS. WK., Dec. 25, 2006, at 72.
\item[170] Roane, \textit{supra} note 118.
\item[172] Kiviat, \textit{supra} note 3; see also Monks, \textit{supra} note 3 (quoting David Yermack, professor of finance at New York University).
\item[173] Kiviat, \textit{supra} note 3.
\item[174] Shearer, \textit{supra} note 20 (quoting John LeClaire, Partner and Chair of the Private Equity Group at Goodwin Procter).
\item[175] Written by Tracie M. Dorfman, Boston University School of Law (J.D. 2007)
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