DEVELOPMENTS IN BANKING AND FINANCIAL LAW: 2005

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I. BUSINESS BANKRUPTCIES

The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") became generally effective on October 17, 2005.[1] This article examines selected provisions of the BAPCPA that amend sections of the Bankruptcy Code of considerable import to business bankruptcies. Viewed collectively, these provisions expand the rights of creditors and diminish the discretion afforded to bankruptcy courts in business reorganizations under Chapter 11. This article also examines provisions of the BAPCPA that are intended to minimize cost and delay in Chapter 11 cases involving small business debtors.[2]

A. Overview of Small Business Amendments

The 1994 amendments to the Bankruptcy Code created the National Bankruptcy Review Commission (the "Commission").[3] The Commission was a response to a dramatic increase in proposed bankruptcy legislation during the 1980s and early 1990s.[4] In the Commission's first formal report, it concluded that Chapter 11 "was too costly and cumbersome for the small cases that represent the vast majority of Chapter 11 filings."[5] It attributed the unnecessary costs and delays it observed to the fact that it was not cost effective for creditors to closely monitor a small business debtor and actively participate in its reorganization.[6]

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[1] Pub. L. No. 109-8, 119 Stat. 23 (2005). All future references will be to the amended provisions of the Bankruptcy Code.

[2] A debtor is a small business debtor if: "(1) the debtor is engaged in commercial or business activities, including an affiliate of the debtor that is also in bankruptcy, but excluding any debtor whose primary activity is the business of owning or operating real estate; (2) the debtor has noncontingent, liquidated, secured, and unsecured debts that, in the aggregate, do not exceed $ 2 million on the date of the petition or order for relief, excluding debts owed to affiliates or insiders of the debtor; and (3) the United States trustee has not appointed a committee of unsecured creditors under section 1102 or the court has determined that the creditors' committee is not sufficiently active and representative to provide effective oversight of the debtor." Alan N. Resnick & Henry J. Sommer, *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: A Section-by-Section Analysis*, *in* 1 Collier on Bankruptcy (15th Ed. 2005).

[3] *See* Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 AM. BANKR. L.J. 645, 646 (2005).

[4] *See id.*

[5] *Id.* at 650.

[6] *See id.*

The BAPCPA responds to the Commission's observations in several noteworthy ways. The act places the responsibility for monitoring small business debtors primarily on the United States Trustee, who must interview the debtor prior to the first creditors' meeting.[7] The U.S. Trustee must also evaluate the ability of the debtor to confirm a reorganization plan, and must move to have the case dismissed or transferred to Chapter 7 in the event that the Trustee finds "material grounds for any relief under Section 1112 of Title 11."[8] The amended Code also requires small business debtors to submit periodic financial reports and allows the U.S. Trustee to visit the business premises of a debtor to inspect its books and records.[9] In addition, the amended Code provides that the automatic stay created under Section 362 of Title 11 will not be granted to small business debtors that are serial filers.[10] Further, treatment as a small business debtor is no longer elective under the amended code.[11] Accordingly, the small business amendments reflect the view that "the benefit of reducing cost and delay in a large number of cases outweighs the cost of occasionally denying a viable debtor the ability to reorganize."[12]

B. Reorganization Plans

A debtor that files for bankruptcy under Chapter 11 may submit a reorganization plan to the bankruptcy court at any point during its case.[13] This right of submission is exclusive to the debtor during the first 120 days after the bankruptcy court issues an order of relief.[14] If the debtor elects not to submit a reorganization plan during the "exclusivity period", such a plan may be submitted by "any party in interest."[15] The right to submit a reorganization plan is

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[7] 28 U.S.C. § 586(7)(a) (2005).
[8] *Id.* §§ 586(7)(c), (8).
[9] *Id.* §§ 308(b), 586(7)(b).
[10] *Id.* § 362 (n)(1) (refusing to extend the automatic stay to a debtor that: (1) is also a debtor in another small business case pending when the petition is filed, (2) was a debtor in a small business cased dismissed within the past two years, or (3) was a debtor in a small business case in which a plan was confirmed in the past two years).
[11] *See* Carlson & Hayes, *supra* note 3, at 653.
[12] *Id.* at 648.
[13] 11 U.S.C. § 1121(a) (2005).
[14] *Id.* § 1121(b).
[15] *Id.* § 1121(c) (defining a "party in interest" as "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee").

also extended to "any party in interest" if a debtor's plan has not been accepted by "each class of claims or interests impaired under the plan" within 180 days of the issuance of bankruptcy court's order of relief.[16]

A debtor can petition the bankruptcy court to extend the 120-day exclusivity period for filing a plan or the 180-day period to obtain acceptances.[17] The debtor must demonstrate "cause" for the extension.[18] Prior to the 2005 amendments, a bankruptcy court could extend either the submission or acceptance period indefinitely if it determined that cause for the extension was present.[19] Many bankruptcy courts interpreted the cause requirement liberally, often extending the exclusivity period throughout the duration of a debtor's case.[20]

The BAPCPA places significant limitations on the continuation of the submission and acceptance periods.[21] The amended code retains the cause requirement, but prohibits extension of the 120-day exclusivity period beyond eighteen months after the date of the court's order of relief.[22] In addition, the 180-day acceptance period may not be extended beyond twenty months after issuance of the court's order.[23] These restrictions increase the leverage of creditors in Chapter 11 cases and are particularly

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[16] *Id.* § 1121 (c)(3).
[17] *See id.* § 1121 (d)(1).
[18] *Id.*; *See In re* Express One Int'l, Inc., 194 B.R. 98, 100 (Bankr. E.D. Tex. 1996) (While the Code does not define "cause," the court offered nine factors relevant to its existence. These factors included: "(a) the size and complexity of the case; (b) the necessity of sufficient time to permit the debtor to negotiate a plan of reorganization and prepare adequate information; (c) the existence of good faith progress toward reorganization; (d) the fact that the debtor is paying its bills as they become due; (e) whether the debtor has demonstrated reasonable prospects for filing a viable plan; (f) whether the debtor has made progress in negotiations with its creditors; (g) the amount of time which has elapsed in the case; (h) whether the debtor is seeking an extension of exclusivity in order to pressure creditors to submit to the debtor's reorganization demands; and (i) whether an unresolved contingency exists."
[19] *See* Lynn M. Lopucki, *The Trouble With Chapter 11*, 1993 WIS. L. REV. 729, 753 (1993).
[20] See *id.* at 753-56 (finding that in seventy-nine percent of cases studied, the exclusivity period was continued throughout the case; *but see* Hon. Samuel L. Bufford, *Chapter 11 Case Management and Delay Reduction: An Empirical Study*, 4 AM. BANKR. INST. L. REV 85, 98 (1996) (finding that the exclusivity period was only extended in two percent of cases studied).
[21] 11 U.S.C. § 1121(d)(2) (2005).
[22] *Id.*
[23] *Id.*

threatening to large corporations involved in complex reorganizations that may be unable to submit an acceptable plan within eighteen months of filing under Chapter 11.[24]

Small business debtors have the exclusive right to submit a reorganization plan during the first 180 days after an order of relief.[25] In small business cases, the bankruptcy court retains the right to extend the exclusivity period indefinitely and to select an appropriate deadline for filing.[26] The court, however, may only extend the exclusivity period if the debtor demonstrates by a preponderance of the evidence that the court will likely confirm a plan within a reasonable period of time.[27] This heightened burden further the reflects the Commission's observation that "reducing time spent in Chapter 11 has a predicated effect of reducing the direct and indirect costs of administering a Chapter 11 case . . . thereby preserving assets for distribution to unsecured creditors."[28]

C. Preferential Payments

A debtor reorganizing under Chapter 11 may recover any payment made to a creditor during the ninety day period before it filed for bankruptcy, provided that it was insolvent at the time that the payment was made.[29] Prior to the 2005 amendments, a creditor could retain a preferential payment if it could demonstrate that: "(1) the payment was of a debt incurred in the ordinary course of business of both parties, (2) the payment was made in the ordinary course of business of both parties, and (3) the payment was made according to ordinary business terms."[30] The BAPCPA modifies this exception by allowing a creditor to retain the repayment of a debt that was either made in the parties' ordinary course of business or was in accordance with ordinary business terms.[31] While the expansion of the preference exception is another instance in which the BAPCPA

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[24] Alan M. Christenfeld & Shephard W. Melzer, *2005 Bankruptcy Amendments: A Secured Creditor's Perspective*, N.Y. LAW JOURNAL, Aug. 4, 2005, at 5.
[25] 11 U.S.C. § 1121(e)(1) (2005).
[26] *Id.* § 1121(e)(3).
[27] *Id.* § 1121(e)(3)(A).
[28] *See* Carlson & Hayes, *supra* note 3, at 658.
[29] 11 U.S.C. §§ 547 b(3), (4)(A) (2005).
[30] Richard Levin & Alesia Ranney Marinelli, *The Creeping Repeal of Chapter 11: The Significant Buisness Provision of the Bankruptcy Abuse Protection and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 637 (2005) (citing 11 U.S.C. § 547(c)(2) (2000)).
[31] 11 U.S.C. § 547(c)(2) (2005).

has enhanced the rights of creditors, this provision may also "reduce recoveries to other creditor groups and . . . increase litigation by causing creditors who otherwise have settled to defend against those preference demands."[32]

The BAPCPA also directly overrules the Seventh Circuit's decision in *In Re DePrizio*.[33] In *DePrizio*, the court held that a trustee could recover a payment to a non-insider[34] creditor, made during the expanded one year preference period for insiders, if an insider benefited from the payment.[35] Pursuant to the 2005 amendments, only payments made directly to insiders are subject to the one year recovery period.[36] Further, the BAPCPA prohibits recovery of payments or transfers less than $5,000 in value.[37]

D. Real Property Leases

Prior to the 2005 amendments, a debtor had sixty days after issuance of the court's order of relief to assume or reject an unexpired nonresidential real property lease.[38] Bankruptcy courts were able to extend the sixty day period indefinitely if the debtor could demonstrate cause for the extension.[39] Debtors historically were granted several extensions, particularly in cases involving multiple leases, and the acceptance period was often continued until the date of plan confirmation.[40] The amended code extends the acceptance period from 60 to 120 days.[41] The court, however, may only grant a single ninety day extension unless the landlord consents to further extension of the acceptance period.[42]

As a consequence of these modifications, debtors may be "forced to reject valuable leases or prematurely assume leases that

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[32] Levin & Marinelli, *supra* note 30, at 637.
[33] Levitt v. Ingersoll Rand Financial Corp. (*In re* DePrizio), 874 F.2d 1186 (7th Cir. 1989).
[34] 11 U.S.C. § 101(31)(B) (2005) (For corporate debtors, "insiders" include directors, officers, persons in control of the debtor, general partners and relatives of directors, officers, persons in control of the debtor and general partners).
[35] *See* Deprizio, 874 F.2d at 1198.
[36] 11 U.S.C. § 547(i).
[37] *Id*. § 547(c)(9).
[38] 11 U.S.C. § 365(d)(4) (2000).
[39] *Id*.
[40] Christenfeld & Melzer, *supra* note 24, at 5.
[41] 11 U.S.C. § 365(d)(4)(A)(i) (2005).
[42] *Id.* § (d)(4)(B).

ultimately become burdensome to the estate."[43] Debtors that prematurely assume, and subsequently reject nonresidential real property leases are subject to administrative expense claims brought by landlords under Section 503(a) of Title 11.[44] These claims receive a higher priority than those of unsecured creditors, and bankruptcy courts are prohibited from approving a reorganization plan if such a claim is pending.[45] Further, prior to these amendments, some bankruptcy courts held that there was no cap on the amount of administrative expense claims brought as a result of rejected leases.[46] The BAPCPA, anticipating an increase in rejected leases claims, adds Section 503(b)(7) to the Code, which limits landlord administrative claims to two years of monetary obligations under the rejected lease.[47]

E. Creditors Committees

Prior to 1986, Section 1102 of Title 11 granted bankruptcy courts the authority to change the membership of a creditors committee if it determined the committee was "not representative of the different types of claims or interests to be represented."[48] The repeal of this provision created "substantial uncertainty and inconsistent case law" regarding the ability of bankruptcy courts to alter the composition of creditors committees.[49] The BAPCPA expressly authorizes bankruptcy courts to instruct the U.S. Trustee to change committee membership "if the court determines that the change is necessary to ensure adequate representation of creditors or equity security holders."[50] In addition, bankruptcy courts may also order the U.S. Trustee to appoint a creditor that is a "small business concern" to the committee, provided the aggregate amount of the creditor's claim is "disproportionately large" in comparison to its

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[43] Kenneth L. Klee, *The Bankruptcy Abuse Protection and Consumer Protection Act of 2005 – Business Bankruptcy Amendments*, SL068 A.L.I – A.B.I. 189 (2005).
[44] 11 U.S.C. § 503(a) (2005).
[45] Levin & Marinelli, *supra* note 30, at 604.
[46] Nostas Associates Club v. Costich (*In re* Klein Sleep Products Inc.), 78 F.3d 18, 23 (2d Cir 1996) (finding that the full amount of any damages incurred as a result of the rejection of an assumed lease are administrative expenses recoverable under 11 U.S.C. § 503(a)).
[47] 11 U.S.C. § 503(b)(7) (2005).
[48] Levin & Marinelli, *supra* note 30, at 627-28.
[49] *Id*.
[50] 11 U.S.C. § 1102(a)(4) (2005).

gross annual revenue.[51] Further, creditor committees can no longer withhold information from non-member creditors, from whom they must also solicit and receive comments.[52]

F. Executive Compensation and Severance

The BAPCPA places new limitations on the ability of businesses reorganizing under Chapter 11 to issue post petition compensation and severance packages to its directors and officers.[53] Under the amended Code, payments made to retain directors and officers are prohibited unless: (1) the recipient has a bona fide offer from another employer at an equal or greater rate of compensation; (2) the recipient is essential to the survival of the business; and (3) the amount does not exceed ten times the amount of similar payments made to non-management employees for any purpose during the past calendar year.[54] If no similar payments were made to non-management employees, the compensation package cannot exceed twenty-five percent of any other payment to the recipient during the prior calendar year.[55] Further, severance payments to insiders are prohibited unless such payment is part of a program generally available to all employees, and the payment does not exceed ten times the mean severance payment to non-management employees during the calendar year in which the payment is made.[56]

G. Reclamation of Goods

The Bankruptcy Code, prior to the BAPCPA, recognized the common law right of a seller that shipped goods to an insolvent corporation to make a demand claim for the return of those goods.[57] This right was subject to Section 546(c) of Title 11, which provided that the right could only be exercised if the seller made a demand, in writing, within 10 days of the receipt of the goods by the debtor.[58] The BAPCPA enhances the rights of sellers that ship goods to insolvent businesses. Under the amended code, these sellers may file

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[51] *Id*.
[52] *See id*. § 1102(3)(b).
[53] Levin & Marinelli, *supra* note 30, at 620.
[54] 11 U.S.C. § 503(c)(1) (2005).
[55] *Id.* § 503(c)(1)(C)(ii).
[56] *Id.* § 503(c)(2).
[57] 11 U.S.C. § 503(c) (2000).
[58] *See id*. § 503(c)(1)(A).

a priority administrative claim for the full value of any goods received by the debtor within twenty days of filing for bankruptcy.[59] In addition, section 546(c), as amended, treats reclamation claims as a right preserved by the Bankruptcy Code irrespective of state law.[60] A seller now has the right to demand the return of goods received by an insolvent business within 45 of filing, or 20 days after filing if the 45 day period expires after the commencement of the debtor's case.[61] For many debtors, "setting up a system to monitor reclamation demands and to segregate or track reclaimed goods, even if possible, will create a substantial administrative burden in terms of time and expense that they will not be equipped to handle."[62]

H. Dismissal and Transfer to Chapter 7

Section 1112 of Title 11 permits any "party in interest" to move for the dismissal of a case filed under Chapter 11 or its conversion to Chapter 7.[63] Prior to the recent amendments, Section 1112 contained "a non exclusive list of ten items" that could constitute "cause" for the case's dismissal or conversion.[64] However, a debtor continuing to sustain losses after filing under Chapter 11 could prevent the dismissal or transfer of its case if it could prove there was a reasonable likelihood of the business' rehabilitation.[65]

Under the amended code, a debtor seeking to avoid a motion to dismiss or transfer its case must establish that: (1) there is a reasonable likelihood that a reorganization plan will be confirmed with a reasonable period of time, (2) the grounds for granting the motion were the result of an act or omission by the debtor that was reasonably justifiable and can be cured in a reasonable period of time, and (3) circumstances do not exist suggesting that granting the motion is in the best interests of the estate.[66] The BAPCPA also expands the list of enumerated factors that may establish "cause" for

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[59] 11 U.S.C. § 503(b)(9) (2005).
[60] Jonathan N. Helfat & Richard M Kohn, *New Bankruptcy Law Includes Provisions on Business Bankruptcies*, SECURED LENDER, July 1, 2005.
[61] 11 U.S.C. § 546(c)(1) (2005).
[62] Levin & Marinelli, *supra* note 30, at 605.
[63] 11 U.S.C. § 1112(b)(2) (2005).
[64] Helfat & Kohn, *supra* note 60.
[65] 11 U.S.C. § 1112(b)(1) (2000); Helfat & Kohn, *supra* note 60.
[66] 11 U.S.C. § 1112(b)(2) (2005).

dismissal or transfer to Chapter 7.[67] Proof of a debtor's failure to maintain appropriate insurance, pay post-filing taxes in a timely manner, provide required information to the U.S. trustee, or attend a required creditors meeting are among the recent inclusions to Section 1112 of Title 11.[68]

I. Appointment of Chapter 11 Trustees

The BAPCPA has amended Section 1104 of Title 11 in response to recent allegations of fraud in high profile bankruptcy cases such as Enron and WorldCom.[69] The revised code requires the U.S. Trustee to move for the appointment of a Chapter 11 trustee if "reasonable grounds" exist to suspect that the insiders of a corporate debtor "participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.[70] In addition, the BAPCPA "slightly changes" the factors bankruptcy courts consider in determining whether the appointment of a Chapter 11 trustee is warranted.[71] As a consequence of this revision, corporate debtors may loose control over the reorganization process because of the fraudulent actions of board members who have already been replaced.[72]

J. Conclusion

The 2005 amendments to the Bankruptcy Code expand the rights of creditors and they diminish the discretion afforded to bankruptcy court judges in business reorganizations under Chapter 11. These amendments were intended to minimize unnecessary costs and delays and to provide creditors with additional rights in Chapter 11 reorganizations. However, the amendments may also prevent otherwise viable debtors from reorganizing and may create new challenges for small businesses that file under Chapter 11.

Joseph Zujkowski[73]

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[67] *See id*. § 1112(b)(4); Helfat & Kohn, *supra* note 60.
[68] *Id.*
[69] Helfat & Kohn, *supra* note 60.
[70] 11 U.S.C. § 1104 (2005).
[71] Levin & Marinelli, *supra* note 30, at 618,
[72] Helfat & Kohn, *supra* note 60.
[73] Student, Boston University School of Law (J.D. 2007).

II. AIRLINE BANKRUPTCIES

A. Introduction

On September 14, 2005, Delta Airlines ("Delta") and Northwest Airlines ("Northwest"), the third and fourth largest airlines respectively, filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code.[1] Delta and Northwest filed for bankruptcy protection for various reasons, which include, competition from low cost carriers ("LCCs"), the rising cost of fuel (severely impacted by Hurricane Katrina) and ongoing labor struggles.[2] The purpose of this article is to describe the major factors surrounding Delta and Northwest Airlines bankruptcy and to examine each airline's reorganization plan to see how they plan to emerge from bankruptcy.

B. Overarching Factors that Affected Both Delta and Northwest Airlines

1. Low Cost Carriers ("LCC")

Competition from LCCs, such as Southwest and Jet Blue, has created a situation where legacy carriers must significantly lower its costs to compete with LCCs, which have much lower labor and operating costs than legacy carriers.[3] Legacy carriers are those airlines that existed before airline deregulation.[4] In particular, Delta, which has substantially less international traffic than most of the other large carriers, has had a difficult time as it faces "competition on more routes from [LCCs] than some of its rivals."[5] Since 2000, while Delta's passenger traffic is down 3.8% and Northwest's passenger traffic is down 4.2%, LCCs such as Southwest have posted

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[1] Even Perez & Susan Carey, *Delta, Northwest See Bankruptcy As Key to Revival*, WALL ST. J., Sept. 15, 2005, at A1.
[2] *Id.*
[3] Daniel Rollman, Comment, *Flying Low: Chapter11's Contribution To The Self-Destructive Nature Of Airline Industry Economics*, 21 EMORY BANKR. DEV. J. 381, 382 (2004).
[4] Perez & Carey, *supra* note 1.
[5] Chris Isidore, Delta Air Lines Files for Bankruptcy, CNN Money, *at* http://money.cnn.com/2005/09/14/news/fortune500/delta/index.htm, (Sept. 15, 2005).

record increases in passenger traffic, increasing by 42% during the same time period.[6]

2. Hurricane Katrina and Increased Cost of Fuel

Delta and Northwest's problems existed prior to Hurricane Katrina; specifically, both airlines have struggled since the September 11, 2001 terrorist attacks.[7] Since 2001, Delta has lost $6.1 billion from its airline operations.[8] Hurricane Katrina augmented and compounded the financial difficulties faced by the two airlines by creating a spike in oil prices.[9] Delta's cost per gallon of gas "soared 50 percent in the second quarter [of 2005] from a year earlier."[10] Northwest estimated that it would spend about $3.3 billion for fuel in 2005.[11] This is in comparison to the $2.2 billion it spent in 2004 and the $1.6 billion in 2003.[12]

3. Ongoing Labor Struggles

Reducing labor costs has been a focus for both Delta and Northwest. Delta's labor problems have primarily been with its pilots.[13] Northwest has had to handle labor disputes from its mechanics, flight attendants and pilots.[14] Northwest has stated that in order for it to emerge from bankruptcy and become more competitive with LCCs, it must cut $1.4 billion in wage and benefits from employees.[15]

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[6] Scott McCartney, *Fewer Travelers Routed Through "Hub" Airports*, WALL ST. J., Feb. 14, 2006, at D4.
[7] Isidore, *supra* note 5.
[8] *Id.*
[9] McCartney, *supra* note 6.
[10] Isidore, *supra* note 5.
[11] Chris Isidore, Northwest Files For Bankruptcy, CNN Money, *at* http://money.cnn.com/2005/09/14/news/fortune500/northwest/, (Sept. 14, 2005).
[12] *Id.*
[13] *Delta, Northwest Air Continue In Bankruptcy; UAL Exit Near*, DOW JONES NEWSWIRES (Jan. 31, 2005), *available at* http://online.wsj.com/article/BT_CO_20060131_000163.html.
[14] Susan Carey, *Northwest Machinists Pact Could Save Jobs*, WALL ST. J. Jan. 23, 2006, at A6
[15] *Update: Northwest Pilots Give Union Strike Vote Authority*, DOW JONES NEWSWIRES, *available at* http://online.wsj.com/article/BT_CO_20060203_006498.html (Feb. 3, 2006).

C. Delta

Delta's plan has three main components: (1) in-court restructuring through debt relief, lease and facility savings and fleet modifications; (2) increase revenue and network productivity by improving its route network; and (3) reduce employment costs through pay cuts and job reductions.[16]

1. In-court Restructuring

Delta estimates that it will save $970 million through in-court restructuring.[17] By the end of 2006, Delta plans on "reconfigur[ing] its fleet and network [by] retiring four of the 11 aircraft types it currently flies and use small regional jets on routes where larger aircraft types aren't profitable."[18] The company plans on reducing its mainline operating fleet by more than eighty aircrafts by 2006 and has opted to reject the leases on forty mainline aircrafts that were not operating when Delta filed for bankruptcy.[19] Most of the planes that have been reduced are older planes that Delta no longer uses or are less fuel efficient than more modern planes.[20] The rejection of the leases will save Delta $607 million.[21]

2. Increasing Revenue and Network Productivity

In January, 2005 Delta closed its money-losing Dallas hub.[22] Delta also abandoned its Cincinnati hub (which at the time was Delta's second largest, after Atlanta.)[23] By closing these two hubs and modifying its fleet, Delta estimates it will cut its unit cost, or "the cost to fly one seat one mile," by 11% within a year.[24] On top

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[16] Press Release, Delta Air Lines, Delta Airlines Press Release, *available at* http:/online.wsj.com/article/SB112739244488748539.html (Nov. 14, 2005).
[17] *Id.*
[18] Perez & Carey, *supra.* note 1.
[19] Press Release, *supra,* note 16.
[20] Evan Perez, *Delta Cuts Deep In Push to Become Low-Cost Airline*, WALL ST. J., Sept. 23, 2005, at A1.
[21] Evan Perez, *Delta's Big Loss Raises Heat on Union-At $1.13 Billion in the Red in Quarter, Carrier Outlines Its Pay-Cut Offer to Pilots,* WALL ST. J., Nov. 11, 2005, at A3
[22] Perez, *supra* note 20.
[23] *Id.*
[24] *Id.*

of cutting costs through rejection of leases and reduction of aircrafts, Delta has focused on improving the efficiency of its hub-and-spoke system in order to be more competitive with LCCs. Unlike large carriers such as Delta which usually send passengers to hub airports and them "shuffle them to connecting flights," LCCs are able to be more efficient by providing point-to-point service without making connections.[25] Delta estimates that increasing its efficiency will result in a reduction of seat capacity by 15%-20%.[26]

3. Pay Cuts and Job Reductions

One of Delta's main objectives has been to get its pilots to agree to a $325 million concession in the form of pay cuts and reduced benefits.[27] If agreed to, the concessions would result in a 20% pay cut.[28] The Air Line Pilots Association unit ("ALPA"), a pilots union which represents more than 6000 of Delta's pilots, made a counter-offer of a temporary 9% cut in wages that would last for seven months beginning on December 1, 2005.[29]

In December, 2005, the ALPA signed a temporary 14% wage cut that would reportedly save Delta about $150 million a year.[30] This agreement is set to expire in March 2006, and if a permanent agreement is not reached by then, Lee Moak, chairman of the ALPA's executive committee, has said that the pilots could strike.[31] Even if the two sides are unable to reach a permanent agreement by March, it is uncertain whether the pilots can legally strike.[32] Officials at Delta maintain that such a strike would be illegal.[33]

In addition to pay cuts, Delta may be seeking relief from its pension obligations.[34] Since filing for bankruptcy, Delta has stopped making contributions to its "qualified defined-benefit pension plan,"

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[25] McCartney, *supra* note 6.
[26] Perez, *supra* note 20.
[27] *Id.*
[28] Even Perez & Susan Carey, *Delta Pilots Float Strike Option*; *US Airways Posts $87 Million Loss*, WALL ST. J., Nov. 10, 2005, at B2.
[29] *Id.*
[30] Evan Perez, *Delta Offers Pilots A Payment Plan If Pensions are Cut*, WALL ST. J., Feb. 10, 2006, at A14.
[31] *Id.*
[32] Perez & Carey, *supra* note 28.
[33] *Id.*
[34] Susan Carey & Evan Perez, *Delta and Northwest Seek Relief for Pension Plans*, WALL ST. J., Sept. 16, 2005, at A3.

and has discontinued payments to employees who retired before the Chapter 11 filing if they were retired under a "nonqualified retirement plan."[35] Delta has stated that its pension plans are under funded by more than $5 billion and that pension cuts are necessary in order to emerge from bankruptcy.[36]

Though Delta has not sought approval from the bankruptcy court to terminate its pension plans, there are indications that it may.[37] Delta's newest contract offer to its pilots includes a clause which stipulates that the airline will give employees a "$300 million payment if it terminates [its] pension plan."[38] This has increased concern among pilots that "Delta could become the latest airline to foist underfunded pension obligation on the federal government."[39]

D. Northwest

Northwest has stated that bankruptcy protection will allow it to "realize three major goals essential to the transformation of Northwest Airlines."[40] First, the airline plans on reducing labor and non-labor costs.[41] Second, it wants to implement a more efficient business model.[42] Third, it wants to improve its debt/equity levels in order to better ensure long term profitability.[43] Northwest estimates that this plan will result in a $2.2-$2.5 billion increase in profits.[44]

1. Reduction of Labor and Non-Labor Costs

In October, 2005, Northwest requested permission from the bankruptcy court to be able to void its current labor contracts if

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[35] Marie Beaudette, Retired Delta Pilots Ask Court To Force Pension Funding, DOW JONES NEWSWIRES, *available at* http://online.wsj.com/article/SB112775857725052280.html (Sept. 26, 2005).
[36] Valerie Bauerlein, Delta Air Gives Retirees No Guarantees on Pension, DOW JONES NEWSWIRES, *available at* http://online.wsj.com/article/SB113053964432183030.html (Oct. 28, 2005).
[37] Beaudette, *supra*, note 35.
[38] Perez, *supra* note 30.
[39] *Id.*
[40] Press Release, Northwest Airlines, Northwest Airlines: Full Statement, *available at* http://msnbc.msn.com/id/9344716 (Sept. 14, 2005).
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] Susan Carey, *Northwest Outlines Financial Plan,* WALL ST. J., Oct. 1, 2005, at B6.

employees refused to additional pay cuts of around $900 million.[45] Both United and US Airways have used similar threats of contract annulments in order to win concessions from employees.[46] This ability to threaten contract annulments is allowed under Section 1113 of the bankruptcy code, which allows airlines to argue that the contract rejections are a necessary part of reorganization.[47]

1) Mechanics

On August 20, 2005, Northwest's 4,400 mechanics and cleaners went on strike.[48] In response to the strike, Northwest hired 1,200 replacement workers.[49] In September 2005, talks resumed, but after the union rejected Northwest's proposal to cut 3,000 jobs, Northwest started offering some of the replacement workers permanent jobs.[50]

Facing a permanent loss in jobs, the International Association of Mechanists ("IAM"), a union representing Northwest's ramp workers and customer-service agents, agreed to resume concessionary talks in January 2006.[51] For its part, Northwest has backed off of its original proposal to permanently outsource all airport jobs to third-party vendors.[52] Northwest's proposed concessionary contract settlement will be voted on by the 14,000 Northwest ground workers in February 2006.[53]

Under the proposed settlement pact, wages would be cut by 11.5% with incremental increases in 2008 and 2009, and the IAM members' defined-benefit pension plan would be "frozen and future pension coverage would be offered through the union's IAM National Pension Plan."[54] Mechanists would also have to agree to reductions in vacation time as well as reductions in health care

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[45] Susan Carey, *Northwest Seeks Sway Over Unions*, WALL ST. J., Oct. 13, 2005, at A5.
[46] *Id.*
[47] *Id.*
[48] Susan Carey, *Northwest, Striking Mechanics Are to Meet on Talk*, WALL ST. J., Oct. 12, 2005, at B5.
[49] *Id.*
[50] *Id.*
[51] Susan Carey, *Northwest Machinists Pact Could Save Jobs*, WALL ST. J. Jan. 23, 2006, at A6.
[52] Carey, *supra* note 14.
[53] *Id.*
[54] *Id.*

coverage.[55] Northwest has stated that these concessions will enable it to increase part-time employment at all its airports.[56]

2) Flight Attendants

Northwest is also trying to win concessions from its flight attendants.[57] In addition to the pay cuts, Northwest is seeking to outsource many of these positions to "regional flight attendants," who are not members of the Professional Flight Attendants Association (PFAA), the union representing Northwest's flight attendants.[58] "Regional flight attendants" are nonunion flight attendants based in various foreign countries such as, Japan, China, South Korea and the Philippines.[59] Northwest initially proposed to have 75% of its "flights across the Atlantic and Pacific and all of its flights between Amsterdam and India," to be staffed by these "regional flight attendants."[60] Northwest later offered to reduce this number to 30%.[61] According to Michael Becker, Northwest's senior voice president of human resources and labor relations, staffing international fights with "regional flight attendants" would save the airline $20.2 million this year.[62] By 2010, Northwest believes that this plan will result in a savings of $195 million.[63]

On November 16, 2005 an interim pay-cut agreement was reached between the airline and the PFAA.[64] This agreement was intended to be a temporary agreement, scheduled to expire on February 13, 2006, while the airline negotiated a longer-term contract with the PFAA.[65] However, Judge Allan Gropper, the presiding judge over Northwest's bankruptcy, indicated that since

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[55] *Id.*
[56] *Id.*
[57] Susan Carey, *Northwest Targets Flight Attendants For Outsourcing*, WALL ST. J., Oct. 26, 2005, at B5.
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Northwest Wants to Hire Non-US Attendants for Intl Flights*, DOW JONES NEWSWIRE, *available at* http://online.wsj.com/article/BT_CO_2006002_009976.html (Feb. 2, 2006).
[62] *Id.*
[63] Carey, *supra* note 57.
[64] Christopher Scinta, *Judge Extends Pay Cuts for Northwest Flight Attendants*, DOW JONES NEWSWIRE, *available at* http://online.wsj.com/article/BT_CO_20060209_009056.html (Feb. 9, 2006).
[65] *Id.*

there "[was] no evidence introduced to indicate [that Northwest's] financial position . . . changed materially," that the interim pay-cut agreement should be extended indefinitely.[66]

3) Pilots

On February 13, 2006, Northwest's pilots voted on whether to authorize a strike.[67] If a majority of the pilots vote to strike, the union could authorize a strike by the beginning of March.[68] Bill Mellon, spokesperson for Northwest, stated that any strike "would be illegal under bankruptcy law," and further stated that in the event the Air Line Pilot Association ("ALPA"), the airline representing Northwest's pilots, did attempt to declare a strike, Northwest would "seek an immediate court injunction against any attempted strike."[69]

Initially, Northwest had proposed a creation of a new subsidiary airline that would operate "large regional jets of 77-100 seats."[70] This would not only result in substantial job losses for flight attendants, but it is estimated that a new subsidiary airline would have resulted in 1,500 pilots losing their jobs.[71] Northwest has subsequently backed off of this proposal and proposed to the ALPA that it be allowed to "let outside regional carriers operate planes of fewer than 77 seats on Northwest's behalf," which is a similar arrangement other large carriers have.[72]

While the machinists have agreed to vote on a concessionary contract, the pilots and flight attendants are still negotiating possible settlements with the airline.[73] Judge Gropper had agreed to allow the airline to continue negotiations with the pilots and flight attendants unions until March.[74] If an agreement is not reached by then, he is expected to make a decision on Northwest's request to reject its current contracts it has with the pilots and flight attendants.[75]

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[66] *Id.*
[67] *Northwest Pilots to Vote on Feb 13 to Authorize Strike*, DOW JONES NEWSWIRE, *available at* http://online.wsj.com/article/BT_CO_20060210_007085.html (Feb. 10, 2006).
[68] *Id.*
[69] *Id.*
[70] Marie Beaudette, *Northwest Airlines, Unions, Spar In Court Over Cuts*, WALL ST. J., Jan. 18, 2006, at B3.
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*

2. Efficient Business Model

Northwest's new business model focuses on shrinking its operations.[76] The airline will return 13 planes to lessors and plans on rejecting more leases as they continue to reduce the size of its fleet.[77] On October 27, 2005, Northwest was given permission by the bankruptcy court to reject leases on more than 100 planes.[78] There is no indication of how many of these leases Northwest will actually reject, but this option will allow Northwest to obtain better financing terms from plane owners.[79] In addition to reducing the number of planes in their fleet, Northwest plans on reducing the number of hours its mainline fleet operates by 13%.[80]

3. Improving Debt/Equity Levels

Just before Northwest filed for bankruptcy on September 14, 2005, its credit rating with S&P was double-C, placing Northwest in the junk-bond range.[81] Northwest hopes that the money it will save through labor cuts and capacity reductions will result in a profit improvement of around $2.2-$2.5 billion. Eventually, Northwest hopes to achieve a credit rating of double-B or better in order to help the airline increase its credit line for future profitability.[82]

As of now, Northwest has not decided whether it will cancel its pension plan, but Northwest Chief Executive Doug Steenland has stated that, "Northwest must reserve its right to seek to terminate its defined-benefit pension plan, depending on what legislation, if any, is ultimately enacted."[83] Since filing for bankruptcy, Northwest has not made any pension payments, and this has saved the airline $65 million in pension payments.[84]

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[76] Carey & Perez, *supra* note 34.
[77] *Id.*
[78] Ilan Brat, *Northwest Airlines' Loss Widens,* WALL ST. J., Oct. 28, 2005, at A6.
[79] *Id.*
[80] Carey & Perez, *supra* note 34.
[81] Carey, *supra* note 44.
[82] *Id.*
[83] Carey & Perez, *supra* note 34.
[84] *Id.*

E. Conclusion

On February 1, 2005, after three years of restructuring, United Airlines emerged from bankruptcy protection.[85] While the timelines for Delta and Northwest to emerge from bankruptcy are not certain, experts do not believe that it will take as long for these airlines to restructure.[86] However, William Rochelle, an airline bankruptcy attorney in New York, noted that under current bankruptcy laws, "an intelligent airline . . . is not going to be in a rush to get out of Chapter 11."[87] Also, while the surge in oil prices caused by Hurricane Katrina has subsided, news of "disruption in Nigerian oil supplies and tensions over Iran's nuclear ambitions" have caused oil prices to increase to more than $66 a barrel for the first time since September 2005.[88] If oil prices continue to remain high, both Delta and Northwest may have a difficult time implementing their restructuring programs because both airlines have formulated their financial restructuring around lowered oil prices.[89] While both airlines seem to have a distinct capital restructuring plan, whether they are able to implement them will depend on the airlines ability to successfully negotiate new labor contracts with their respective employees and whether the price of oil stabilizes.

Austin Kim[90]

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[85] Ann Keeton, *New United Airlines Shares Fall in Early Trading*, WALL ST. J., Feb. 2, 2006.
[86] *Delta*, *supra*, note 13.
[87] *Id.*
[88] David Bird, *Crude Futures Top $66 On Fresh Supply Concerns*, WALL ST. J., Jan. 18, 2006, at C5
[89] Keeton, *supra* note 85.
[90] Student, Boston University School of Law (J.D. 2007).

III. HEDGE FUND INDUSTRY

A. Introduction

The increase in assets held by hedge funds combined with the perpetration of securities frauds by a number of hedge fund advisors has increased regulatory scrutiny on the hedge fund industry. The Securities and Exchange Commission ("SEC") has recently litigated several cases involving hedge fund fraud, including the lawsuit, which resulted in the collapse of the Bayou Management Hedge Funds ("Bayou").[1] As these cases moved towards resolution, the hedge fund adviser registration requirement became effective on February 2006.[2]

Hedge funds are defined by an investment strategy and a legal position distinct from other investment vehicles.[3] Traditionally, hedge funds were formed for the purpose of hedging highly leveraged long positions by utilizing short sales and put and call options in order to reduce vulnerability to market fluctuations.[4] Hedge funds are investment vehicles which are not registered as investment companies under the Investment Company Act and are organized by professional investment managers.[5] The interests in hedge funds are not sold in registered public offerings.[6] There are three elements that make hedge funds unique in the marketplace: high leverage, elite investors, and little SEC oversight.[7] Hedge funds seem attractive to investors because of perceived higher returns and the inclusion within a hedge fund of investment alternatives that are

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[1] SEC v. Israel III, et al., Litigation Release No. 19406, 2005 SEC LEXIS 2463, at *1 (Sept. 29, 2005).

[2] Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at C.F.R. pts. 275 & 279), available at Registration Under the Advisers Act of Certain Hedge Fund Advisers [hereinafter *Final Rules*].

[3] Roberta S. Karmel, *The Sec at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility - What Regulation By the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 923 (2005).

[4] *Id.*

[5] *Id.*

[6] *Id.*

[7] Joseph Hellrung, *Note & Comment: Emerging Issues in Banking Regulation: Hedge Fund Regulation: Investors are Knocking at the Door, but Can the SEC Clean House Before Everyone Rushes In?*, 9 N.C. BANKING INST. 317, 319-320 (2005).

not correlated with stock markets.[8] As elite investors, pension funds and institutional investors attempted to exceed market benchmarks, "[t]he number of hedge funds worldwide has increased from approximately 600 funds with $38 billion in assets in 1990 to more than 8000 funds with $1 trillion in assets in 2004."[9] Some research groups predict that hedge fund assets will grow up to seventy five percent in the next five years.[10]

B. SEC Litigation of Hedge Fund Fraud

1. Hedge Fund Fraud

Hedge fund fraud has become a significant cause of concern for the SEC.[11] In 2005, the SEC brought eleven enforcement cases against hedge funds directly and another four cases against broker-dealers tied to hedge funds.[12] In 2004, the SEC brought nineteen enforcement cases against hedge funds.[13] In the past five years, the SEC brought forty six enforcement cases, asserting that hedge fund investors have been defrauded of an estimated $1 billion by their advisers.[14] The types of fraud include "gross overstatement of performance by hedge fund advisers . . . payment of unnecessary and undisclosed commissions, and misappropriation of client assets by using parallel unregistered advisory firms and hedge funds."[15] In the commentary addressing the new SEC rules, the Commission noted that "[a] key element of hedge fund advisers' fraud in most of [the] recent enforcement cases has been the advisers' misrepresentation of their funds' performance to current investors, which in some cases was used to induce a false sense of security for investors when they

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[8] Roel C. Campos, Comm'r, SEC, Remarks Before the SIA-Hedge Fund Conference (Sept. 14, 2005), *available at* http://www.sec.gov/news/speech/spch091405rcc.htm.
[9] *Id.*
[10] *In Brief: 75% Hedge Fund Asset Rise Seen by 2010*, AM. BANKER, Sept. 21, 2005, at 9.
[11] Campos, *supra* note 8.
[12] *Id.*
[13] *Id.*
[14] *Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers Before the S. Comm. on Banking, Hous. and Urban Affairs*, 108th Cong. (2004) (statement of William H. Donaldson, SEC Chairman), available at http://www.sec.gov/news/testimony/ts071504whd.htm. [hereinafter *Donaldson*].
[15] *Id.*

might otherwise have exercised their redemption rights."[16] SEC Commissioner, Roel C. Campos, attributed the rise of hedge fund fraud to a combination of growth in the hedge fund industry and the availability of uninformed money.[17] One of the SEC's responses to the perpetration of fraud involving hedge funds is the adoption of a "risk-based approach to examinations, in hopes of zeroing in on problem areas faster."[18] Most significantly, the SEC has adopted a registration requirement for hedge fund advisers which may counteract a significant portion of hedge fund fraud. Approximately eighty percent of the enforcement cases brought in the past five years alleging hedge fund fraud involved hedge fund advisers that were not registered with the Commission.[19]

2. SEC v. Samuel Israel III; Daniel E. Marino; Bayou Management, LLC

On September 29, 2005, the U.S. Attorney for the Southern District of New York filed criminal charges against two officers of the Bayou Group for defrauding investors.[20] The Bayou Group was a family of hedge funds into which investors deposited over $450 million from 1996 through 2005.[21] In a related civil action, the SEC alleged that during that period the fund's Chief Executive Officer, Samuel Israel III, and the fund's Chief Financial Officer, Daniel Marino, defrauded investors by grossly exaggerating Bayou's performance.[22] According to the SEC, this made the Bayou funds appear to be profitable and attractive investments despite the fact that they never posted a year-end profit.[23] In order to induce investors to purchase and hold Bayou, the SEC alleged that Israel and Marino created and disseminated "periodic account statements and performance summaries containing fictitious profit and loss figures" that hid "multimillion dollar trading losses from investors."[24]

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[16] *Final Rules*, *supra* note 2.
[17] Campos, *supra* note 8.
[18] John Hintze, *No More Bayous?*, SEC. INDUSTRY NEWS, Nov. 7, 2005.
[19] Donaldson, *supra* note 14.
[20] SEC v. Israel III, et al., Litigation Release No. 19406, 2005 SEC LEXIS 2463, at *1 (Sept. 29, 2005).
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*

Israel and Marino entered guilty pleas to investment adviser fraud, mail fraud and conspiracy in Federal District Court in White Plains.[25] Mr. Marino also pleaded guilty to wire fraud.[26] The enforcement penalties may subject the two to imprisonment of up to 50 years, and include possible fines of $250,000 per count and possible restitution.[27] The Commodity Futures Trading Commission also filed a civil action against the individuals, accusing them of fraud.[28] While authorities were able to seize approximately $100 million in what is believed to be Bayou investors' funds, it is unclear what happened to the remaining $350 million investors entrusted to the Bayou funds.[29] One commentator suggests that the Bayou litigation demonstrates the possibilities of malfeasance and self-dealing enabled by the opaque form of hedge funds, and that the registration of hedge fund advisers may be insufficient to protect investors without some additional information.[30] The theory is that if hedge fund advisors were required to report the identity of the accountant responsible for auditing the fund, as well as the name of the broker-dealer through which the fund trades, the SEC would be better able to police the industry and prevent frauds such as that which occurred at Bayou.[31]

3. SEC v. K.L. Group, LLC

The SEC sought injunctive relief to halt a fraud by a group of Palm Beach, Florida based hedge funds, their principals, their unregistered investment advisers and an affiliated registered broker-dealer.[32] According to the SEC's complaint, "the defendants conducted a fraudulent scheme that resulted in the loss of most, if not all, of the $81 million raised from investors."[33] The SEC alleged that from "as early as 1999 and continuing through February 2005 the

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[25] Jenny Anderson, *Two at Hedge Fund Emerge to Plead Guilty to Fraud*, N.Y. TIMES, Sept. 30, 2005, at C1.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] Jenny Anderson, *A Modest Proposal to Prevent Hedge Fund Fraud*, N.Y. TIMES, Oct. 7, 2005, at C6.
[31] *Id.*
[32] SEC Staff, *SEC Obtains Emergency Relief Against Palm Beach, Florida, Hedge Funds for $81 Million Fraudulent Offerings*, *available at* http://sec.gov/news/press/2005-27.htm.
[33] *Id.*

hedge funds raised over $81 million from at least 250 investors by boasting of consistent above-market returns through trading in aggressive growth stocks."[34] The SEC further alleged that "[t]he investment advisers . . . sent false account statements to investors in at least one of the hedge funds that showed consistently high returns" despite the fact that the funds "were suffering tremendous trading losses."[35]

Both Bayou Group and KL Financial relied upon broker-dealer affiliates to perpetrate their fraudulent schemes.[36] The broker-dealers set up by Bayou Group and KL Financial gave them "credibility in the market and went on to play a part in fraud schemes that have allegedly cost investors hundreds of millions of dollars."[37] An attorney who represented investors in KL claimed that KL's relationship with the broker-dealer, Shoreland Trading, and the firm that cleared Shoreland's trading activities, Goldman Sachs, "gave them a degree of credibility," and further argued that, "anybody who was looking at it saw who its broker-dealer was clearing through and saw it had a relationship with an actual brokerage firm."[38] Investors in Bayou acknowledged that a contributing factor in their relationship with the hedge fund was the fact that Bayou's affiliated broker-dealer, Bayou Securities, was registered and presumably periodically examined.[39] However, these investors may not have been aware of the regulatory fines assessed against the Bayou brokerage.[40]

4. SEC v. Mark R. Conway & Groundswell Partners LLC

In another case of hedge fund fraud, the SEC obtained an emergency asset freeze and temporary restraining order against hedge fund manager Mark R. Conway and his firm, Groundswell Partners LLC, of Waltham, Massachusetts.[41] According to the complaint, Conway hid losses incurred by the fund and misled

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[34] *Id.*
[35] *Id.*
[36] Hintze, *supra* note 18.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] SEC v. Conway, Litigation Release No. 19460, 2005 SEC LEXIS 2913, a *1 (Nov. 9, 2005).

investors by altering financial statements.[42] The SEC alleges that Conway admitted in a tape recorded conversation to losing a large amount of money in the fund.[43] In an effort to make up the losses, he deviated from the fund's original investment strategy without notifying investors, ultimately losing $29 million of the fund's $43 million in assets.[44] The complaint further alleged that Conway admitted to altering financial statements, profit and loss spreadsheets and account statements sent to investors.[45] Conway also allegedly admitted to creating a fictitious auditor and fictitious audit reports for the fund.[46] Walter Ricciardi, head of the SEC's Boston office, said of the case, "[h]edge funds are attracting massive amounts of money. Unfortunately, they're also attracting fraudsters."[47]

C. The Registration Requirement and Avoidance Strategies

1. The Rule: Registration under the Advisers Act

The new SEC rules, which became operative on February 1, 2006, require advisers to hedge funds with more than 14 investors and $25 million in assets to file as registered investment advisers.[48] Hedge fund advisers, the legal entities that own and manage hedge funds, will have to register by submitting a document called Form ADV, which will indicate the adviser's address, the hedge fund manager's professional history and any disciplinary history.[49] The rules affect funds with a lock up of under two years, require appointment of chief compliance officers, and will subject advisers to random SEC audits.[50] When promulgating the new rules, the SEC considered a number of factors including rapid growth in the number and size of hedge funds, the growing number of enforcement cases involving hedge fund advisers, and the increasingly broad economic

[42] Gregory Zuckerman, *Hedge Fraud Is Alleged by SEC*, WALL ST. J., Nov. 10, 2005, at C6.
[43] SEC Staff, *supra* note 41.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] Zuckerman, *supra* note 42.
[48] Final Rules, *supra* note 2.
[49] Anderson, *supra* note 30.
[50] Campos, *supra* note 8.

consequences for the securities markets as these investments have evolved from an investment by the very wealthy to an investment used by pension funds, institutional investors, and the retail markets through funds of funds.[51]

SEC Commissioner Roel C. Campos explains that, "[t]he concept of registration under the Advisers Act was selected because of its minimalist approach in both regulatory burden and in cost but extensive benefits of census information, deterrence of fraud (through inspections), barring unfit persons from the industry, adoption of compliance controls, and limits on retailization."[52] The registration requirement allows hedge fund advisers to operate with relative freedom and does not limit their choice of investment strategies.[53] The Advisers Act serves as a disclosure and anti-fraud law, and is a minimally invasive means of managing conflicts of interest and ensuring fair practices.[54] There are approximately 8,500 investment advisers currently registered with the SEC, many of whom manage hedge funds and for whom the registration requirement has proven to be feasible and not overly burdensome.[55] Five of the ten largest hedge fund advisors are already registered under the Investment Advisors Act.[56] A recent study found the performance of registered hedge fund advisors was consistent with the performance of unregistered advisers.[57]

Campos claims that despite a mixed review from those affected by the new rules, hedge fund advisers will adapt their practices to comply with the requirements and will use registration as a "seal of approval" to increase their credibility with investors.[58] However, Campos also noted that in order to avoid the registration requirement "[s]ome hedge funds have begun to prohibit their investors from withdrawing their money for two years, allowing

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[51] Final Rules, *supra* note 2.
[52] Campos, *supra* note 8.
[53] *Id.*
[54] Paul F. Roye, Speech by SEC Staff: Remarks before the Managed Funds Association Educational Seminar Series 2005 Guidance on the SEC's New Regulatory Framework for Hedge Fund Advisers (Feb. 9, 2005), *available at* http://www.sec.gov/news/speech/spch020905pfr.htm.
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Roel C. Campos, Comm'r, SEC, Remarks Before the Managed Funds Association (July 12, 2005), *available at* http://www.sec.gov/news/speech/spch071205rcc.htm.

them to fall under an exception to the rules that was included to avoid forcing private-equity firms to register."[59]

2. The Two-Year Lock-up Loophole

The SEC's definition of private funds, which are required to register under the Advisers Act excluded hedge funds that have at least a two year lock up for initial and subsequent investments.[60] The SEC defined "private funds," which must comply with the registration requirement, as "limited to investment pools with redemption features that offer investors a short-term right to withdraw their assets from management, based on their individual liquidity needs and other preferences, in a manner similar to clients that directly open an account with an adviser."[61] The condition of a short-term right to withdraw assets thereby excludes from the registration requirement private equity funds, venture capital funds, or other funds that require long-term commitment of capital.[62] The Commission distinguished these excluded funds as not presenting "significant enforcement problems with advisers with respect to their management of private equity or venture capital funds" in contrast to the "substantial record of frauds associated with hedge funds."[63] Such a distinction allows the SEC to concentrate its enforcement efforts and deter fraud in the marketplace and is consistent with the customary industry policy of hedge fund lock ups of less than one year.[64]

3. SEC and Industry Comment on the Lock-up

SEC Commissioners Cynthia Glassman and Paul Atkins dissented from the final registration rule and criticized the structure of the rule that excludes hedge funds with a two year lock-up.[65] Glassman and Atkins claim that the two year lock-up will provide an incentive for advisers to extend redemption periods to avoid the costs

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[59] *Id.*
[60] Gregory Zuckerman & Ian McDonald, *Hedge Funds Avoid SEC Registration Rule* WALL ST. J., Nov. 10, 2005, at C1.
[61] Final Rules, *supra* note 2.
[62] *Id.*
[63] *Id.*
[64] Hellrung, *supra* note 7, at 343.
[65] Final Rules, *supra* note 2, at Glassman and Atkins' Dissent.

and regulations that follow with registration.[66] Longer redemption periods make it more difficult for investors to vote on the quality and integrity of the hedge fund manager by liquidating their positions in the fund.[67] They suggested that instead of focusing on redemption period, the definition of a private fund hedge fund should look to portfolio content or frequency of trading.[68]

The Commissioners' criticism of the two year lock-up rule is grounded in the possibility that hedge fund advisers seeking to avoid the costs and encumbrances of registration may extend lock up periods to avoid the statutory private fund definition.[69] Ellington Management Group, LLC issued a comment letter regarding the proposed registration rule and claimed that "many hedge fund managers wishing to avoid registration will be trying to institute two year lock-ups exactly for this purpose."[70] An attorney advising the Managed Funds Association, a hedge fund trade group, stated that a number of hedge fund advisers are exploring longer lock-ups.[71] According to this attorney, the two-year lockup "is attractive if you can do it, but there are liquidity issues."[72] The Wall Street Journal reported that a large number of major hedge-fund firms do not plan to register with the SEC despite the new registration rules.[73] By adopting measures to take advantage of the lock-up requirement, these hedge funds could potentially undercut the SEC's efforts to uncover fraud and gather information on the industry.[74]

There is some question whether the exemption extended to hedge funds with a lock-up of two years or greater will swallow the rule and further compromise the interests of hedge fund investors who do not demand liquidity.[75] Commissioner Atkins suggests that in structuring the rule to exclude hedge funds with longer lock-ups, the SEC has "strengthened incentives to lengthen lock-up periods and have thereby made it harder for investors to recover their money

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[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.* at n. 87.
[71] Carol E. Curtis, *The Two-Year Itch: Hedge Fund Advisers Consider Loophole in Registration Rule*, SECURITIES INDUSTRY NEWS, May 9, 2005.
[72] *Id.*
[73] Zuckerman & McDonald, *supra* note 60.
[74] *Id.*
[75] Hellrung, *supra* note 7, at 342-343.

from bad or fraudulent advisers."[76] The incentive to avoid the registration requirements are strong because fund advisers are wary of the cost of complying with the SEC's registration requirement, which could cost more than $500,000 for many funds.[77] Furthermore, some hedge fund advisers contend that the total cost of registration involves numerous secondary expenses including the possibility of time consuming SEC audits that could tie up traders and senior management for weeks.[78] However, other commentators suggest that the two year lock-up will not be a material factor for hedge funds because investors either prefer funds that allow monthly liquidity, or are already committed to funds with a lengthy lock-up.[79]

The SEC will continue to monitor developments regarding the two year lock-up provision and whether the provision continues effectively to distinguish hedge funds from private equity and venture capital funds.[80] Paul Roye, the architect of the hedge fund registration rule explained, "[it is our expectation that few investors will agree to leave their money tied up for so long and that the market will therefore prevent circumvention of the rule."[81] Roye suggests that reasonably informed investors will be reluctant to hand a multi-million dollar investment to an investment adviser who may be trying to avoid SEC registration and that a redemption period longer than two years may serve as a red flag for hedge fund investors.[82] Thus, even if some funds are able to avoid the SEC registration requirement, the decision to deliberately avoid registration will be a signal of concern for investors.[83]

D. Conclusion

Recent high profile hedge fund frauds have highlighted the need for greater regulatory involvement.[84] The implementation of the adviser registration requirement will enable greater SEC oversight in the hedge fund industry.[85] While some funds will

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[76] Paul S. Atkins, Comm'r, SEC, Remarks Before the Managed Funds Association (Sept. 29, 2005), *available at* http://www.sec.gov/news/speech/spch092905psa.htm.
[77] Zuckerman & McDonald, *supra* note 60.
[78] *Id.*
[79] Curtis, *supra* note 71.
[80] Final Rules, *supra* note 2, at n. 238.
[81] Roye, *supra* note 54.
[82] *Id.*
[83] *Id.*
[84] Donaldson, *supra* note 14.
[85] Final Rules, *supra* note 2.

attempt to avoid the registration requirement through extended lock-ups, the registration requirement is designed as a minimally invasive means of deterring and detecting fraud by registered hedge fund advisers.[86]

David I. Silverman[87]

[86] Roye, *supra* note 54.
[87] Student, Boston University School of Law (J.D. 2007).

IV. SARBANES-OXLEY ACT

A. Introduction

In response to corporate scandals such as Enron and Worldcom, Congress passed the Sarbanes-Oxley Act ("SOX") in 2002.[1] The purpose of SOX was to protect investors by improving the accuracy and reliability of the financial reports that publicly traded companies are required to file.[2] It has been over three years since Congress passed SOX, and while no one doubts that the Act was beneficial and necessary, the benefits have yet to be quantified.[3] Meanwhile, many companies complain of the high compliance costs they incur,[4] most of which revolve around the cost of complying with Section 404 of the Act.[5] The complaints are due to the extra work and expenses that Section 404 imposes on public companies and their auditors.[6] Section 404 requires that management in publicly traded companies registered with the Securities and Exchange Commission ("SEC" or "Commission") establish, maintain and assess the effectiveness of their internal controls over financial reporting.[7] The section also requires that an independent public auditor attest to and report on management's assessment.[8]

B. First Year Observations

1. Direct Costs

Section 404 took effect for the first time this year for public U.S. companies with revenue of $75 million or more.[9] For most of these companies, the requirements of Section 404 had to be included

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[1] Nikki Swartz, *Executives Praise SOX but Seek Changes*, INFO. MGMT. J., July/Aug. 2005, at 22, 22.
[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.A.(2002)).
[3] Swartz, *Executives Praise SOX, supra* note 1, at 23.
[4] *Id.*
[5] *See* Peter Koh, *Counting the Cost: Rank's Termination of Its ADR Programme and a Survey on U.S. Public Company Costs Highlight Impact of Legislation*, EUROMONEY, Aug. 1, 2005, at 23, 23.
[6] Robert W. Rouse et al., *Sarbanes-Oxley Update: Where Are We Today?*, J. OF CORP. ACCT. & FIN., 2005, at 66.
[7] Sarbanes-Oxley Act of 2002 § 404.
[8] *Id.*
[9] Swartz, *Executives Praise SOX, supra* note 1.

in their most recent annual reports, which led to increased internal and external costs last year.[10] Financial Executives International ("FEI"), a professional association of corporate finance executives, surveyed 217 public companies with average revenues of $5 billion and found that compliance with Section 404 cost the companies an average of $4.36 million.[11] The average cost of compliance was up 39% from the $3.14 million that the companies had originally anticipated.[12] There is no doubt that the costs of complying with Section 404 were higher than anyone had expected.[13] The SEC originally estimated that the total cost of implementing SOX would be less than $1.5 billion, but the actual cost for the first year of compliance will be closer to $35 billion.[14]

Critics believe that one reason why compliance is so expensive is because Section 404 is redundant.[15] In addition to the increased cost of complying with the documentation and testing of internal controls requirement, companies must also incur the increased auditing fees of their external auditor.[16] Thus, Section 404 requires public companies to hire an external auditor to retest everything that the Section requires management to test.[17] Most of the increase in compliance costs is a result of a 66% rise in external costs for consulting, software and other vendors, and a 58% increase in fees charged by external auditors.[18] The 217 companies that took part in the FEI survey reported spending an average of $1.3 million on auditor fees.[19] Similarly, a study of 633 companies in the Fortune 1000 performed by professors at the University of Nebraska at

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[10] Andrew Countryman, *Sarbanes-Oxley Mandates Send Corporate Audit Expenses Soaring*, KNIGHT RIDDER TRIBUNE BUS. NEWS, June 4, 2005, at 1.

[11] Press Release, Fin. Executives Int'l, Sarbanes-Oxley Compliance Costs Exceed Estimates (Mar. 21, 2005), *available at* http://www.fei.org/download/404_pr_3_21_2005.pdf.

[12] *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost*, CPA J., Oct. 1, 2005, at 19.

[13] *The Impact of the Sarbanes-Oxley Act: Hearing Before the H. Comm.. on Financial Services*, 109th Cong. 2 (2005) (statement of Michael G. Oxley, Chairman, H. Comm. on Financial Services).

[14] Dana R. Hermanson, *Is the Sarbanes-Oxley Act Worth It?*, INTERNAL AUDITING, July/Aug. 2005, at 33.

[15] Deborah Solomon, *Corporate Governance (A Special Report); At What Price? Critics Say the Cost of Complying With Sarbanes-Oxley Is a Lot Higher Than It Should be*, WALL ST. J. (E. Ed.), Oct. 17, 2005, at R3.

[16] *Id.*

[17] *Id.*

[18] *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost, supra* note 12.

[19] Countryman, *supra* note 10.

Omaha, reported that audit fees rose an average of nearly 64%.[20] In 2004, the average audit fee paid by the 1,000 largest public companies in that study was $5.8 million, while the average in 2003 was $3.5 million.[21] Auditors, however, defend the increase in the audit fees that they charge and insist that they are reasonable.[22] For example, James Quigley, CEO of Deloitte & Touche USA LLP, attributed the increase in fees to the additional work that is necessary to issue an opinion on management's assessment of internal controls.[23]

2. Indirect Costs

While the direct cost of SOX on public companies has been greater than anyone expected, some believe that there have been indirect effects as well.[24] First, spending on capital expenditures and research and development has decreased since the implementation of SOX.[25] Some feel that the decrease in spending is a result of CEOs becoming more risk averse because of SOX.[26] Second, SOX also impacts private companies and nonprofit organizations, even though the legislation was only intended to apply to public companies.[27] A recent survey by Foley & Larder reports that 80% of privately held companies and 97% of nonprofits stated that the passage of SOX has resulted in an increase in governance costs.[28] Thus, private companies and nonprofits are apparently pressured to adopt elements of SOX even though they are not required to.[29]

3. Delayed Filings

An unintended result of Section 404 and SOX has been the delay by companies in filing their financial reports.[30] Nearly eighty companies with annual revenue of more than $100 million notified

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[20] *Id.*
[21] Mark Friedman, *SOX Ups Public Companies' Audit Costs by 135 Percent*, NORTHWEST ARK. BUS. J., Oct. 10, 2005, at 17, 18.
[22] Countryman, *supra* note 10.
[23] *Id.*
[24] Hermanson, *supra* note 14.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at 33-34.
[29] *See id.* at 33.
[30] *See* Swartz, *Executives Praise SOX, supra* note 1, at 23.

the SEC that they could not meet the filing deadline for their quarterly reports.[31] In late 2004, the number of larger companies to miss the deadline for filing quarterly reports doubled from the previous quarter.[32] Similarly, hundreds of companies missed the deadline this year to file their annual reports for 2004 as new SOX requirements became effective.[33] For instance, TRC, a leading provider of technical and financial services to commercial and government clients, announced in September 2005 that it would need another extension to file its annual report.[34] The company identified "material weaknesses" in its internal review of controls and said that it needed more time to complete its assessment of internal controls, which Section 404 requires.[35] Warwick Valley Telephone is another example of the nearly 1,800 companies that has asked the SEC to extend the deadline for filing their annual reports.[36]

Furthermore, in March 2005, over a dozen Silicon Valley companies asked for an extension to file their annual financial reports because they needed more time to meet the SOX requirements.[37] Companies like McAfee and Borland Software stated they needed more time to document, test and obtain an independent auditor's approval on their internal control systems.[38] Other companies such as Rita Medical Systems and Lexar Media anticipate that auditors will give them poor grades for their internal controls last year, and therefore, they will need some of the extra time to amend parts of their past reports.[39] Though companies are blaming the delay on Section 404, it is not clear exactly how much of the delay is due to Section 404 issues because the SEC does not keep track of such matters.[40]

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[31] *Id.* at 24.
[32] David Enrich, *More Companies Miss Deadline For SEC Filing in Latest Period*, WALL ST. J. (E. Ed.), Nov. 17, 2004, at 1.
[33] Swartz, *Executives Praise SOX, supra* note 1, at 23.
[34] *TRC Delays Filing of Form 10-K*, BUS. WIRE, Sept. 28, 2005.
[35] *Id.*
[36] Michael Levensohn, *Warwick, N.Y., Firm Blames Sarbanes-Oxley For Delay in Financial Statements*, KNIGHT RIDDER TRIBUNE BUS. NEWS, Apr. 6, 2005, at 1.
[37] *Auditing Rules to Delay SEC Filings*, KNIGHT RIDDER TRIBUNE BUS. NEWS, Mar. 17, 2005, at 1.
[38] *Id.*
[39] *See id.*
[40] Levensohn, *supra* note 36.

C. Section 404: More Time Given

1. Small Companies

Many believe that the high costs of complying with Section 404 would place an even greater burden on small public companies.[41] Small public companies constitute approximately 80% of all public companies in the U.S., and yet, they account for only 6% of total public company market capitalization.[42] As a result, Section 404 compliance costs constitute a higher percentage of revenue for smaller companies.[43] A February 2005 study showed that Section 404 costs constitute an average of 2.5% of revenues for small companies with less than $100 million in revenues.[44] RLI Corporation, for example, spent roughly $1.9 million on Section 404 compliance costs, constituting approximately 2.6% of its $73 million net earning in 2004.[45]

Recognizing the potential undue burden on small companies, the SEC decided on March 3, 2005, to extend the deadline to comply with Section 404 for small companies from July 15, 2005 to July 15, 2006.[46] Later, on September 21, 2005, the SEC voted to extend the deadline again, giving small companies until July 15, 2007 to comply.[47] Companies with a market capitalization of less than $75 million qualify for the extension.[48] The SEC extended the deadline in response to heavy pressure from business groups to ease up on enforcement because the high costs of compliance fall especially hard on small companies.[49]

Even though the latest extension in September gives small companies until 2007 to comply, many of them feel they have

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[41] Molly M. Peterson, *No Major Changes Likely For Sarbanes-Oxley, Hagel Says*, CONG. DAILY, Oct. 5, 2005.
[42] Jim Thyen, Chairman of the Size Subcommittee, Report of the Size Subcommittee to the Advisory Committee on Smaller Public Companies (Aug. 10, 2005), *available at* http://www.sec.gov/rules/other/265-23/adavernslides081005.pdf.
[43] *See id.*
[44] *Id.*
[45] Countryman, s*upra* note 10.
[46] Ed Taylor, *Small Public Companies Welcome Extension on Sarbanes-Oxley Compliance*, KNIGHT RIDDER TRIBUNE BUS. NEWS, Mar. 11, 2005, at 1.
[47] *See* Damian Paletta, *In Brief: Small Companies Get Rule Extension*, AM. BANKER, Sept. 22, 2005, at 3.
[48] Andrew Parker, *Small Companies Win Extension Sarbanes-Oxley*, FIN. TIMES UK (London), Sept. 22, 2005, at 26.
[49] Taylor, *supra* note 46.

already spent too much on SOX compliance.[50] Section 404 has given small companies the most headaches because they are not capable of absorbing the extra expenses like large companies can.[51] Furthermore, the costs are not limited to the money spent on documenting, testing and auditing.[52] For small and large companies alike, Section 404 takes away large amounts of valuable time and effort that could be spent elsewhere.[53]

2. Foreign Companies

In March 2005, when the SEC first extended the deadline for small public companies to comply with Section 404, the Commission extended the deadline for publicly traded foreign companies to 2006 as well.[54] Previously, foreign companies were required to comply by July 15, 2005.[55] Generally, the extension applies to companies that are incorporated and have more than half of their ownership, management, and assets outside of the U.S.[56] Although the extension provides foreign companies with some relief, SOX has already influenced many foreign companies in deciding whether or not to list in American exchanges.[57] The reporting requirements of SOX have deterred foreign companies from offering IPOs in the U.S. because many foreign companies find the requirements difficult to comply with.[58] While traditional U.S. regulations were directed at disclosure, SOX goes further and requires certain types of governance arrangements, including independent directors and specific types of relationships with external auditors.[59] Chinese companies, for example, are projected to raise $17 billion this year

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[50] Mike Allen, *Cost of Compliance Sarbanes-Oxley: Headache for Small Companies*, ORANGE COUNTY BUS. J., Oct. 24, 2005, at 38.
[51] *Id.*
[52] *Id.*
[53] *See id.*
[54] Nikki Swartz, *SEC Extends SOX Deadline for Foreign Companies*, INFO. MGMT. J., May/June 2005, at 8.
[55] *Id.*
[56] *Id.*
[57] Mark Rockwell, *Startups Wrestle with Accounting Rules: In Wake of Sarbanes-Oxley Act, Smaller Companies Face Greater Obstacles in Going Public*, WIRELESS WK., Aug. 15, 2005, at 13.
[58] Richard A. McCormack, *Growing Number of Chinese IPOs Are Bypassing U.S. Equity Markets: Does China Pose a Financial Opportunity or Threat?*, MFG. & TECH. NEWS, Sept. 1, 2005, at 1, 1.
[59] *Id.*

through IPOs, but many of them are choosing to forgo U.S. capital markets to go into the less stringent Hong Kong and London markets.[60]

Even foreign companies that are already listed on U.S. exchanges are considering de-listing because of the SOX requirements.[61] For example, Rank Group, the British company that owns Hard Rock Cafe, announced in July of this year that it plans to delist from Nasdaq.[62] It stated that the costs of complying with reporting requirements was the main reason, even though foreign companies were given an extra year to comply with SOX.[63] Neal Wolkoff, chairman and CEO of the American Stock Exchange believes that under SOX and the current system of regulation, both domestic and foreign companies are deterred from accessing the U.S. capital markets.[64]

D. Cutting the Costs

In response to the complaints over the high costs of SOX compliance, the SEC and the Public Company Accounting Oversight Board ("PCAOB") have taken steps to reduce the cost of complying with Section 404.[65] In mid 2005, both the SEC and the PCAOB issued guidelines for companies to reduce the cost of compliance.[66] The guidelines were issued after the two regulators held an April 13 roundtable discussion with industry officials.[67] The regulators said that companies and auditors should use more common sense in applying the new requirements in order to reduce costs.[68] The new guidelines offer companies that are subject to SOX greater flexibility in determining the best way to comply with Section 404 by effectively allowing management to come up with an internal control audit system that works best for their own specific company.[69] The

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[60] *Id.*
[61] *Id.*
[62] Koh, *supra* note 5.
[63] *Id.*
[64] *See* Neal L. Wolkoff, *Sarbanes-Oxley Is a Curse for Small-Cap Companies*, WALL ST. J. (E. Ed.), Aug. 15, 2005, at A13.
[65] Matt Brady & Arthur D. Postal, *Regulators Ease Up on Compliance Costs*, NAT'L UNDERWRITER, May 23, 2005, at 31.
[66] Gordon Platt, *Regulators Act to Cut Costs of Compliance With Sarbox*, GLOBAL FIN., June 2005, at 7.
[67] Brady & Postal, *supra* note 65.
[68] Platt, *supra* note 66.
[69] Brady & Postal, *supra* note 65.

guidelines allow external auditors to communicate directly with management to set up individually tailored audits and to perform integrated audits of internal controls and financial statements.[70]

In its statement, the SEC specifically stated that it decided not to issue a one size fits all system for internal auditing so that companies can determine the best way to monitor themselves.[71] The Commission wanted to give management flexibility in determining the required amount of testing and documentation so that companies can focus on the goal and purpose of SOX instead of the process.[72] The SEC emphasized that management does not need to assess other internal controls that are not associated with financial reporting.[73] Both the SEC and the PCAOB said that companies should use their "own experience and informed judgment in designing an assessment process."[74] The scope and process of the internal control mechanism that management adopts only needs to provide reasonable assurance, not absolute assurance.[75]

E. Benefits of SOX

The direct costs of implementing SOX are usually documented by the companies, but the benefits have been much more difficult to quantify.[76] Although little research has been conducted on the benefits of SOX, it does not mean that they do not exist.[77] For example, several recent publications have identified some of the benefits of SOX even though they are hard to express in dollars.[78] The potential benefits include improved controls and ethical climate, better corporate governance and more reliable financial statements.[79] A recent survey asked nearly 175 chief audit executives and internal audit managers to identify control improvements resulting from Section 404 compliance efforts.[80] The participants specifically identified benefits improvements in the overall control environment,

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[70] *Id.*
[71] *Id.* at 32.
[72] *Id.*
[73] Platt, *supra* note 66.
[74] Brady & Postal, *supra* note 65, at 32.
[75] Platt, *supra* note 66.
[76] Hermanson, *supra* note 14.
[77] *See* Larry Rittenberg & Patricia K. Miller, *The Good News About Compliance*, INTERNAL AUDITOR, June 2005, at 55, 56.
[78] Hermanson, *supra* note 14, at 34.
[79] *Id.* at 33.
[80] Rittenberg & Miller, *supra* note 77.

routine accounting controls, anti-fraud processes, compensation schemes and high-risk accounting areas.[81] Control environment and anti-fraud activities were the two areas that the most participants agreed there were improvements in.[82]

The majority of the participants also felt that Section 404 requirements have helped to integrate controls into the corporate culture and will result in increased effectiveness and efficiency in the future.[83] The best way for companies to deal with SOX compliance and to sustain the benefits at the lowest cost possible is to adopt a long-term mentality towards compliance.[84] In year one of SOX compliance, many companies took an "all hands on deck" approach in order to meet the compliance deadlines.[85] SOX compliance is not a one-time event, however, and a company's compliance program must evolve from a short-term approach and become "embedded in the fabric of the organization's business processes, procedures, and culture."[86]

F. Conclusion

Congress passed SOX in order to boost investor confidence by improving corporate governance and internal controls.[87] Last year was the first year of compliance for large public companies, and it is time to review the results.[88] There is no question that the costs have been more than anyone expected.[89] The costs of implementing SOX and Section 404 are an especially high burden on smaller companies that do not have the same resources as larger companies to absorb the costs.[90] Aware of the potential undue burden on smaller companies, the SEC extended the deadline for smaller companies to comply with Section 404 twice this year.[91] SOX has also impacted foreign companies and U.S. capital markets.[92]

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[81] *Id.*
[82] *Id.*
[83] *Id.* at 60.
[84] *See* J. Stephen McNally & David D. Wagaman, *Hard Climb is Done, But Trek Continues*, PA. CPA J., Fall 2005, at 24.
[85] *Id.*
[86] *Id.*
[87] *See* Wolkoff, *supra* note 64.
[88] *Sarbanes-Oxley Act Improves Investor Confidence, But at a Cost, supra* note 12.
[89] *The Impact of the Sarbanes-Oxley Act*, *supra* note 13.
[90] Peterson, *supra* note 41.
[91] *See* Taylor, *supra* note 46; Paletta, *supra* note 47.
[92] Rockwell, *supra* note 57.

Although many companies complain about the costs, the passage of SOX was probably "necessary to restore investor confidence."[93] Furthermore, SOX has produced some benefits, and although they are hard to quantify, it is too early to know whether the benefits outweigh the costs.[94]

Samson Huang[95]

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[93] Swartz, *Executives Praise SOX*, *supra* note 1, at 23.
[94] Rittenberg & Miller, *supra* note 77, at 60.
[95] Student, Boston University School of Law (J.D. 2007).

V. GRAMM-LEACH-BLILEY ACT

A. Introduction

The Gramm-Leach-Bliley Act of 1999 ("GLBA") seeks to modernize the financial services industry by permitting banks to compete with securities brokerage firms and insurance companies.[1] The GLBA also protects individual privacy rights by imposing strict regulations on the methods of sharing customers' private financial information with third parties.[2] The GLBA joins the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"), the Sarbanes-Oxley Act ("SOX") and the proposed Basel II accord as the chief operational risk regulatory requirements for financial institutions.[3] This article will outline a recent study commissioned by the Financial Services Roundtable and the BITS Operational Risk Management Working Group which examined redundancies existing among these regulations. This article will also explore recent federal court cases defining the scope and definition of the GLBA.

B. BITS Study

Federal financial services legislation is typically drafted as a reaction to current financial concerns.[4] For example, the GLBA was enacted at a time when personal identity theft and the inappropriate use of customer financial information were credible threats.[5] Other recent financial regulations aim to address specific risks; however, the piecemeal drafting of legislation has resulted in significant overlap.[6] As a result, large U.S. banking organizations have been required to establish separate internal reporting and compliance systems which inefficiently address each regulation.[7] BITS Operational Risk Management Working Group and the Financial

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[1] FINANCIAL SERVICES ROUNDTABLE, RECONCILIATION OF REGULATORY OVERLAP FOR THE MANAGEMENT AND SUPERVISION OF OPERATIONAL RISK IN U.S. FINANCIAL INSTITUTIONS 8 (2005).
[2] *Id.*
[3] *Id*. at 2.
[4] *Id*. at 6.
[5] *Id*.
[6] *Id*. at 7.
[7] *Id.* at 3.

Services Roundtable examined these redundancies and published a study summarizing their findings in May 2005.[8]

The GLBA requires that an institution's board of directors comply with an internal control process governing the protection of its customers' identity through a continuous control and oversight process.[9] The study compared these requirements to the internal control systems mandated by FDICIA and SOX and concluded that although the intent of these statutes varies, the required internal control processes are very similar.[10] Additionally, the proposed Basel II accord requires banks to maintain an overall system of internal controls to ensure that operational risk is minimized.[11] Basel II defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events."[12] The study determined that this definition would implicitly include the risk of disbursement of private information protected in the GLBA.[13]

To comply with these various regulations, financial institutions have constructed separate compliance measures which address similar regulations.[14] The study warns that the cost of compliance with each regulatory requirement is becoming substantial and the process is inefficient in light of the logical solution to streamline the regulations.[15] The BITS report suggests that a more coordinated examination is necessary to ameliorate the fractured approach to regulatory compliance.[16] It concludes by recommending that the financial services community work directly with regulators to promote a more holistic compliance approach which will lead to more efficient internal controls.[17]

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[8] *Id*. at 5.
[9] *Id* at 11.
[10] *Id*.
[11] *Id*.
[12] *Id*.
[13] *Id*.
[14] *Id*.
[15] *Id*.
[16] *Id.* at 26.
[17] *Id.* at 26.

C. Recent Caselaw

1. GLBA Preemption of State Law: *Mass. Bankers Ass'n v. Bowler*.[18]

In May 2000, the Massachusetts Bankers Association ("MBA") petitioned the Office of the Comptroller of the Currency of the United States ("OCC") to determine whether the GLBA preempted certain provisions of the Massachusetts Consumer Protection Act Relative to the Sale of Insurance by Banks ("Consumer Protection Act").[19] The OCC concluded that the GLBA does preempt certain provisions of the Consumer Protection Act.[20] In response, the Massachusetts Commissioners of Insurance and Banks and the Commonwealth of Massachusetts sought review in the First Circuit Court of Appeals to settle the regulatory conflict arising from the OCC opinion.[21] In 2003, the Court of Appeals dismissed the case for lack of jurisdiction because the court determined there was no regulatory conflict.[22]

Soon after, MBA and some of its members filed a complaint in federal district court against the Massachusetts Commissioner of Insurance and the Massachusetts Commissioner of Banks, challenging four specific provisions of Massachusetts law which prohibit banks "from selling, soliciting and marketing insurance products."[23] The Referral Prohibition bars bank employees from referring bank customers to in-house licensed insurance agents unless the customer inquires directly about the insurance.[24] The Referral Fee Prohibition restricts banks from paying a commission to employees who refer customers to the bank's insurance agents.[25] The Waiting Period Restriction requires banks to refrain from soliciting insurance sales until after the customer's credit is pre-approved and the approval is communicated to the customer in writing.[26] Lastly, the Separation Restriction requires the bank to conduct insurance solicitation in a separate area from banking

[18] Mass. Bankers Ass'n v. Bowler, 392 F. Supp. 2d 24 (D. Mass. 2005).
[19] *Id*. at 25.
[20] *Id*.
[21] *Id*.
[22] *Id*. at 25-26.
[23] *Id*. at 26.
[24] *Id*.
[25] *Id*.
[26] *Id*.

business.[27] MBA asserted that the GLBA preempts these four state provisions because the GLBA permits a depository institution to engage in insurance sales, solicitation or cross marketing.[28]

The Court applied the preemptive standard[29] defined in *Barnett Bank of Marion County v. Nelson*.[30] The *Barnett* court held that when determining the preemptive scope of a federal statute the court must consider whether the state regulation significantly impairs the exercise of power granted by Congress in the federal statute.[31] Therefore, this case turned on whether the Massachusetts provisions "prevented or significantly interfered" with the bank's ability to engage in sales, solicitation and marketing of insurance.[32]

The Court relied on data showing that Massachusetts banks referred very few customers to their insurance affiliates.[33] For example, one BankNorth branch in Massachusetts did not refer any customers to its insurance affiliates, while its Maine branch referred 4,200 customers.[34] Relying on this data, the Court reasoned that the Referral Prohibition and the Referral Fee Prohibition provisions were clearly hindering the banks' ability to sell insurance products and were therefore preempted by the GLBA.[35] The Court also determined that most customers are likely to seek insurance before their loan applications are approved; therefore, the GLBA preempted the Waiting Period provision because it effectively barred banks from competing in the insurance industry.[36] Lastly, the Court held that the GLBA preempted the Separation Restriction because the restriction requires banks to accommodate a larger space and incur more costs so it impedes the banks' ability to engage in insurance activities.[37] The provision also requires the customer to meet with two separate employees in two separate locations of the bank which results in an inefficient practice that does not allow the bank to successfully cross market the banking and insurance product.[38] In

[27] *Id.*
[28] *Id.*
[29] *Id.* at 27.
[30] 517 U.S. 25 (1996).
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.* at 28.
[36] *Id.*
[37] *Id.*
[38] *Id.*

sum, the Court determined that any state law which interferes with a bank's ability to sell insurance under the GLBA shall be preempted.

2. OCC regulatory power under GLBA: Nat'l City Bank of Ind. v. Turnbaugh.[39]

National City Bank of Indiana ("National City") brought suit against the Maryland Department of Labor seeking declaratory and injunctive relief enjoining the enforcement of a Maryland law that restricts the amount of prepayment fees that mortgage lenders could impose.[40] National City provides mortgage services to Maryland homeowners through their wholly-owned operating subsidiaries and contends that its subsidiaries are subject only to regulatory and supervisory control of the OCC, not the state of Maryland.[41] The Court recognized that the GLBA implicitly confers power to the OCC to regulate a national bank's operating subsidiary if the subsidiary is engaged in activities that national banks are permitted to engage in directly.[42] Thus, the Court found that operating subsidiaries of national banks should be treated the same as national banks and that OCC authority preempts state regulatory authority.[43]

3. Limitations on Privacy Rights under the GLBA: *Chao v. Cmty Trust Co.*[44]

The Secretary of Labor brought an action against the Community Trust Company ("CTC") to compel compliance with a subpoena for records pursuant to an ongoing investigation.[45] CTC refused to produce the records, stating that the GLBA precludes such an act because it would intrude on individual privacy rights.[46] CTC argued that the GLBA requires prior notice before an institution may disclose a customer's personal information and, without that notice, CTC could not comply with the subpoena.[47] However, the Court

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[39] Nat'l City Bank of Ind. v. Turnbaugh, 367 F. Supp. 2d 805 (D. Md. 2005).
[40] *Id*. at 809.
[41] *Id*.
[42] *Id*. at 818.
[43] *Id*.
[44] Chao v. Cmty Trust Co., No. 05-MC-18, 2005 WL 1084619 (E.D.Pa. Sept. 26, 2005).
[45] *Id.* at *1.
[46] *Id*. at *3.
[47] *Id*. at *2.

held that the GLBA notice requirement is waived when disclosure of information is required "to comply with a properly authorized civil, criminal or regulatory investigation or subpoena or summons by Federal, State or local authorities."[48] Since the Secretary of Labor was conducting a properly authorized investigation, the GLBA did not apply and the subpoena was enforceable.[49]

4. Private Right of Action under the GLBA: Briggs v. Emporia State Bank and Trust Co.[50]

During divorce proceedings between Linda Briggs, an Emporia State Bank and Trust ("Emporia") employee, and John Briggs, an Emporia customer, the court issued an authorization directing the bank to produce John Briggs' banking records.[51] As a result, Emporia allowed Ms. Briggs to access Mr. Briggs' financial statements as well as the financial statements of his brother and sister-in-law, Scott and Jann Briggs respectively.[52] Ms. Briggs provided all this information to her divorce attorney.[53] Scott and Jann Briggs brought suit against Emporia alleging the bank violated the GLBA by allowing Linda Briggs access to their personal and confidential financial information.[54]

While the GLBA provides for the protection of customers' privacy through security and confidentiality measures, the Court established that the GLBA does not expressly provide for a private right of action to enforce an institution's failure to comply with the obligation.[55] In the absence of an explicit private right of action, the action must be implicit.[56] Therefore, the Court followed *Boswell v. Skywest Airlines*[57] which instructs the Court to determine whether Congress, "by implication, intended to create a private cause of action" by creating a personal right and a private remedy.[58] The

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[48] *Id.*
[49] *Id.*
[50] Briggs v. Emporia State Bank and Trust Co., No. 05-2125-JWL, 2005 WL 2035038 (D. Kan. Aug. 23, 2005).
[51] *Id.* at *1.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.* at *2.
[56] *Id.*
[57] 361 F.3d 1263, 1266 (10th Cir. 2004),
[58] *Id.*

Court examined the text and structure of the GLBA and failed to find evidence of any congressional intent to create a private right of action.[59] In fact, the GLBA expressly states that federal and state regulators are the proper enforcers of the GLBA.[60] Thus, the Court concluded that no alternative private remedy exists.[61]

5. GLBA Effects on the Preemptive Scope of the Fair Credit Reporting Act: *Am. Bankers Ass'n v. Gould.*[62]

The California Financial Information Privacy Act ("SB1") regulates a financial institution's ability to disclose personal information about California consumers.[63] The American Bankers Association ("ABA"), the Financial Services Roundtable and the Consumer Bankers Associations brought suit against the California Attorney General seeking declaratory and injunctive relief asserting that the Fair Credit Reporting Act ("FCRA") preempts certain provisions of SB1.[64] The district court relied on the GLBA in granting summary judgment to the Attorney General and the ABA appealed.[65] On appeal, the Court of Appeals for the Ninth Circuit found that the FCRA did in fact preempt SB1, but then considered whether the GLBA affected this preemption in any way.[66] The Court determined that the lower court erroneously applied the GLBA since the GLBA expressly states that none of its provisions shall "modify, limit, or supersede the operation of the [FCRA]."[67] Therefore, the GLBA has no effect on FCRA preemption.

D. Conclusion

The GLBA has been in effect for nearly seven years and has undergone significant scrutiny and judicial review since its enactment. This year shed increasing light on the fundamental problem of redundant federal financial services regulation. The

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[59] *Id*. at *3.
[60] *Id*.
[61] *Id*.
[62] Am. Bankers Ass'n v. Gould, 412 F.3d 1081 (9th Cir. 2005).
[63] *Id*. at 1085.
[64] *Id*.
[65] *Id*.
[66] *Id*. at 1087.
[67] *Id*.

Financial Roundtable and BITS Operational Risk Management Working Group study examined the inefficient compliance schemes and suggested that streamlining regulations may lead to increased productivity and accuracy.[68] Compliance reform will likely continue to be a salient issue in 2006.

In 2005, federal courts continued to determine the scope of the GLBA through cases that focused on the preemptive effects of the statute, its effect on operating subsidiaries, restrictions on privacy rights and whether the statute confers a private right of action. The District Court of Massachusetts affirmed the preemptive nature of the GLBA in *Massachusetts Bankers Association v. Bowler*.[69] The District Court of Maryland, in *National City Bank of Indiana v. Turnbaugh*, determined the GLBA implicitly gave the OCC the power to regulate a national bank's operating subsidiary as defined in the GLBA and this power preempts state power to govern such a subsidiary.[70] In *Chao v. Community Trust Company* the Eastern District Court of Pennsylvania affirmed the explicit exception in the GLBA which exempts a financial institution's notice requirement when disclosure of customer information is required by a properly authorized subpoena.[71] The District Court of Kansas determined that no private right of action exists within the GLBA in *Briggs v. Emporia State Bank and Trust Company*.[72] Lastly, the Ninth Circuit held that the GLBA has no effect on the FCRA's preemption of California state law in *American Bankers Association v. Gould*.[73]

Tracie Dorfman[74]

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[68] FINANCIAL SERVICES ROUNDTABLE , *supra* note 17.
[69] Bowler, *supra* note 18.
[70] Turnbaugh, *supra* note 38.
[71] Chao, *supra* note 43.
[72] Briggs, *supra* note 49.
[73] Am. Bankers Ass'n., *supra* note 60.
[74] Student, Boston University School of Law (J.D. 2007).

VI. BASEL II

A. Introduction

In June 2004, the Basel Committee on Banking Supervision ("Committee") issued "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" ("Basel II").[1] Through the revision of the original Basel Capital Accord of 1988 ("Basel I"), the Committee has sought to provide significantly more risk-sensitive capital requirement standards for banking institutions.[2] The Committee intends even the most advanced approaches for these standards to be available for implementation in its member countries by year-end 2007.[3] It also advises the supervisory authorities of other interested countries to devise their own implementation timetables according to their individual needs.[4] In addition to working toward Basel II implementation, the Committee continues to promote global financial stability by maintaining its role as the central forum for cooperation among banking supervisors and executives.[5] The Committee also continues to facilitate worldwide cooperation among the banking, securities and insurance industries.[6] Through its publications in the past year, the Committee has sought to assist banks in their use of the fair value option accounting standard, the valuation of loans, the management of the compliance function, and the enhancement of corporate governance.[7]

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[1] *See* Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (June 2004), *available at* http://www.bis.org/publ/bcbs107.pdf [hereinafter *Basel II Report*]. The Basel Committee on Banking Supervision was established by the central bank governors of the Group of Ten countries in 1975. *Id.* at 1 n.1. The Committee is composed of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. *Id.*

[2] *Id*. at 2.

[3] *Id.* at 1.

[4] *Id*.

[5] *See* Basel Committee on Banking Supervision, *Report for the G7 Summit* (May 2005), *available at* http://www.bis.org/publ/bcbs113a.pdf [hereinafter *G7 Summit Report*].

[6] *Id.*

[7] *Id.*

The first part of this article examines the progress the United States and other countries around the world have made in preparing for the implementation of Basel II. The second part will address additional Basel Committee issues of the past year.

B. Worldwide Implementation Progress

According to the timetable set out in Basel II, the foundation internal ratings-based ("IRB") approach for evaluating corporate credit risk will be available for implementation in the Committee member countries by year-end 2006.[8] Prior to implementation, a parallel run will take place for one year from year-end 2005, during which the current capital requirement regime and the new framework will apply in tandem.[9] During the first three years of implementation, the supervisory authorities will also apply limits on the amount by which each banking institution's risk-based capital can decline with the application of Basel II.[10] For the first year from year-end 2006, the risk capital will not be permitted to fall below 95% of the capital level the current system otherwise requires, and the floor limitation will incrementally decrease to 90% at year-end 2007 and to 80% at year-end 2008.[11]

On the other hand, the advanced IRB approach for corporate credit risk and the Advanced Measurement Approaches ("AMA") for evaluating operational risks will be available for implementation from year-end 2007.[12] Two years of parallel run from year-end 2005 will precede implementation of these approaches, and the floors would apply for two years, starting at 90% at year-end 2007 and falling to 80% at year-end 2008.[13]

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[8] *Basel II Report*, *supra* note 1.

[9] *Id.* at 13.

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

1. United States of America

1) Implementation Postponed

The United States banking and thrift agencies ("Agencies") expect to require only a small number of large, internationally active U.S. banking institutions to comply with the Basel II standards.[14] These institutions are estimated to number around ten, and an additional ten to fifteen banks that have resources to comply with the new regulations may voluntarily do so.[15] The U.S. institutions complying with Basel II will be subject to the "advanced approaches"– the advanced IRB approach and the AMA – for risk and capital measurement.[16]

The Agencies initially scheduled implementation to begin in January 2008, in accordance with the Committee timeline for the advanced approaches.[17] In September 2005, however, they decided to postpone the implementation date to January 2009.[18] According to the new timetable, the U.S. banking institutions will conduct a year-long parallel run from January 2008.[19] From January 2009, floors will apply for at least three years, with the level of limitation incrementally falling from 95% in 2009 to 90% in 2010 and to 85% in 2011.[20]

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[14] Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Insurance Corp., Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Banking Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts* (June 26, 2004), *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20040626/default.htm.

[15] *Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study: J. Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit and Subcomm. on Domestic & Int'l Monetary Policy, Trade & Tech. of the H. Comm. on Fin. Servs.*, 109th Cong. 1 (2005) (testimony of William J. Small, Chairman & CEO, First Defiance Fin. Corp.).

[16] Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Insurance Corp., Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 14.

[17] *Id.*

[18] Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Insurance Corp., Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Banking Agencies Announce Review Plan for Implementation of Basel II Framework* (Sept. 30, 2005), *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050930/default.htm.

[19] *Id.*

[20] *Id.*

The Agencies decided to delay implementation because of concerns identified in its analysis of the quantitative impact study ("QIS4"), designed to gauge the effects of Basel II on capital requirements.[21] The results of QIS4 showed that the twenty-six U.S. banks that participated in the study would have experienced a 17% average drop and a 26% median decrease in effective minimum required capital under the Basel II framework as compared to the current standards.[22] These results raised serious concerns among the Agencies, members of Congress, and the majority of U.S. banking institutions that large U.S. banks complying with Basel II might gain a competitive advantage over the rest of the U.S. banks.[23]

2) Proposal for Basel IA

To address the concerns of competitive inequality, the Agencies proposed modifications to Basel I in an advanced notice of proposed rulemaking ("ANPR") published in October 2005.[24] Commonly referred to as "Basel IA," the proposed modifications seek to improve the competitiveness of non-Basel II banks by increasing the risk sensitivity of the current capital framework without imposing an undue regulatory burden on banking institutions.[25] The ANPR, for example, discusses "modifications that would increase the number of risk-weight categories, permit greater use of external ratings as an indicator of credit risk for externally-rated exposure, expand the types of guarantees and collateral that may be recognized, and modify the risk weight associated with residential mortgages."[26]

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[21] *Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study: J. Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit and Subcomm. on Domestic & Int'l Monetary Policy, Trade & Tech. of the H. Comm. on Fin. Servs.*, 109th Cong. 7-8 (2005) (testimony of Julie L. Williams, Acting Director, Office of the Comptroller of the Currency).

[22] *Id*. at 18.

[23] *Banking Agencies Publish "Basel IA" Risk Capital Proposal for U.S. Banking Institutions Not Adopting Basel II*, GOODWIN PROCTOR FIN. SERVICES ALERT, Oct. 11, 2005, at 1.

[24] Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications, 70 Fed. Reg. 61,068, 61,070 (Oct. 20, 2005) (to be codified at 7 C.F.R. pt. 3).

[25] *Id*.

[26] *Id*. at 61,069.

Despite the potential benefits of Basel IA, some small banks have urged the Agencies not to entirely abandon Basel I, arguing that community banks should have the option to choose between Basel I and Basel IA.[27] They claim that for certain privately held banks in small markets and banks that have overcapitalized by choice, the regulatory burden of new risk-analysis systems and record-keeping requirements could outweigh the benefits of reduced capital requirements.[28] In light of the situation, the Agencies are considering the creation of a three-tiered capital framework, with about twenty of the largest banks using Basel II, the majority using Basel IA, and the rest continuing to comply with the current Basel I standards.[29]

3) European Union

The Basel II capital adequacy framework is legislative in nature in the European Union ("EU") and binding for all EU member states, regardless of their membership in the Basel Committee, and for their banks and other credit institutions.[30] To give legal effect to Basel II, the European Commission ("Commission") proposed the Capital Requirement Directive ("CRD"), mirroring the Basel II structure, in July 2004.[31] The CRD requires both the European Parliament ("Parliament") and member states' approval to come into

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[27] Rob Garver, *Worth the Trouble? Bankers Split on Basel IA*, AM. BANKER, Oct. 4, 2005, at 1A.

[28] *Id.*

[29] Damian Paletta, *Regulators Offer Details on Basel IA*, AM. BANKER, Oct. 7, 2005, at 1.

[30] THE EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM, CAD3: IMPLEMENTATION OF THE NEW CAPITAL ACCORD IN THE EU 3 (May 28, 2003), http://epfsf.org/meetings/2003/briefings/briefing_28may2003.pdf. Of the twenty-five EU member states, nine are represented on the Committee – Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, and the United Kingdom; the remaining sixteen countries – Austria, Czech Republic, Cyprus, Denmark, Estonia, Finland, Greece, Hungary, Ireland, Latvia, Lithuania, Malta, Poland, Portugal, Slovak Republic, and Slovenia – are not members of the Committee. ANDREW CORNFORD, FINANCIAL MARKETS CENTER, THE GLOBAL IMPLEMENTATION OF BASEL II: PROSPECTS AND OUTSTANDING PROBLEMS 4 (June 2005), http://www.fmcenter.org/atf/cf/%7BDFBB2772-F5C5-4DFE-B310-D82A61944339%7D/BaselII.IMPL.P&OP_4_.PDF.

[31] Cornford, *supra* note 30.

effect.[32] The Parliament approved the CRD in September 2005, and it will now be submitted to the EU member states for adoption.[33] Unlike the U.S., which has decided to postpone Basel II implementation, the EU member states are expected to implement the CRD beginning in 2007 and the advanced approaches in 2008.[34]

The new members of the EU may, however, face significant challenges in implementing Basel II.[35] For example, while Basel II will recognize risk mitigation instruments and reward them by capital relief, the new EU members hardly use such instruments.[36] They also need to review and upgrade operational systems to minimize the new capital charge related to operational risks.[37] Moreover, preparations for and implementation of Basel II will be expensive as one estimate shows that the cost will be between €80 million and €150 million for a large EU bank, though proportionately less for smaller banks.[38] The share of foreign ownership in the banking sector in the Czech Republic, Estonia, and the Slovak Republic is over 90%, and the issues of information and cost sharing between home and host supervisors will also have to be addressed.[39]

4) Asia-Pacific Region

Asia-Pacific banking systems are making progress on the implementation of Basel II, although the level of progress varies widely among the countries.[40] According to Standard & Poor's credit analyst Ian Thompson, Singapore and Australia have made the best progress while Hong Kong, Taiwan, and Japan have also made

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[32] Julien Ponthus, *EU Parliament Backs Basel II Rules: Final Approval Seen by Year-end*, AFX INTERNATIONAL PRESS, Sept. 28, 2005.

[33] *Id.*

[34] *Banking Agencies Announce Revised Timetable for US Implementation of Basel II; Europe Moves Forward*, GOODWIN PROCTOR FIN. SERVICES ALERT, Oct. 11, 2005, at 4.

[35] Piroska M. Nagy, *Emerging Europe Faces Basel Upheaval: There Are Major Issues to Iron Out for EU Emerging Markets in Adopting Basel II*, THE BANKER, Oct. 1, 2005.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *S & P: Asia Pacific Banking Systems Moving Ahead on Basel II Implementation*, THE ASIAN BANKER J., May 15, 2005 [hereinafter *Asia Pacific Banking Systems*].

good progress.[41] The Monetary Authority of Singapore ("MAS") plans to implement simple solutions by the end of 2006 and complex solutions by the end of 2007, and the Australian regulators plan to implement both approaches by the end of 2007.[42]

China, on the other hand, is opting for a more gradual implementation of Basel II.[43] Announcing its intention to remain with Basel I for now, China has revised its capital requirement rules based on the current framework and plans to implement them by January 2007.[44] Shifting to Basel II soon after the implementation of the revised rules would impose significant costs on both banks and supervisors.[45] The high level of non-performing loans in Chinese bank assets would also make application of Basel II difficult.[46] Moreover, the Chinese banking system would have to address the problem of its lack of historical data and credit culture necessary for the evaluation of credit and operational risks under Basel II.[47]

India, which initially indicated its intention to remain with Basel I, has more recently decided to apply Basel II.[48] In February 2005, the Reserve Bank of India declared that all Indian banks would be subject to the Standardized approach for credit risk evaluation and the Basic Indicator approach for measuring operational risks.[49]

5) Latin America

In a survey conducted by the Financial Stability Institute of the Bank for International Settlements in 2004, eleven out of fifteen Latin American countries, representing more than 95% of the region's banking assets, stated that they intended to adopt Basel II.[50]

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[41] *Id.*

[42] *MAS Favours Early Basel II Implementation*, THE ASIAN BANKER J., Aug. 31, 2005.

[43] *Asia Pacific Banking System*, *supra* note 39.

[44] Cornford, *supra* note 30, at 9.

[45] *Id.* at 9.

[46] *Id.*

[47] *Basel II: EU Regulators to Export Approaches to Asia*, THE ASIAN BANKER, Oct. 15, 2005.

[48] Cornford, *supra* note 30, at 9.

[49] *Id.*

[50] BANK FOR INTERNATIONAL SETTLEMENTS, THE IMPLEMENTATION OF THE NEW CAPITAL ADEQUACY FRAMEWORK IN LATIN AMERICA: SUMMARY OF RESPONSES TO

While Mexico and Chile are rapidly preparing for adoption of the new standards, Latin American countries vary significantly in their timing of Basel II implementation.[51]

One of the most serious challenges Latin American countries face in implementing Basel II is that they lack sufficient and robust historical data to feed credit and operational risk databases.[52] Banks that are planning to implement the advanced approaches are especially concerned because Basel II will, for example, require at least five years of historical default data to evaluate the probability of default in their portfolios.[53] This means that banks aiming to adopt Basel II in 2010 should have started data collection by January 2005.[54]

For banks planning to adopt less sophisticated approaches, the capital required for possible credit loss in key portfolios will be determined mainly by the external credit ratings of clients.[55] However, external credit ratings for Latin American bank clients are often unavailable.[56] In Chile, for example, only 0.1% of the estimated 120,000 companies receiving bank loans have an external rating.[57] This indicates that loans without such ratings will continue to receive treatment under the current regime (i.e., the capital requirement of 8% of the loan's total value).[58]

6) Africa

According to Financial Stability Institute's survey conducted in 2004, sixteen out of twenty-two African countries plan to implement Basel II between 2006 and 2009, while only one country has decided not to adopt the new framework in the near future.[59]

THE BASEL II IMPLEMENTATION ASSISTANCE QUESTIONNAIRE 1 (July 2005), http://www.bis.org/fsi/fsipapers04latinamerica.pdf.

[51] Andres Portillas, *Preparing for Basel II*, LATIN FINANCE, Feb. 2005.

[52] *Id.*

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

[59] BANK FOR INTERNATIONAL SETTLEMENTS, THE IMPLEMENTATION OF NEW CAPITAL ADEQUACY FRAMEWORK IN AFRICA: SUMMARY OF RESPONSES TO THE BASEL II

However, the International Monetary Fund ("IMF") has recently warned developing countries that "premature adoption of Basel II in countries with limited capacity could inappropriately divert resources from more urgent priorities, ultimately weakening rather than strengthening supervision."[60] The IMF reasons that "a supervisory focus on meeting the specific requirements of Basel II, with the associated reallocation of resources, may distract supervisors from more immediate concerns, such as building a stronger system for day-to-day based supervision."[61] It further advises that even for countries that are ready to adopt Basel II, "the speed of implementation should not take precedence over quality."[62]

C. Basel Committee Issues

In addition to its involvement in the worldwide implementation of the Basel II Framework, the Committee seeks to ensure the stability of the financial system through providing bank supervisors, boards of directors, senior management and staff with guidance in the form of published reports and working groups.[63]

The Committee functions as a main forum for central banks and supervisory authorities to discuss and share information on banking supervisory issues.[64] The Committee continues to hold workshops aimed at forging strong working relationships at the senior and staff levels, collaborates with non-member groups of supervisors through the Core Principles Liaison Group, and promotes discussion and information sharing among senior bank supervisors through the International Conference of Banking Supervisors.[65]

The Committee has also maintained a strong influence in global financial stability through the Joint Forum.[66] The Joint Forum

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IMPLEMENTATION ASSISTANCE QUESTIONNAIRE 1 (July 2004), http://www.bis.org/fsi/fsipapers04africa.pdf.

[60] Public Information Notice, International Monetary Fund, *IMF Executive Board Discusses Implications of the New Basel Capital Adequacy Framework for Banks* (Nov. 7, 2005), *available at* http://www.imf.org/external/np/sec/pn/2005/pn05154.htm.

[61] *Id*.

[62] *Id*.

[63] *G7 Summit Report*, *supra* note 5, at 10.

[64] *Id.* at 8.

[65] *Id.*

[66] *Id.*

– established in 1996 under the aegis of the Committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors – deals with issues common to the banking, securities and insurance sectors.[67] Over the past year, the Joint Forum has published a report examining trends in outsourcing the financial sector, has issued the final version of its paper on credit risk transfer activity and has released a consultative document on business continuity in response to the major operational disruptions of terrorism and natural disasters.[68]

Beyond its working group and Joint Forum activities, the Committee has published several papers in the past year on issues including accounting and auditing issues, compliance, and corporate governance.[69] This article describes these publications in greater detail.

1. Accounting and Auditing

1) The Fair Value Option

The Committee has been heavily involved in strengthening the international community's market foundations through accounting- and auditing-related activities.[70] In the accounting field, the Committee has focused on resolving the differences of opinion over the correct form for the fair value option of the International Accounting Standards Board ("IASB").[71] The IASB's fair value option allows reporting initial recognition of any financial instrument at fair value through profit and loss.[72] Under International Accounting Standard ("IAS") 39 – the international accounting

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[67] *Id.*

[68] *Id. See* The Joint Forum, *Outsourcing in Financial Services* (Feb. 2005), *available at* http://www.bis.org/publ/joint12.pdf; *Credit Risk Transfers* (Mar. 2005), *available at* http://www.bis.org/publ/joint13.pdf; *High-level principles for business continuity – Consultative paper* (Dec. 2005), *available at* http://www.bis.org/publ/joint14.pdf.

[69] *See* Bank for International Settlements, *Basel Committee on Banking Supervision*, *available at* http://www.bis.org/bcbs/index.htm. This website lists all Committee publications by year and category.

[70] *G7 Summit Report*, *supra* note 5, at 5.

[71] *Id.*

[72] Basel Committee on Banking Supervision, *Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards* (July 2005), *available at* http://www.bis.org/publ/bcbs114.pdf, at 3 [hereinafter *Fair Value Option Report*].

standard for the recognition and measurement of financial instruments – the fair value option may only be applied when (1) it will prevent an accounting mismatch, (2) it complies with a risk management or investment strategy, and (3) an instrument has an embedded derivative that meets certain conditions.[73] The Committee has issued a consultative document to provide guidance to supervisors regarding the fair value option under IAS 39 entitled "Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards."[74] This document provides the prudential supervisor a means to determine when use of the fair value option is suitable and how to respond when certain conditions are not met.[75]

The Committee has structured the draft supervisory guidance around eight principles under two broad headings: (1) supervisory expectations relevant to the use of the fair value option; and (2) supervisory assessment of risk management, controls and capital adequacy.[76] Under the first heading, there are four principles addressing supervisory concerns.[77] First, banks should aim to meet the criteria under IAS 39.[78] Second, banks should have appropriate risk management systems in place prior to the initial application of the fair value option.[79] Third, banks should only apply the fair value option to instruments for which fair values can be reliably estimated.[80] Fourth, banks must utilize additional information to aid in the assessment of the impact on the bank when using the fair value option.[81]

Under the second heading, the Committee presents an additional four principles.[82] First, supervisors should evaluate whether a bank's internal financial analysis of counterparties has ascertained their use of the fair value option and its effect on their

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[73] *Id.*

[74] *Id.*

[75] *Id.* at 4.

[76] *Id.* at 1.

[77] *Id.*

[78] *Id.* at 7.

[79] *Id.* at 8.

[80] *Id.* at 10.

[81] *Id.* at 11.

[82] *Id.* at 1.

earnings, capital and analytical ratios.[83] Second, supervisors should review a bank's risk management and control practices as they relate to the fair value option.[84] Third, supervisors should consider a bank's use of the fair value option relating to its impact on capital adequacy assessment.[85] Fourth, under the fair value option supervisors should exclude gains and losses attributed to the designation of a financial liability at fair value from regulatory capital, because banks may recognize a gain and a resulting increase in capital when its creditworthiness is deteriorating if it applies the option to its own debt.[86]

2) Credit Risk Assessment and Loan Valuation

In addition to supervisory guidance on the fair value option, the Committee has released a consultative document entitled "Sound credit risk assessment and valuation for loans."[87] The purpose of this document is "to provide banks and supervisors with guidance on sound credit risk assessment and valuation policies and practices for loans regardless of the accounting framework applied."[88] This paper is also principles-based, including ten principles under two broad headings.[89] Those two headings are (1) supervisory expectations concerning sound credit risk assessment and valuation for loans, and (2) supervisory evaluation of credit risk assessment for loans, controls and capital adequacy.[90]

The Committee lists seven principles under the first heading.[91] First, the directors and senior managers must ensure that their bank has "the appropriate credit risk assessment and internal controls to consistently determine provisions for loan losses in accordance with the bank's stated policies and procedures, the

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[83] *Id.* at 12.

[84] *Id.*

[85] *Id.* at 13.

[86] *Id.* at 14.

[87] Basel Committee for Banking Supervision, *Sound credit risk assessment and valuation for loans* (Nov. 2005), *available at* http://www.bis.org/publ/bcbs121.pdf.

[88] *Id.* at 2.

[89] *Id.* at 1.

[90] *Id.*

[91] *Id.* at 4.

applicable accounting framework and supervisory guidance commensurate with the size, nature and complexity of the bank's lending operations."[92] Second, banks should implement a system to classify loans on the basis of credit risk.[93] Third, banks need to have effective validation procedures in place for their credit risk assessment models.[94] Fourth, banks should monitor their loan portfolios through an effective loan loss methodology as part of its overall credit risk monitoring system.[95] Fifth, the total amount of all individual and collectively assessed loan provisions should be able to absorb estimated credit losses in the loan portfolio.[96] Sixth, in recognizing loan losses banks may use their experienced credit judgment and reasonable estimates, as long as the scope of discretion is limited.[97] Seventh, a bank's credit risk monitoring system for loans "should provide the bank with the necessary tools, procedures and observable data to use for credit risk assessment purposes, account for impairment of loans and the determination of regulatory capital requirements."[98]

The Committee lists three more principles under the second heading of supervisory evaluation.[99] First, the Committee addresses the evaluation procedures for prudential supervisors.[100] Through periodic evaluation of a bank's credit risk policies and practices for assessing loan quality, supervisors should be satisfied that the loan review system is adequate, the board of directors and senior management are provided with appropriate information about the credit quality of the loan portfolio and management has made reasonable and informed judgments.[101] Supervisors may make these evaluations through regular supervisory reporting or on-site examinations.[102] Second, the Committee encourages supervisors to assess the methods a bank uses to calculate loan loss provisions to

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[92] *Id.*

[93] *Id.* at 5.

[94] *Id.* at 6.

[95] *Id.* at 6-7.

[96] *Id.* at 8.

[97] *Id.* at 9.

[98] *Id.* at 10.

[99] *Id.* at 1.

[100] *Id.* at 12.

[101] *Id.*

[102] *Id.*

determine whether those methods are producing adequate and timely recognition of credit losses in the loan portfolio.[103] Finally, the Committee aims to ensure that banking supervisors "consider credit risk assessment and valuation practices when assessing a bank's capital adequacy."[104]

2. Compliance

The Committee has issued a paper entitled "Compliance and the compliance function in banks."[105] This document coincides with the Committee's "ongoing efforts to address bank supervisory issues and enhance sound practices in business organizations."[106] The Committee focuses on the compliance function within a bank's organizational structure in terms of how that function mitigates the "compliance risk" posed to banks.[107]

Jaime Caruana, Chairman of the Basel Committee and Governor of the Bank of Spain, has noted: "[c]ompliance has emerged as a distinct branch of risk management within the banking system, and banking supervisors have recognized the need to communicate fundamental supervisory expectations in this important and sensitive area. The Committee believes that this paper will provide banks with essential tools to meet these expectations."[108]

The paper recognizes that there are significant differences between banks regarding the organization of the compliance function, especially between large and small banks.[109] Regardless of

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[103] *Id.* at 13.

[104] *Id.*

[105] Basel Committee on Banking Supervision, *Compliance and the compliance function in banks* (Apr. 2005), *available at* http://www.bis.org/publ/bcbs121.pdf [hereinafter *Compliance Report*].

[106] *Id.* at 7.

[107] *Id.* at 7. "Compliance risk is defined in this paper as the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities." *Id.*

[108] *Basel Committee Issues Guidance on the Compliance Function in Banks*, BANKING & FIN. SERVICES POL'Y REP., June 2005, at 37.

[109] *Compliance Report*, *supra* note 105, at 7-8. *See also Basel Committee Issues Guidance on the Compliance Function in Banks*, THE ASIAN BANKER JOURNAL, May 15, 2005 (quoting Professor Arnold Schilder, member of the Basel Committee, Chairman of the Committee's Accounting Task Force and Executive Director of the Netherlands Bank, as stating: "We have . . . refined this [principles-based] approach,

the organization of the compliance function within the bank's overall structure, "it should be independent and sufficiently resourced, its responsibilities should be clearly specified and its activities should be subject to periodic independent review by the internal audit function."[110] The paper addresses the "specific responsibilities of the bank's board of directors and senior management for compliance,"[111] and establishes principles for banks to follow in setting up its compliance function.[112]

Under the first principle, the board of directors bears the oversight responsibility for the bank's compliance function.[113] The board's purpose is to "promote the values of honesty and integrity throughout the organization" in order to ensure the effectiveness of the bank's compliance policy.[114] In particular, the board should approve the bank's compliance policy, including a formal document establishing a permanent and effective compliance function, and the board should annually assess the extent to which the bank is managing its compliance risk effectively.[115]

The second principle states that the bank's senior management is responsible for the effective management of the bank's compliance risk.[116] Under the third and fourth principles, the management must establish the written compliance policy, ensure that it is observed with the assistance of the compliance function and report at a minimum on an annual basis to the board of directors on the management of the bank's compliance risk.[117]

The paper then establishes the principles pertaining to the compliance function.[118] These principles address the function's

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in particular the operational implications for smaller banks that cannot – and do not need to – put in place the same structure and processes necessary in larger or more complex institutions.").

[110] *Compliance Report*, *supra* note 105, at 8.

[111] *Id.*

[112] *Id.* at 7. For purposes of this report, the term "compliance function" is used "to describe staff carrying out compliance responsibilities; it is not intended to prescribe a particular organizational structure." *Id.*

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] *Id.* at 10.

[118] *Id.* at 10-15.

independence, resources, responsibilities and relationship with the internal audit.[119]

The fifth principle, or the concept of independence, involves four related elements: (1) the compliance function must have formal status within the bank; (2) a group compliance officer or head of compliance must have overall responsibility for coordinating the management of the bank's compliance risk; (3) the compliance function staff must be absent of potential conflict of interest between their compliance responsibilities and any other responsibilities they may have; and (4) the compliance function staff must have access to the information and personnel necessary to carry out their responsibilities.[120]

The sixth principle states that the compliance function staff should have the resources to do its job effectively.[121] This requires the staff to be well-trained and well-educated in order to keep up-to-date with developments in compliance laws, rules and standards.[122]

The seventh principle addresses the responsibilities of the compliance function.[123] The function's major responsibility should be to assist senior management in managing effectively the compliance risks faced by the bank.[124] This task is best achieved through advising senior management on the compliance laws, rules and standards, assisting them in educating staff on compliance issues, and establishing written guidance to the staff on compliance issues.[125] Further responsibilities include: (1) identifying, measuring, and assessing the compliance risk; (2) monitoring, testing and reporting; and (3) adhering to any statutory responsibilities and liaising with external regulators, standard setters and experts.[126] The compliance function should carry out these responsibilities under a compliance program that sets out its planned activities.[127]

The eighth principle states that the "scope and breadth of the activities of the compliance function should be subject to periodic

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[119] *Id.*

[120] *Id.* at 10-13.

[121] *Id.* at 13.

[122] *Id.*

[123] *Id.*

[124] *Id.*

[125] *Id.* at 13-14.

[126] *Id*. at 14.

[127] *Id*.

review by the internal audit function.[128] The ninth principle handles cross-border issues if the bank has any, emphasizing that "the compliance staff should have knowledge of the compliance risk in their local jurisdiction."[129] Finally, the tenth principle provides that while specific tasks of the compliance function may be outsourced, the overall function must be subject to oversight by the head of compliance.[130]

3. Corporate Governance

The Committee has issued a consultative document entitled "Enhancing corporate governance for banking organizations."[131] The document is "intended to respond to the attention generated by the high-profile breakdowns in governance experienced since the document was first published in 1999."[132] The 1999 publication "drew from principles of corporate governance that were published earlier that year by the Organization for Economic Cooperation and Development with the purpose of assisting governments in their efforts to evaluate and improve their frameworks for corporate governance and to provide guidance for financial market regulators and participants in financial markets."[133] The OECD has since revised those principles,[134] and the Committee has realized that it must revise its guidance in order to provide "practical guidance that is relevant to the unique characteristics facing banking organizations."[135]

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[128] *Id.* at 15.

[129] *Basel Committee Publishes Guidance on Bank Compliance Function – Goodwin Proctor LLP*, MONDAQ BUSINESS BRIEFING, May 24, 2005.

[130] *Compliance Report*, *supra* note 105, at 15.

[131] Basel Committee on Banking Supervision, *Consultative Document: Enhancing corporate governance of banking organizations* (July 2005), *available at* http://www.bis.org/publ/bcbs117.pdf [hereinafter *Corporate Governance Report*].

[132] *Basel Committee Updates Guidance for Enhancing Bank Governance*, DIRECTORS & TRUSTEES DIGEST, October 1, 2005, at 3.

[133] *Corporate Governance Report*, *supra* note 131 at 1.

[134] *OECD Principles of Corporate Governance* (revised Apr. 2004, originally issued June 1999) *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf [hereinafter *OECD Principles*].

OECD Principles, *supra* note 132.

[135] *Corporate Governance Report*, *supra* note 131 at 1.

The Committee emphasizes that "[t]he board of directors and senior management at each institution have an obligation to understand the risk profile of that institution and ensure that capital levels adequately reflect such risk."[136] The paper "sets forth a broad framework of fundamental corporate governance principles to guide the actions of the directors, managers and supervisors of a diverse range of banking organizations in a number of countries and legal systems, including both Basel Committee member countries and non-member countries."[137]

First, the Committee lists the following principles as critical elements of any corporate governance process:

> (1) Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organization;[138]
> (2) Setting and enforcing clear lines of responsibility and accountability throughout the organization;[139]
> (3) Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are able to exercise sound independent judgment about the affairs of the bank;[140]
> (4) Ensuring that there is appropriate oversight by senior management;[141]
> (5) Effectively utilizing the work conducted by internal and external auditors, as well as other control functions, in recognition of their critical contribution to sound corporate governance;[142]
> (6) Ensuring that compensation policies and practices are consistent with the bank's ethical

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[136] *Id.* at 2.

[137] *Id.* (noting that the "terms 'bank' and 'banking organization'. . . generally refer to banks, holding companies or other companies considered by banking supervisors to be the parent of a banking group under applicable national law as determined by the entity's national supervisor." *Id.* at 2 n.7.).

[138] *Id.* at 7-8

[139] *Id.* at 8-10.

[140] *Id.* at 10-12.

[141] *Id.* at 12-13.

[142] *Id.* at 13-14.

> values, objectives, strategy and control environment;[143]
> (7) Conducting corporate governance in a transparent manner;[144] and
> (8) Maintaining an understanding of the bank's operational structure, including operating in jurisdictions, or through structures, that impede transparency (i.e. "know-your-structure").[145]

Second, while the Committee recognizes that the primary responsibility for good corporate governance rests with the board of directors and senior management of banks, it also lists others who can promote good corporate governance, including: (1) shareholders;[146] (2) auditors;[147] (3) banking industry associations;[148] (4) governments;[149] (5) banking supervisors;[150] (6) securities regulators, stock exchanges and other self-regulatory organizations;[151] and (7) employees.[152]

Finally, the Committee explains the role of supervisors in greater detail, emphasizing that "supervisors should determine whether the bank has appropriate corporate governance policies and practices with which it is satisfactorily complying and bring to the board of directors' and management's attention problems that they detect through their supervisory efforts."[153] Most importantly, "[w]hen the bank takes risks that it cannot measure or control, supervisors should hold the board of directors and senior

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[143] *Id.* at 14.

[144] *Id.* at 15-16.

[145] *Id.* at 16-18.

[146] *Id.* at 19 ("through active and informed shareholder rights").

[147] *Id.* ("through a well-established and qualified audit profession, audit standards and communications to boards of directors, senior management and supervisors").

[148] *Id.* ("through initiatives related to voluntary industry principles and agreement on and publication of sound practices").

[149] *Id.* ("through laws, regulations, enforcement and an effective judicial framework").

[150] *Id.* ("through issuance of guidance and assessment of corporate governance practices").

[151] *Id.* ("through disclosure and listing requirements")

[152] *Id.* ("through communication of concerns regarding illegal or unethical practices or other corporate governance weaknesses").

[153] *Id.* at 20.

management accountable and require that corrective measures be taken in a timely manner."[154]

Vepa Kamesam of the Institute of Insurance and Risk Management and former deputy governor of the Reserve Bank of India, has raised the concern that "regional factors [must] be taken into account to assess the relevance of the prescriptions made in the document," and that "[the document] has evolved from being a guidance note to setting global standards to imposing conditionalities on countries."[155]

Regional and national groups and governmental entities such as India's Academy of Corporate Governance held round-table discussions of academicians and banking sector insiders to deliberate and make recommendations on the document.[156] These groups and entities had until October 31, 2005 to submit their criticisms of the document before its finalization and permanent submission.[157]

D. Conclusion

Although Basel I was originally intended for international banks, it became the general standard throughout the world, and a similar destiny appears to lie before Basel II.[158] With the exception of the U.S., all the Committee member countries and other EU member states are preparing for full implementation of Basel II.[159] Also, competitive pressures from large international banks are spurring implementation in other countries around the world.[160]
The past year has seen the Committee continue to function as the central forum for international banking and finance through the Joint Forum and other working groups.[161] The Committee has also issued several publications addressing issues from accounting to corporate governance.[162] These efforts, beyond the ongoing work to

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[154] *Id.*

[155] *ACG's Views on Basel Document*, BUSINESS STANDARD, Oct. 18, 2005, at 8.

[156] *Id.*

[157] *Corporate Governance Report*, *supra* note 131, at 1.

[158] Portillas, *supra* note 51.

[159] Cornford, *supra* note 30.

[160] Portillas, *supra* note 51.

[161] *G7 Summit Report*, *supra* note 5, at 1.

[162] *See Fair Value Option Report*, *supra* note 72, and *Corporate Governance Report*, *supra* note 131.

implement Basel II, have continued to promote cooperation among banking supervisors and stability in the global banking and financial systems.[163]

Yohan Gohng[164]
David Hesford[165]

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[163] *G7 Summit Report*, *supra* note 5, at 1.

[164] Student, Boston University School of Law (J.D. 2007).

[165] Student, Boston University School of Law (J.D. 2007).

VII. DOMESTIC MERGERS & ACQUISITIONS

A. Mergers and Acquisitions

The following are some of the largest and most important mergers and acquisitions in the banking industry in 2005:

1. Bank of America Buys MBNA Corp.

On Thursday, June 30, 2005, Bank of America announced plans to purchase credit card issuer MBNA for $35 billion.[1] Upon completion, the merger would create the nation's largest credit card company, with the combined company controlling twenty-two percent of the 600 million Visa, MasterCard, Discover and American Express cards in circulation.[2]

The move into the credit card market is expected to help Bank of America diversify in two ways. First, the acquisition is expected to lessen Bank of America's reliance on market sensitive, volatile sources of earnings (such as private equity investments), and increase the share of Bank of America's earnings from more stable consumer operations to fifty-five percent of total earnings.[3] Second, the MBNA deal would allow Bank of America to expand into key international markets – of MBNA's $108 billion in managed card loans, $21.5 billion of its receivables are from the United Kingdom, and MBNA also has a representative office in China.[4] However, Bank of America is expected to continue to derive ninety-five percent of its revenues from within the United States after the acquisition.[5] In addition, the deal is expected to help Bank of America save $850 million in after-tax expenses, mostly through the elimination of 6,000 jobs and overlapping technologies.[6]

The deal will also create complications for Bank of America's competitors Wachovia and SunTrust Bank.[7] Both SunTrust and Wachovia exited the credit card business through the

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[1] Peralte C. Paul, *Bank Of America's Bid For MBNA Signal Banks' Desire To Get Back Into Cards*, ATLANTA J. AND CONST., July 1, 2005.
[2] *Id.*
[3] Paul Davis, *Bank of America's Big Play in Cards*, AM. BANKER, July 1, 2005, at 1.
[4] *Id.*
[5] *Id.*
[6] *Id.*
[7] Paul, *supra* note 1.

sale of their credit card portfolios to MBNA in 1999 and 2000, respectively, but remained among MBNA's largest customers (a large portion of MBNA's business includes issuing cards for banks – approximately $15 billion to $20 billion of MBNA's total loan portfolio comes from issuing other banks' credit cards).[8] When SunTrust's and Wachovia's contracts with MBNA expire, their credit card accounts will remain with MBNA.[9] Therefore, assuming that neither bank would continue generating business for MBNA after the acquisition, both SunTrust and Wachovia would need to either rebuild their credit card portfolios "from scratch" or acquire another bank's credit card portfolio.[10]

Bank of America is to pay 0.5009 of a share for each share of MBNA, as well as $4.125 per share in cash, thus valuing MBNA at $27.50 per share (and resulting in a 30% premium).[11] MBNA's shares rose $5.09 to $26.06 on the news of the acquisition.[12] Bank of America's shares fell $1.30 to $45.61 on the announcement, as Bank of America expects lower earnings next year as a result of the acquisition.[13]

2. Washington Mutual Acquires Providian Financial Corp.

In a bid to enter the credit card market, Washington Mutual Inc. announced its acquisition of San Francisco-based credit card provider Providian Financial Corp. on June 6, 2005.[14] Providian offers Visa cards in its own name and in partnership with entities such as the Democratic Party and PayPal Inc., while also offering MasterCards in a partnership with EBay Inc.[15]

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[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Caroline Merrell, *BoA Stuns Market With $35Bln Deal*, THE TIMES (LONDON), July 1, 2005, at 56.
[12] Joseph Menn, *BofA Agrees To Buy Credit Card Giant MBNA; The $35Billion Deal Would Give It The Lead In The Amounts Of Loans In A Rapidly Shifting Sector*, LOS ANGELES TIMES, July 1, 2005, at C1.
[13] *Id.*
[14] Jim Cole, *Will Providian Buy Prove Transforming For Wamu?*, AM. BANKER, June 7, 2005, at 1.
[15] E. Scott Reckard, *Bank's Deal Is In The Cards; Washington Mutual Agrees To Buy Providian, Which Offers Customers Visa and MasterCards*, LOS ANGELES TIMES, June 7, 2005, at C1.

Analysts expect the $6.45 billion deal to diversify Washington Mutual's balance sheet and allow the company to continue its efforts to turn around its struggling mortgage business, while at the same time relying less on mortgages as a source of revenue (Washington Mutual had shed approximately 40% of its work force and $100 million in costs from the its mortgage unit in the year leading up to the announcement of the acquisition).[16] Indeed, upon completion, the deal would increase Washington Mutual's loan portfolio to $232 billion from $214 billion, with credit card lending composing 8% of that total.[17] From there, Washington Mutual would be in position to expand the credit card unit by offering Washington Mutual-branded credit cards to its deposit and loan customers, using the savings and loan's network of 1,968 banking branches, 341 mortgage offices, and 9.2 million debit cards as a marketing platform to appeal to its current consumers.[18]

Providian had long been rumored to be looking for a buyer after completing its own turnaround efforts.[19] Providian's customers had traditionally included many borrowers with credit problems, who are often the first to be impacted by an economic downturn.[20] When those customers were faced with the recession of 2001, Providian's financial situation worsened, and regulators forced the company to sell its assets and decrease in size after making too many loans to sub-prime borrowers.[21] The company went from a $667.4 million profit in 2000 to a $54.6 million loss in 2001.[22] Under the leadership of Chairman and Chief Executive Joseph Saunders, Providian eliminated that liability, selling $2.5 billion in credit card assets.[23] Saunders also sold off the company's British and Argentinean card operations, an online lender, and slashed 1,500 jobs.[24] Providian has since begun to focus on customers with better credit scores, raising the company's average client credit score to 660, and no longer offering credit cards to applicants with a credit score below 600.[25]

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[16] Cole, *supra* note 14.
[17] Reckard, *supra* note 15, at C1.
[18] *Id.*
[19] Cole, *supra* note 14.
[20] Reckard, *supra* note 15, at C1.
[21] *Id.*
[22] Drew Desilver, *Providian Credit Coup For WaMu; $6 Billion Purchase Of Big Card Issuer - Move Eases Reliance On Mortgage Business*, THE SEATTLE TIMES, June 7, 2005, at C1.
[23] *Id.*
[24] *Id.*
[25] Reckard, *supra* note 15, at C1.

Shares of both companies declined on news of the merger – Washington Mutual fell $1.03 to close at $40.54, while Providian shares declined $0.33 to close at $17.63.[26] The initial negative reaction to the deal may be explained by the market's perception of Providian's loan portfolio; analysts noted that Providian had been in search of a suitor for a while, and many other larger banks likely turned down the opportunity to acquire Providian, leading to the inference that Providian's portfolio is not very impressive.[27] Although Providian has been able to decrease its delinquency rates from 11.1% in 2002 to 5.16% in the first quarter of 2005, its rate is still higher than MBNA (4.17% in the first quarter of 2005), and Capital One Financial (3.45%).[28] Other analysts expressed concern as to whether Washington Mutual can generate enough cash to fund both Providian's credit card operations and its planned 250-branch expansion for the year.[29]

Providian stockholders will receive the equivalent of 0.45 shares of Washington Mutual stock for each share of Providian, with 89% in stock and 11% in cash.[30] The final value of the deal will depend on the average price of Washington Mutual stock in the ten trading days before the transaction closes.[31] Lehman Brothers, Morgan Stanley and Simpson Thacher & Bartlett advised Washington Mutual. Goldman Sachs, Citigroup Global Markets and Wachtell, Lipton, Rosen & Katz advised Providian.[32]

3. Capital One Financial Corp. Acquires Hibernia

In search of a regional bank that would help diversify revenues and provide a cheaper source of funding, Capital One Financial Corp. announced its acquisition of New Orleans-based Hibernia on March 6, 2005.[33] Capital One will pay $5.3 billion in cash and stock for the $22 billion asset Hibernia, which operates over

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[26] Eric Dash, *Bank To Buy Credit Card Business for $6.45 Billion*, THE NEW YORK TIMES, June 7, 2005, at C2.
[27] Desilver, *supra* note 22, at C1.
[28] *Id*.
[29] Reckard, *supra* note 15, at C1.
[30] *Id*.
[31] *Id*.
[32] Dash, *supra* note 26, at C2.
[33] David Boraks & Lavonne Kuykendall, *Cap One: No More Deals Necessary; Capital One Acquires Hibernia*, AM. BANKER, Mar. 8, 2005, at 1.

300 branches in Louisiana and Texas, representing a 24% premium over Hibernia's market capitalization at the time the deal was announced.[34]

The deal ended a year of speculation on whom Capital One would acquire.[35] Capital One was rumored to be interested in bidding for GreenPoint Financial Corp. of New York, as well as Internet issuer Egg PLC, of the United Kingdom.[36] But Capital One approached Hibernia to discuss a potential acquisition towards the end of 2004, and discussions accelerated in January of 2005.[37]

In presenting the acquisition to investors, Capital One stressed Hibernia's presence in the attractive Texas market as a key driver to the deal, noting that Dallas-Fort Worth and Houston have the fourth- and fifth-highest population-per-branch ratios among the nation's fifteen largest metro areas (thus indicating that both regions are still somewhat underserved by banks).[38] The acquisition also provides Virginia-based Capital One with a commercial bank through which the company can boost its credit card distribution, which had otherwise been conducted almost exclusively through direct mail.[39] Most analysts, however, see Hibernia's deposits as the key driver to the deal.[40] At the time the acquisition was announced, Hibernia had $15.8 billion in deposits nationally and $3.4 billion in deposits in Texas, which would provide a cheap source of financing for the combined companies' loans.[41] Furthermore, Hibernia is able to attract additional cheap funding at an average rate of $14.8 million in deposits within the first twelve months a new branch's opening.[42] Capital One also funds its lending through the sales of bonds and pools of its loans sold as securities.[43]

The deal will make Capital One the nation's ninth-largest consumer lender, and among the top twenty in their share of the U.S.

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[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] Ieva M. Augstums, *Bank Deal Shows Interest In Texas: Capital One Is Planning To Use Hibernia's Locations To Expand In State's Crowded Retail Market*, THE DALLAS MORNING NEWS, Mar. 8, 2005, at 1D.
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] Augstums, *supra* note 38, at 1D.
[43] Terence O'Hara, *Capital One To Buy New Orleans Bank; McLean-Based Issuer Of Credit Cards Seeks to Diversify Its Holdings*, THE WASHINGTON POST, Mar. 7, 2005, at E01.

deposit market.[44] Capital One entered the acquisition with 48.6 million accounts, making it the nation's fifth-largest credit card issuer.[45] Hibernia will be renamed "Capital One Bank", and will continue to be run by Hibernia Chief Executive Officer J. Herbert Boydstun upon the completion of the acquisition.[46] Hibernia shares rose $5.67 to $32.24 upon news of the transaction, while Capital One shares declined nearly 3% to $76.[47]

4. Sovereign Bank Sells Equity Stake to Banco Santander; Buys Independence Community Bank Corp.

Several months after Sovereign Bancorp's chief executive hinted towards the possibility of partnering with a foreign bank during a July conference call, Sovereign announced that it will sell a 19.8% equity stake to Banco Santander, of Madrid, in exchange for $2.4 billion.[48] The deal was announced on Monday, October 24, 2005.[49] The agreement will give Banco Santander the option to buy an additional 5% of Sovereign after July 2006, and to buy 100% of Sovereign after two years.[50] On the same day, Sovereign also announced that it will acquire Independence Community Bank Corp. for $3.6 billion.[51]

Santander's initial $2.4 billion purchase amounts to $27 per share, representing a 24% premium over Sovereign's 20-day trading average in the trading period leading to the deal (the stock had closed at $23.37 on the Friday prior to the deal's announcement).[52] The sale of Sovereign's equity stake also came at a time when Sovereign was facing increasing pressure from its largest shareholder,

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[44] Carol Hazard, *Capital One Banks On Purchase*, RICHMOND TIMES, Mar. 8, 2005.

[45] Joe Gyan, Jr., *Hibernia Deal Wins Markets' Approval; Capital One Stock Rises After Initial Fall*, THE ADVOCATE (BATON ROUGE, LOUISIANA), at 4-C.

[46] *Id.*

[47] Hazard, *supra* note 44.

[48] Laurie Kulikowski, *Sovereign Gets An Investor, Buying A Bank; Sovereign Bancorp Inc. To Sell Equity To Banco Santander Central Hispano SA*, AM. BANKER, Oct. 25, 2005, at 19.

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] Sasha Talcott, *Spanish Bank Buys Sovereign Stake*, BOSTON GLOBE, Oct. 25, 2005, at D1.

Relational Investors LLC.[53] Relational, a 7% shareholder in Sovereign, had sought to appoint two of its own executives onto Sovereign's board of directors, after accusing Sovereign directors of being overpaid to the extent that their independence was in question.[54] Relational also had complained that Sovereign's shares had been underperforming its peers, and that Sovereign's management had misled investors regarding the bank's acquisition strategy.[55] Santander's purchase, which is not subject to a shareholder vote, provides Sovereign management with a "friendly 20 percent voting bloc to help executives thwart Relational's plans."[56]

Sovereign intends to put the $2.4 billion received from the Santander deal towards its $3.6 billion purchase of Brooklyn-based Independence Community Bank.[57] Sovereign's valuation of Independence represents a price of $42 per share, a 29% premium above Independent's prior closing price.[58] The acquisition of Independent is intended to help Sovereign penetrate the New York market and thereby "fill a gap in Sovereign's 650-branch network, which stretches from Massachusetts to Maryland."[59] Independent currently operates 120 branches in the New York metropolitan area.[60]

5. Wachovia Buys Westcorp

In a move designed to expand its auto financing business, Wachovia announced a $3.9 billion acquisition of the $16-billion asset Westcorp on September 12, 2005.[61] The deal would provide Wachovia with 8,500 automobile dealer customers nationwide through the acquisition of Westcorp's auto finance business, WFS

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[53] Kulikowski, *supra* note 48, at 19.
[54] Talcott, *supra* note 52, at D1.
[55] *Id.*
[56] *Id.*
[57] Heather Timmons, *Santander Investing In Philadelphia Bank*, THE NEW YORK TIMES, Oct. 25, 2005, at C4.
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] Jim Cole, *Wachovia Playing Up Auto Side of Calif. Deal: But Buying Westcorp Will Also Set It Up In A Coveted Market; Wachovia Corp.'s Acquisition Of Westcorp of Irvine, California*, AM. BANKER, Sept. 13, 2005, at 1.

Financial, while also providing Wachovia with nineteen retail banking branches in California.[62]

Upon completion of the long-awaited deal, Wachovia will go from a regional player in the auto loan business to the nation's ninth-largest auto lender, with offices in 47 states.[63] The acquisition comes at a time when Wachovia, which had a heavy focus on home lending, is facing growing concerns regarding whether the housing market can sustain its current growth.[64] In response, by buying Westcorp, Wachovia will enter the "subprime" auto loan business for the first time, allowing it to charge customers with past credit problems higher interest rates.[65] After the transaction, the combined company's auto loan portfolio would amount to $19 billion, 22% of which would be to sub-prime borrowers.[66] Wachovia also expects to be able to capitalize on cross-selling of its banking services to new automobile dealer customers within twelve months of the transaction's closing date.[67]

The acquisition also provides Wachovia with its first entry-point on the West Coast, in the wealthy Los Angeles, Orange and San Diego counties.[68] Wachovia sees this California expansion as only "icing on the cake," however, allowing the bank to enter the California market with minimal impact, and then deciding how to proceed from there.[69] At the moment, Wachovia intends to continue building new branches in Texas and New York City,[70] and banking industry analysts do not expect Wachovia to announce any plans of further expansion into California until late 2006.[71] Other industry experts, however, claim that a potential merger with San Francisco-based Wells Fargo & Co. may be a future possibility.[72]

The acquisition is expected to close in the first quarter of 2006.[73] Wachovia expects the acquisition to lead to a decline in

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[62] *Id*.
[63] Rick Rothacker & Binyamin Appelbaum, *Wachovia Revs Up Deal For Auto-Loan Business*, THE CHARLOTTE OBSERVOR, Sept. 13, 2005.
[64] *Id*.
[65] *Id*.
[66] Cole, *supra* note 61 at 1.
[67] *Id*.
[68] Rothacker & Appelbaum, *supra* note 63.
[69] Cole, *supra* note 61 at 1.
[70] *Id*.
[71] Rothacker & Appelbaum, *supra* note 63.
[72] *Id*.
[73] *Id*.

earnings in 2006, but should likely boost profits in 2007.[74] The expected decline in short-term profits led to a 1.6% decline in Wachovia's share prices upon announcement of the acquisition.[75]

B. The Future

Looking to the future, current national trends indicate that banks will continue to open more branches, particularly in urban areas.[76] Indeed, most of the national growth in bank branches has been in metropolitan areas, increasing 3% from 2004 to 2005, and 15% overall since 1995.[77] As banks continue their attempts to expand their retail operations, many see Colorado as an attractive state for expansion, especially after Bank of America chief executive Kenneth Lewis noted that Colorado is the "largest, fastest-growing state we're not in."[78] Indeed, Colorado's deposit base grew 9% in the twelve months ended in June of 2005.[79] However, Texas and Florida still remain the strongest states in terms of their abilities to attract "out-of-state bankers bent on expanding their retail networks," making both states attractive expansion targets as well.[80]

Analysts have also specifically identified several banks which could become acquisition targets in the near future. Mark Morgan, an analyst at Rochdale Securities, LLC has identified BankUnited Financial Corp. of Coral Gables, Florida, and CVB Financial Corp. of Ontario, California as likely acquisition targets.[81] "Rochdale's list also included North Fork Bancorp. Inc. of Melville, N.Y.; New York Community Bancorp Inc. of Westbury; Webster Financial Corp. of Waterbury, Conn.; TCF Financial Corp. of Wayzata, Minn.; and City National Corp. of Los Angeles."[82] Meanwhile, the SunTrust Robinson Humphrey list has identified Fidelity Bankshares Inc. (of West Palm Beach, Florida), Fidelity

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[74] *Id.*
[75] *Id.*
[76] David McPherson, *Banks and More Banks: Growing Number of R.I. Branches Mirrors U.S. Trend*, PROVIDENCE J., Dec. 1, 2005.
[77] *Id.*
[78] Paul Davis, *Expansion-Minded Banks Turning Sights to Colorado*, AM. BANKER, Dec. 7, 2005, at 1.
[79] *Id.*
[80] *Id.*
[81] Laurie Kulikowski, *BankUnited, CVB, Two Fidelitys on Might-Sell Lists; BankUnited Financial Corp., CVB Financial Corp., Fidelity Bankshares Inc., Fidelity Southern Corp.*, AM. BANKER, Dec. 8, 2005, at 20.
[82] *Id.*

Southern Corp. (of Atlanta), and Prosperity Bancshares Inc. (of Houston) as likely acquisition targets, within the next several years.[83] Chief executives from several of the identified banking institutions have expressed their desires to keep their banks independent, however.[84]

Alex Khalarian[85]

[83] *Id.*
[84] *Id.*
[85] Student, Boston University School of Law (J.D. 2007).

VIII. INTERNATIONAL MERGERS & ACQUISITIONS

A. Introduction

2005 was busy for international bank mergers. Global mergers and acquisitions among financial institutions reached $339 billion in the year ending September 19th, according to Dealogic.[1] This puts the sector on track to record its most active deal-making year since 2000.[2] Experts predict an increasing number of cross-border deals as a result of an increasingly supportive regulatory, political and market environment.[3]

The much expected consolidation among European banks has finally begun to pick up momentum.[4] European banks continue to press for consolidation, in order to create savings through economies of scale and to compete with the large American banks which have been consolidating in the U.S.[5] The reluctance of European banks to buy rivals in other countries, an obstacle to consolidation in the past, seems to be dissipating as European bank shareholders have become more amenable to cross-border mergers.[6] Although the recent rejection of the European Union constitution by two nations may threaten integration and reform of the financial sector in the short term, it is not expected to do so in the long term.[7] Last year, Banco Santander of Spain became a pioneer in the European cross-border deal market when it purchased Britain's Abbey National, and this year its European rivals have followed suit.[8] ABN Amro of the Netherlands and BBVA of Spain both made bids for Italian banks and in June, Unicredito of Italy agreed to a takeover of HVB of Germany.[9] All of these mergers have involved larger banks buying smaller ones, with no question who the surviving entity would be.[10] Mergers of equals, involving banks of similar

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[1] Peter Thal Larsen, *Banking on a Pick-Up in* Consolidation, FIN. TIMES, Oct. 5, 2005, at 4.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] Karen Krebsbach, *M and A Activity; European Deals Press Onward*, U.S. BANKER, Aug. 1, 2005.
[6] Larsen, *supra* note 1.
[7] Krebsbach, *supra* note 4.
[8] Larsen, *supra* note 1.
[9] *Id.*
[10] *Id.*

sizes, could be more difficult to carry out, as they would force difficult compromises such as the choice of chief executive and the location of the combined headquarters.[11] For this reason, investment bankers predict continued activity at the smaller end of the market in sectors such as private banking where consolidation is likely in the face of pressure on fees and the rising costs of information technology.[12]

B. Unicredito (Italy) purchases HVB Group (Germany)

On June 12, 2005, Unicredito of Italy announced a €15.4 billion all stock deal to acquire Germany's HVB.[13] This all-share transaction marks the largest European cross border deal to date and makes Unicredito the ninth largest bank in Europe, fifth largest financial services group in the eurozone and larger than all but three banks in the United States.[14] The combined bank will have assets of €733 billion, more then 7,000 branches, and a customer base of more than 28 million.[15] Unicredito's CEO, Alessandro Profumo will be the head of the merged group.[16] Unicredito is offering five of its shares for each HVB shares, a 16.9 percent premium to the bank's three month average share price.[17] The banks expect the deal to generate synergies of €985 million per year, on a pre-tax basis, mostly from proposed cost cuts from the release of 9,100 workers.[18] These job cuts will primarily be made in eastern Europe.[19] Restructuring charges, which will amount to €1.35 billion, will all be in this year's expenses.[20] The deal marks an end to a seven-year existence for HVB that was marred by billions of euros in bad debts and investment losses.[21]

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[11] *Id.*
[12] *Id.*
[13] Patrick Jenkins & Adrian Michaels, *UniCredito Seals Deal on Euros 15bn HVB Tie-Up,* FIN. TIMES, June 13, 2005, at 1; Larsen, *supra* note 1.
[14] Jenkins & Michaels, *supra* note 13*;* Larsen, *supra* note 1.
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*

C. ABN Amro (Netherlands) purchases Antonveneta (Italy)

On September 26, 2005 ABN Amro of the Netherlands pierced the nearly impervious veil of the Italian banking sector when it bought a 39 percent stake of Banco Antonvenata, a midsize bank in northeastern Italy, from Banco Populare Italiana (BPI) for €3.2 billion.[22] This agreement came ten days after a tentative deal was reached.[23] Amro will add this stake to its 30 percent stake of Antonveneta, giving it a 69 percent stake, a level high enough to set off an obligatory public tender offer for the remaining 31 percent.[24] Amro will launch this tender offer for the remaining shares at €26.50, the price it paid to BPI.[25] In purchasing Antonvenata, Amro acquires 1000 bank branches in Northeast Italy with both private and business clients.[26]

Amro first set to acquire the Antonveneta more than nine months before, but was confronted by a panoply of defenses erected by Antonio Fazio, the head of Italy's central bank, to prevent such a takeover.[27] Amro's first offer to buy Antonvenata failed when BPI made a higher bid despite unstable finances.[28] Amro was only able to complete this deal after investigators uncovered close ties between Fazio and BPI, Amro's rival in the takeover.[29] Officials impounded BPI's shares in Antoveneta, froze its offers and suspended BPI's chief executive Gianpiero Fiorani.[30] Antonio Fazio is now facing calls for his resignation, although he denies any wrongdoing in the transaction.[31] Despite the success of ABN Amro's venture, industry specialists expect it will be some time before another Italian bank will be bought by another foreign rival, as foreigners face obstacles

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[22] Eric Sylvers, *Amro in Deal To Control Italian Bank,* N.Y. TIMES, Sept. 27, 2005, at C6.
[23] *Id.*
[24] *Id.*
[25] Ian Bickerton & Adrian Michaels, *ABN Chief Slams Italian Rivals***,** FIN. TIMES, Sept. 27, 2005, at 32.
[26] Eric Sylvers, *ABN Appears to Gain a Foothold in Italy,* N.Y. TIMES, Sept. 16, 2005, at C6.
[27] *Id.*
[28] *Id.*
[29] Bickerton & Michaels, *supra* note 25.
[30] *Id.*
[31] *Id.*

including shareholders' pacts and antiquated bylaws that make some Italian banks almost impossible to purchase.[32]

D. Banco Bilbao Vizcaya Argentaria (Spain) Bids for Banca Nazionale del Lavoro (Italy) But Loses Out to Unipol (Italy)

Banco Bilbao Vizcaya Argentaria (BBVA), Spain's second largest financial group, was not as successful as ABN Amro in mounting a takeover in the resistant Italian banking market. The Spanish bank is now mounting a legal challenge in order to overturn Unipol's (BNL) €8.3 billion bid on technical grounds.[33] After acquiring a fifteen percent stake in Banca Nazionale del Lavoro (BNL), Italy's sixth-largest lender, BBVA withdrew its offer for BNL on July 22, 2005 when Unipol, an Italian insurer, announced it had built up a 51 percent stake in BNL with the help of international banks and local co-operatives.[34] Unipol then made an offer for the remainder of BNL shares at €2.70 per share.[35] Although BBVA's bid, valued BNL at €8.3 billion, larger than Uniopol's €8.25 billion bid, they were outmaneuvered by Unipol, a much smaller bank with powerful domestic allies.[36] This has opened up Italian regulators to criticism that the banking battles being fought in Italy have scarred the country's reputation.[37]

BBVA is currently mounting a legal challenge in an attempt to overturn Unipol's offer on technical grounds, alleging that Unipol's offer "was a clear case of discrimination against BBVA and other minority shareholders."[38] If this legal challenge succeeds, Unipol may be forced to raise its bid or to sell out.[39] BBVA is also challenging Unipol's financial solvency in acquiring BNL, which is four times larger than Unipol.[40] If BBVA's legal challenge is successful, Unipol may be forced to sell out or raise its bid.[41] If

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[32] *Id.*
[33] Leslie Crawford, *BBVA Moves To Overturn Unipol Bid,* FIN. TIMES, Oct. 7, 2005, at 28.
[34] *Id.*
[35] *Id.*
[36] Adrian Michaels & Mark Mulligan, *BBVA concedes defeat in Italian attempt*, FIN. TIMES, July 23, 2005, at 8.
[37] *Id.*
[38] Crawford, *supra* note 33.
[39] *Id.*
[40] *Id.*
[41] *Id.*

approved, however, Unipol's takeover of BNL would create Italy's fourth largest financial services company.[42]

E. Barclays (UK) purchases Absa (South Africa)

On July 7, Barclays, the UK's third largest bank, became the first foreigner to buy a South African bank when it acquired a majority stake in Absa, the country's largest lender, for £2.75 billion.[43] The deal represents Barclays' biggest foreign venture to date and South Africa's biggest inward investment since the end of the apartheid era.[44] Absa has seven million customers in South Africa, 675 branches, more than 5,000 ATM's and is the country's leading mortgage lender.[45] Barclays left South Africa in 1986 after facing pressure from anti-apartheid campaigners.[46] Approval of their return was delayed by groups seeking reparations from Barclays for allegedly supporting the apartheid government, but after two days a South African court gave Barclays approval to go ahead with the deal.[47] Barclays plans to integrate its existing operations in Africa with Absa within the next six to 24 months and forecasts $200 million in pre-tax synergies four years after the acquisition is completed.[48] Sixty percent of these synergies would come from an estimated increase in revenues, and the remaining 40 percent would come from cost efficiencies in areas like IT.[49] Job cuts in the Absa staff are expected to be small.[50] Following the merger, Barclays will generate approximately one-third of its earnings from outside of the UK, a number that currently stands at 25 per cent.[51]

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[42] *World Business Briefing Europe: Italy: Unipol Bid For Bank Advance*, N.Y. TIMES, Sept. 15, 2005, at C6.
[43] Paul J. Davies & John Reed, *Barclays Cleared By Court To Take Control Of Absa*,, FIN. TIMES, July 8, 2005, at 23; Jane Croft et al., *Barclays Plans Integration After Absa Bank Deal,* FIN. TIMES, May 10, 2005, at 23; Larsen, *supra* note 1.
[44] Davies & Reed, *supra* note 43.
[45] Croft et al., *supra* note 43.
[46] Davies & Reed, *supra* note 43.
[47] *Id.*
[48] Croft et al., *supra* note 43.
[49] *Id.*
[50] *Id.*
[51] *Id.*

F. BNP Paribas Buys Commercial Federal

BNP Paribas (BNP) is to buy Commercial Federal, a Nebraska based mortgage bank for $1.36 billion.[52] This purchase will reinforce BNP's presence in the Western United States, expanding its U.S. subsidiary, Bancwest, from 541 to 739 branches across twenty western states and add $10.4 billion in assets to its portfolio.[53] Baudouin Prot, chief executive of BNP, has earmarked U.S. retail banking as one of BNP's main focuses for expansion.[54] Bancwest will now have branches in Missouri, Kansas and Oklahoma, and will strengthen its presence in Colorado, Nebraska, Arizona and Iowa.[55]

Bancwest is paying $34 per share in cash and a special dividend of $0.50 to Commercial Federal shareholders.[56] This price represents a 27 percent premium to Commercial Federal's average closing price over the last six months and 33 percent premium over Monday's close.[57] Commercial Federal had a net income of $76 million last year on revenues of $382 million, with a return on equity of more than ten percent.[58] BNP seeks to improve the product mix and increase cross-selling to achieve pre-tax revenue synergies of $12 million.[59]

G. Banco Santander (Spain) Takes a Stake in Sovereign (US)

On Monday, October 24, $18 billion asset Sovereign Bancorp (Sovereign) announced that it would sell a significant chunk of its banking business to $63 billion asset Banco Santander (Santander).[60] Under the deal, Santander will pay $2.4 billion for a 19.8 percent stake in Sovereign, with an option to buy five percent

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[52] Martin Arnold & Paul Davies, *BNP to buy US bank for Dollars 1.36bn,,* FIN. TIMES, June 15, 2005, at 30.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] Laurie Kulikowski, *Sovereign Gets an Investor, Buying a Bank*, AM. BANKER, Oct. 25, 2005, at 19.

after July 2006 and 100 percent after two years.[61] At the same time, Sovereign announced that it would be acquiring Independence Community Bank Corp. in New York for $3.6 billion.[62] The acquisition will conclude a difficult period for Independence, which has faced intense competition in their core business of multi-unit housing lending and has also faced struggles as a result of the flat yield curve.[63] Sovereign is thought to have engaged in the Santander deal in order to gain an ally in its dispute with Relational Investors.[64] Relational Investors, Sovereign's largest shareholder with a seven percent stake, has hired a turnaround specialist, Anthony P. Terraciano, who has held positions at several high-profile banking companies.[65] Relational has recently been pressing to gain seats on Sovereign's board.[66] The Santander deal could also put Sovereign in a better competitive position as several of its rivals have alliances with large foreign banks.[67]

The Santander deal is not without its critics though. Institutional investors in Sovereign have challenged the deal.[68] These investors claim that Sovereign designed the deal in which Santander purchased a 19.8 percent stake in Sovereign, specifically to circumvent the New York Stock Exchange requirement of shareholder approval for any change in control.[69] The requirement sets the controlling threshold for a change in control at twenty percent.[70] In response to this, Relational Investors is waging a proxy fight against the Sovereign's board and managers.[71] Franklin Mutual Advisers, another of Sovereign's large shareholders has also urged Sovereign to put the transaction to a shareholder vote.[72] The Council of Institutional Investors argued in a letter that the New York Stock Exchange can declare the deal a change in control despite the fact that the threshold had not been met and maintain the requirement of a

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[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] Todd Davenport, *Investors, Analyst Slam Sovereign Plan*, AM. BANKER, Nov. 17, 2005, at 9.
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*

shareholder vote.[73] Other investors feel that Sovereign is neglecting the core operations of the business by undertaking transaction risk.[74] Instead, these investors feel that Sovereign should work on improving fundamental performance.[75]

H. Royal Bank of Scotland Buys a Stake in Bank of China

Royal Bank of Scotland (RBS) is leading a consortium that will pay $3.1 billion for a 10 percent stake in Bank of China (BoC).[76] With a $1.6 billion investment, RBS is to take half of the stake bought by the group, which includes Merrill Lynch and tycoon Li Ka-shing.[77] Shareholders of RBS greeted the news of the deal with relief because they had been urging RBS towards not taking a higher stake in the deal or issuing shares in order to fund it.[78] Notably, the consortium won unprecedented warranties and protections from the Chinese Government in

order to protect the investment from a deterioration in the state lender's financial security.[79] These protections could set a precedent that prompts other countries to seek similar protections when doing business with Chinese state run organizations.[80]

The deal values BoC at $30 billion – on a par with China Construction Bank, its larger competitor.[81] BoC has 11,307 branches, controls fourteen percent of the country's deposits, and twelve percent of the Chinese market for loans.[82] RBS is eager to increase its business in Asia, a sector that represents less than 1 percent of its current profits.[83] The two companies are expected to "cooperate on credit cards, wealth management, corporate banking and insurance."[84] As part of the deal, RBS is expected to help BoC

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[73] *Id.*
[74] Kulikowski, *supra* note 60.
[75] *Id.*
[76] Paul J. Davies & Sundeep Tucker, *RBS Gains Foothold in China with Dollars 3bn Deal,* FIN. TIMES, Aug. 19, 2005, at 1.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*

to improve corporate governance and risk management after they have been hit by a string of scandals and internal fraud.[85]

I. Conclusion

2005 added a new aspect to the global banking merger scene, the European cross-border merger. Unicredito and ABN Amro have shown that such deals are not impossible to make. It remains to be seen, however, whether there will be a rush toward European cross-border banking consolidation, especially in the light of the difficulties faced by ABN Amro and BBVA in their takeover attempts.

Jonathan Feiler[86]

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[85] *Id.*

[86] Student, Boston University School of Law (J.D. 2007).

IX. NYSE MERGER AND IPO

A. The NYSE Selects Archipelago Exchange as a Merger Partner

The NYSE was organized in 1792 and incorporated in 1971 as the New York Stock Exchange, Inc., a not-for-profit corporation.[1] The Board of Directors was structured to have six to twelve board members that are completely independent of NYSE management.[2] The exchange trades 1.46 billion shares on an average day.[3] Traditionally, member firms purchase seats on the NYSE, and only seat-holders are allowed to buy and sell securities on the trading floor.[4] There are 1,366 seats, which have remained constant since 1953.[5]

CEO, John Thain ("Thain"), considered taking the NYSE public since his inception in late 2003.[6] Thain replaced Richard Grasso, who put plans to take the exchange public on hold in 1999.[7] In early February 2005, Thain created a special task force to consider changing the exchange's not-for-profit structure to a for-profit publicly traded corporation.[8] Members have criticized the NYSE non-profit structure as restricting expansion of revenue streams.[9]

On April 20, 2005, the NYSE announced a definitive merger agreement with Archipelago Exchange ("ArcaEx"), the largest merger to date between securities exchanges.[10] ArcaEx is an exchange formed in 1996 in response to SEC rules permitting

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[1] New York Stock Exchange, Firsts and Records, http://www.nyse.com/about/history/1022221392987.html (last visited Nov. 12, 2005).

[2] New York Stock Exchange, Leadership, http://www.nyse.com/about/theorganization/1022221392205.html (last visited Nov. 12, 2005).

[3] *Id.*

[4] *Id.*

[5] New York Stock Exchange, Members, http://www.nyse.com/about/members/1089312755132.html (last visited Nov. 12, 2005).

[6] Liz Moyer, *Thain Taking NYSE Public*, FORBES, Apr. 20, 2005, http://www.forbes.com/2005/04/20/cx_em_0420nyse.html (last visited Oct 9, 2005).

[7] Andrei Postelnicu, *NYSE Taskforce to Consider IPO Exchanges*, FIN. TIMES, Feb. 5, 2005, at 8.

[8] *Id*.

[9] *Id.*

[10] News Release, Archipelago, New York Stock Exchange and Archipelago Exchange Agree to Merge (Apr. 20, 2005) *available at* http://investor.archipelago.com/phoenix.zhtml?c=140290&p=irol-newsArticle&ID=698977&highlight=.

Electronic Communication Networks to interact with the NASDAQ National Market.[11] With the tagline "Archipelago. Everything out in the open," the exchange prides itself on "creat[ing] the first totally open, all electronic stock market."[12] This is a fitting match with Thain's agenda to boost NYSE electronic trading.[13]

Leading up to the merger Thain emphasized that the deal allows the exchange to better compete in a global marketplace with greater diversification, efficiency and innovation stating, "[o]ur combination with Archipelago will provide a leading position in the over-the-counter market; state of the art electronic platform for trading ETFs, options and fixed income; and the opportunity to build a listings business for those companies that do not qualify to list on the NYSE."[14] This includes the trading of NASDAQ listed stocks.[15] The NYSE immediately gained new business since ArcaEx controls nearly a quarter of all NASDAQ trades.[16]

B. The Chicago Mercantile Exchange Serves as a Model to the NYSE

The NYSE may have modeled its business plan after the Chicago Mercantile Exchange ("Merc"), the first securities exchange to go public.[17] Thain visited the Merc in November 2004 to study its transition into electronic trading, a transition, which combined with going public, that has been highly successful.[18] The stock now trades at a value five times higher than when first issued, the average volume of contracts traded daily has increased threefold since 2000,

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[11] Archipelago, Inside Archipelago, Our History, http://www.archipelago.com/inside (section titled Our History)
[12] *Id.*
[13]Moyer, *supra* note 6 (Thain announced a hybrid model of trading that would move liquid stocks to an electronic system and allow less liquid stocks to remain on the traditional floor trading system).
[14] John A. Thain, CEO, NYSE, Inc., Public Statement on Agreement to Merge NYSE and Archipelago (Apr. 20, 2005) (transcript *available at* http://nyse.com/Frameset.html?displayPage=/content/articles/1113993488566.html).
[15] *Building Global Competitiveness; NYSE and Archipelago Agree to Merge*, Newsletter (NYSE, N.Y., N.Y.), May 2005, *available at* http://www.nyse.com/Frameset.html?displayPage=/content/articles/1116412455918.html.
[16] Danielle DiMartino, *Trade Secrets: What Would Exchange Mergers Mean to Investors*?, DALLAS MORNING NEWS, Apr. 26, 2005, at 1D.
[17] Mike Hughlett, *Merc Was a Model for the NYSE; Electronic and IPO Courses Were Studied*, CHI. TRIB., Apr. 24, 2005, at C1.
[18] *Id.*

and the average daily use of the electronic system has increased from 14.9% of all trades to approximately 70%.[19] The Merc has a hybrid system, like the system that Thain proposed for the NYSE, which maintains both electronic trading and traditional floor trading.[20] While Thain may be modeling the end result, a publicly traded exchange with a hybrid system of trading, after the Merc, the method of getting there is very different. Specifically, the Merc went public through an IPO, whereas the NYSE merged with the already publicly traded ArcaEx, thus giving the NYSE the advantage of going public faster and cheaper.[21] Additionally, the Merc was one of the first to adopt electronic trading and built its electronic trading platform from scratch.[22] The NYSE, in contrast, is buying the technology via the merger - technology already proven solid through its use by ArcaEx.[23]

C. Speculation as to the Continued Existence of the Famous NYSE Floor

Some NYSE floor traders fear that the merger signifies that their role is headed for extinction.[24] Many workers have expressed resentment that members are getting richer while they are in fear of losing their jobs to machines.[25] Despite the changes the merger will undoubtedly bring, including the expansion of electronic products, Thain and NYSE members have said they see a future for traders on the floor.[26] Yakov Amihud, a professor at New York University's Stern School of Business supports this view, stating that floor traders will play a role for those who seek out human intervention during adverse times, for example in the event of dropping share prices or light trading; "[o]n a rainy day people take shelter at the NYSE."[27] Additionally, floor traders may matter to very large investors.[28] For instance, if a mutual fund wants to sell millions of shares discretely,

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[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] Ben White, *Down on the Street; NYSE's Electronic Future Leads Traders to Worry that What's Good for the Member May Be Bad for Them,* WASH. POST, Apr. 22, 2005, at E01.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] DiMartino, *supra* note 16.

they may prefer to speak to a floor trader for help as opposed to posting the entire amount at once online or continuously selling off small amounts over time, lest attention be drawn to the sale.[29] But not everyone is as optimistic; Charles Geisst, a Wall Street historian and a professor at Manhattan College, expressed the view that after the merger, the exchange, as a publicly traded company, will try to increase value for shareholders which will include closing the floor in favor of a more cost effective all electronic trading model.[30] "[The floor] is an early 19th century model that has survived, but I think it is eventually going to have to go by the wayside. It is in many ways a mercantilist system operating in the modern world."[31]

Two days after the merger announcement of NYSE and ArcaEx, NASDAQ announced a merger with Instinet Group Inc.[32] As a result, competition between the two exchanges may escalate with investors becoming the ultimate beneficiaries.[33] Former Securities and Exchange Commission ("SEC") Chairman William Donaldson expressed his optimism, saying, "[s]mall investors as well as institutions will be guaranteed the best prices for their trades no matter which market their orders are sent to."[34]

D. NYSE as a Self Regulatory Organization

The NYSE is a "self-regulatory organization" that is responsible for maintaining "fair trading" and "policing its members."[35] The NYSE merger could create a tension between the obligations arising from its for-profit status and its functions as a self-regulatory organization.[36] For example, NYSE floor specialists' position requires them to step into the opposite side of a trade when either a buyer or seller cannot be found, and they are expected to reduce volatility and stabilize the market.[37] Suppose the NYSE elects to replace these specialists with computers, which would be a great cost savings and sensible for a for-profit organization, but may

[29] *Id.*
[30] White, *supra* note 24.
[31] *Id.*
[32] DiMartino, *supra* note 16.
[33] *Id.*
[34] *Id.*
[35] Ben White, *Two Plus Two Equals What? In Merger Math, Change for Investors Is the X Factor*, WASH. POST, May 1, 2005, at F01.
[36] *Id.*
[37] *Id.*

not be in the best interest of the marketplace and investors.[38] The incentives to act for shareholders' benefit can conflict with the actions that benefit the marketplace as a whole.

The NYSE plans to create a separate not-for-profit organization, dubbed "NYSE Regulation," that will oversee the regulatory functions.[39] The exchange will issue long term contracts, possibly seven to ten years at a time, to the not-for-profit, which will be funded by revenue from contract and examination fees as well as fines imposed upon regulation violators.[40] Some are not convinced that a separate not-for-profit is enough.[41] Barbara Roper, head of investor protection at the Consumer Federation of America, commented,

> [I]f you look at the directors of a for-profit exchange, they will have a fiduciary duty to shareholders to maximize value. So they would not only have the incentive but perhaps the obligation to give short shrift to any part of the operation that doesn't contribute to the bottom line.[42]

Additionally, some fear that in the competition to sign new companies NYSE and NASDAQ might succumb to the temptation to relax standards to draw in those companies.[43] However, this is not the only view, as former SEC Chairman, Arthur Levitt, stated "[b]y breaking up the clublike atmosphere of the member organization and becoming a more democratic publicly owned company, you take a great step toward more disclosure and greater investor protection."[44] Thain has also suggested that a joint venture with the National Association of Securities Dealers, a self-regulatory body which polices the securities industry, might be an effective way to monitor the exchange.[45]

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[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] Pradnya Joshi, *NYSE Ponders New Policing; Preparing for Transition to For-Profit Model, Stock Exchange Chief Suggests Joining Efforts with Dealers Group to Regulate Securities Industry*, NEWSDAY, Nov. 11, 2005, at A56.

E. Merger Terms Spark Opposition and Lead Some NYSE Members to Court

The merger was not embraced by everyone. Immediately after the announcement, senior executives from major Wall Street firms including Merrill Lynch and Lehman Brothers Holdings Inc. met with Kenneth Langone, former NYSE director, and John Mack, former head of Credit Suisse First Boston, to discuss the possibility of buying the NYSE.[46] Langone, who believes the merger terms are too generous to ArcaEx undervaluing NYSE, and the executives were going to analyze the merger terms for fairness as well as consider alternatives.[47] Langone reportedly planned to poll members to determine if there was a desire to have the exchange consider alternatives to the merger.[48] Some seat-holders share the concerns of Langone.[49] Seat-holder William Higgins has said, "If I found a Rembrandt in my attic, would I take it out and put it at the curbside tag sale? Or would I take it to Christie's and ask them to open it up to a public bid?"[50] Charles Ursadt, vice chairman of the seat-holder group Exchange Members Association, said the members would look favorably on a bid from Langone because it could increase the price of their seats.[51] The NYSE board defended the merger proposal as fair and in the best interest of members, the NYSE, and competition of U.S. financial markets.[52]

Langone has also expressed concern regarding Goldman Sachs' role in the merger.[53] Goldman Sachs is on all sides of the transaction, advising both NYSE and ArcaEx in the merger.[54] Goldman Sachs' compensation from the merger is now upwards of $100 million.[55] The company will receive $3.5 million in advisory

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[46] Walter Hamilton, *Bid to Buy NYSE is Gathering Momentum; Senior Executives Gather to Discuss Possible Courses of Action at a Wall Street Meeting*, L.A. TIMES, Apr. 26, 2005, at C1.
[47] *Id.*
[48] Aaron Lucchetti, *NYSE Members Asked if Options are Wanted to Archipelago Deal*, WALL ST. J., Oct. 18, 2005, at C5.
[49] Hamilton, *supra* note 46.
[50] *Id*. Higgins is involved in a lawsuit to prevent the merger. *See infra* pp. 8-10.
[51] *Id*.
[52] *Id*.
[53] *Id.*
[54] *Id*.
[55] Bloomberg News, *NYSE Merger Would Be Big for Goldman; The Investment Bank Could Realize More than $100 Million from the Exchange's Proposed Union with Archipelago*, L.A. TIMES, Apr. 28, 2005, at C4.

fees, while at the same time it holds 21 seats on the NYSE, which have risen more than $20 million in value since the merger announcement; similarly, Goldman Sachs' 15.5% holding of ArcaEx stock has increased by more than $84 million, now totaling approximately $208 million.[56] Upon completion of the merger, Goldman Sachs will own 5.7% of the combined company, NYSE Group Inc.[57] To add more conflict to the mix, Thain is a previous president of Goldman Sachs.[58] Lucus van Praag, a spokesperson for Goldman Sachs, stated there is not a conflict of interest and that the transaction has had "total transparency."[59] Potential criticism was apparently anticipated by Goldman Sachs.[60] ArcaEx's filing with the SEC on April 26, 2005 included a letter from Goldman Sachs to ArcaEx CEO Gerald Putnam stating, "[y]ou hereby agree not to claim that Goldman Sachs has a conflict of interest."[61] The NYSE sent a letter to members dated April 28, 2005 defending Goldman Sachs' role in the prospective merger.[62] The letter stated, "[t]he fact is that Goldman was only involved in facilitating the transaction and bringing the two parties together, it did not assume fiduciary responsibilities, nor did it negotiate the financial aspects of the transaction on behalf of either the exchange or Archipelago."[63] Thain emphasized that Goldman Sachs did not operate in the role of a fiduciary and the due diligence for the merger was completed by Lazard and Greenhill, two different investment banks.[64] Arthur Levitt, former SEC Chairman, commented in an interview with Bloomberg News that conflicts are common in investment banking and he did not see any harm to investors by Goldman Sachs' role in the merger.[65]

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[56] *Id*.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] Andrew Countryman, *NYSE Defends Goldman Role in Merger*, CHI. TRIB., Apr. 30, 2005, at C1 (ArcaEx filed a copy of this letter with the Securities and Exchange Commission).
[63] *Id.*
[64] Greg Farrell, *NYSE Submits Archipelago Merger Filing*, USA TODAY, July 22, 2005, at 2B.
[65] Countryman, *supra* note 62.

On May 9, 2005,[66] William Higgins, the president of the Association of NYSE Equity Members, filed a class action lawsuit in New York Supreme Court in Manhattan to prevent the merger.[67] Higgins, like Langone, with whom Higgins is understood to have had contact,[68] contends that the NYSE is undervalued and that Goldman Sachs has a conflict of interest.[69] Higgins challenged both the lock-up provision, which restricted seat-holders from selling their shares in the new company for five years, and a provision which provided that five percent of the new company be reserved for certain NYSE employees, including Thain.[70] Higgins' complaint suggested that an appropriate valuation would provide that NYSE members receive up to ninety percent of the new entity.[71] Thain commented on this number stating, "I find it more than a little unusual that there could be any independent valuation before they had [non-public] information."[72]

The Association of NYSE Equity Member purports to represent approximately 400 seat holders.[73] Some association members, according to member William Power, requested a refund of their dues because they disagreed with Higgins' lawsuit.[74]

During discussion for a motion to dismiss in late July, New York State Supreme Court Justice, Charles E. Ramos, expressed concern over Thain's connection to Goldman Sachs and Goldman Sachs' role as advisor to both NYSE and ArcaEx, stating, "[i]f Thain selected the financial advisors, and participated in these discussions, there are some serious conflicts."[75] According to the SEC filing, Thain recused himself from negotiating the terms of Goldman Sachs'

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[66] Andrei Postelnicu, *NYSE Member Blocks Dollars 4bn Deal with Suit Archipelago*, FIN. TIMES, May 10, 2005, at 24.
[67] Eduardo Porter, *A Big Board Member Sues to Stop Archipelago Merger*, N.Y. TIMES, May 10, 2005, at C2.
[68] Postelnicu, *supra* note 66.
[69] David Litterick, *NYSE Faces Lawsuit Over Merger Plan*, THE DAILY TELEGRAPH, May 10, 2005, at 28.
[70] Porter, *supra* note 67. (the lock-up and employee stock provisions have since been altered. *See infra* pp. 10-11.)
[71] *Id*.
[72] Farrell, *supra* note 64.
[73] Litterick, *supra* note 69.
[74] Postelnicu, *supra* note 66.
[75] Bloomberg News, *Possible Conflict Seen in Big Board Merger*, N.Y. TIMES, July 29, 2005, at C3.

advising agreement.[76] Justice Ramos rejected the NYSE Board's motion to dismiss.[77] On November 7, 2005 Higgins made a motion for a preliminary injunction to postpone the shareholder vote to approve the merger, a move which was criticized by NYSE spokesman Richard Adamonis as "wrong and . . . an affront to shareholder democracy."[78] Higgins also requested at that time that the court appoint an independent board to review the merger.[79]

The NYSE altered the merger agreement from the terms announced in April.[80] The changes were included in an 844-page description of the proposed merger filed with the SEC,[81] which the commission subsequently approved.[82] Thain announced that changes to the deal were made in response to members' objections[83] and that members would now only be restricted from selling their stock for three years instead of the previous five year restriction.[84] The exchange has also announced the possibility of allowing shareholders to sell $1 billion to $2 billion of their new stock immediately after the merger during a potential secondary offering.[85] Under the new terms, the members can also "change the mix of stock and cash they receive" in the deal,[86] but the total amount of 70% of the $6 billion deal valuation, remained the same.[87] Thain has said the amount is fair to NYSE members especially in light of the projections that NYSE will contribute sixty five percent of the NYSE Group's 2007 earnings.[88] Additionally, the stock held for NYSE employees was reduced from five percent to one percent, and Thain

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[76] Bloomberg News*, A Conflict of Interest? Judge Will Look Closely at NYSE Executive's Links to Financial Advisers and His Actions in Deal to Acquire Archipelago*, NEWSDAY, July 29, 2005 at A56.
[77] Bloomberg News, *Big Board to Face Lawsuit on Merger*, N.Y. TIMES, Sept. 2, 2005, at C5.
[78] Bloomberg News, *NYSE Group Seeks Delay on Archipelago Vote*, CHI. TRIB., Nov. 9, 2005, at C3.
[79] *Daily Briefing*, THE ATLANTA J. CONSTITUTION, Nov. 9, 2005 at 2C.
[80] Reuters, *NYSE Alters Deal with Archipelago,* L.A. TIMES, July 22, 2005, at C4.
[81] Farrell, *supra* note 64.
[82] *Daily Briefing*, THE ATLANTA J. CONSTITUTION, Nov. 4, 2005 at 2F.
[83] Reuters, *supra* note 80.
[84] *Id.*
[85] Jenny Anderson, *Members Are Told of Plan for Sale of Big Board Stock*, N.Y. TIMES, Oct. 8, 2005, at C4.
[86] Reuters, *supra* note 80.
[87] Farrell, *supra* note 64; *see also id*.
[88] David Wighton, *NYSE Woos Members Over Dollars 6bn Merger Archipelago*, FIN. TIMES, July 22, 2005, at 20.

eliminated himself from the program stating, "[b]y eliminating myself…I was able to advocate for it without benefiting from it."[89]

Although the alterations addressed some of Higgins' criticisms, his lawsuit nevertheless moved forward. NYSE Chairman Marshall Carter released a memorandum on November 10, 2005 calling the lawsuit "baseless" and stated that the costs of defending the suit were approaching $7 million.[90]

Ultimately, the lawsuit concluded in settlement just prior to the NYSE member vote on December 6, 2005.[91] In the settlement, reached on November 15, both sides agreed to the performance of an independent valuation of the deal.[92] Justice Ramos approved the agreement on December 5 and directed that the NYSE shareholder vote on the merger proceed as planned the following day.[93]

F. Structural Changes Result in Transition from the NYSE to the NYSE Group

The merger, approved by NYSE members on December 6,[94] closed March 7, 2006[95] to form NYSE Group, Inc., a for-profit holding company.[96] NYSE members overwhelmingly favored the merger with 95.4% of the 1307 members voting for the merger.[97] It is a "stock for membership merger," meaning the merger agreement provided that NYSE members received cash and stock in consideration for relinquishing their seat[98] this resulted in $5.52 million per seat.[99] ArchEx shareholders received a one for one

[89] Farrell, *supra* note 64.
[90] Gaston F. Ceron, *NYSE Chief Rips Challenge to Archipelago Merger*, CHI. SUN-TIMES, Nov. 11, 2005, at 80.
[91] Bloomberg News, *Judge Backs Big Board*, N.Y. TIMES, Dec. 6, 2005, at C6.
[92] Jenny Anderson, *Big Board Settles with Dissidents Opposed to Planned Merger*, N.Y. TIMES, Nov. 16, 2005, at C4.
[93] Bloomberg News, *supra* note 91.
[94] John Authers, *NYSE Members Back Archipelago*, FIN. TIMES, Dec. 8, 2005, at 24.
[95] News Release, NYSE Group, New York Stock Exchange/Archipelago Holdings Merger Complete (Mar. 7, 2006) *available at* http://www.nyse.com/Frameset.html?displayPage=/press/PressReleases.html.
[96] *See* News Release, Archipelago, *supra* note 10.
[97] John Authers, *supra* note 94.
[98] *See* News Release, Archipelago, *supra* note 10.
[99] Adam Shell, *Taking Stock of – and in –the New York Stock Exchange: The Big Board Becomes a Publically Traded Company Today*, USA TODAY, Mar. 8, 2006, at B1.

exchange of stock equaling thirty percent of the new entity.[100] The rights to trade now take the form of licenses under the new company and were sold via a Dutch Auction from which the NYSE announced it raised $62.8 million in the initial sale.[101] The NYSE established a maximum bid price of $73,935 which represents a 20% premium over the average lease price of exchange seats and a minimum bid of $49,290 which is a 20% discount on the average lease price.[102] Initially, the licenses are starting off at one year terms in order to keep the system as similar as possible to the previous operations.[103] The exchange plans to cap the number of licenses at 1,366, the number of seats that existed prior to the merger.[104]

Thain became CEO of the new company, while former ArcaEx CEO Jerry Putnam is President and Co – Chief Operating Officer along with Catherine R. Kinney retaining her prior title with NYSE.[105]

NYSE Group trades under NYX and has a market capitalization of approximately 12.6 billion.[106] Shares rose 19% on the first day of trading, March 8, 2006, to $80 per share.[107]

Christine Langowski[108]

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[100] Jerry Knight, *Stock Markets on the Open Market: Exchanges Go Public, Generate Windfalls,* WASH. POST, Feb. 20, 2006, at D1.
[101] Bloomberg News, *Big Board Member Sells Licenses*, N.Y. TIMES, Jan. 5, 2006, at C5.
[102] News Release, NYSE, NYSE Inaugural "SEATS" Auction Produces 1,274 Trading Licenses at Annual Price of $49,290 Each (Jan. 4, 2006) *available at* http://www.nyse.com/Frameset.html?displayPage=/press/PressReleases.html (the average lease price of seats refers to the average price of seats with lease dates beginning during a six month period ending October 31, 2005).
[103] John A. Thain, CEO, NYSE, Inc., Keynote Address to the Investment Company Institute (ICI) 2005 Equity Market Conference (Sept. 22, 2005) (transcript *available at* http://nyse.com/Frameset.html?displayPage=/content/articles/1127471919568.html).
[104] *Id.* (approximately 200 of the 1366 seats were not currently in use).
[105] NYSE Group, Mangement Team, http://www.nyse.com/corpgovernance/1140482730419.html (last visited Mar. 30, 2006).
[106] Tribune News Services, *NYSE Group Surges in 1st Day Trading; Analysts Don't Share Investors' Enthusiasm*, CHI. TRIB., Mar. 9, 2005, at C3.
[107] Jenny Anderson, *Big Board Shares Traded for the First Time*, N.Y. TIMES, Mar. 9, 2006, at C11.
[108] Student, Boston University School of Law, (J.D. 2007).

X. WAL-MART'S INDUSTRIAL LOAN COMPANY

A. Introduction

Wal-Mart Stores, Inc. ("Wal-Mart") is a Delaware corporation engaged in retail sales.[1] Wal-Mart filed an application with the Federal Deposit Insurance Corporation ("FDIC") in July, 2005, proposing to open an industrial loan company in Utah under the Utah Revised Business Corporation Act to act as the exclusive provider for payment transactions for Wal-Mart stores.[2] The proposed bank ("the Bank") will not be open to the public and the application on file states that it does not seek to open branches beyond its headquarters in Salt Lake City, Utah.[3] There is fear on many fronts, however, that this will serve as the first step in Wal-Mart's attempt to gain a strong foothold in the financial sector.

B. Wal-mart's First Failed Attempt to Create an Industrial Loan Company

In 2002, Wal-Mart unsuccessfully attempted to acquire an industrial loan company in California.[4] The principal reason for Wal-Mart's failure in this first attempt was intense opposition from the Independent Community Bankers of America ("ICBA").[5] In California, Wal-Mart sought to buy an existing bank that already had branches and some commercial banking functions.[6] In Utah, however, Wal-Mart is seeking to create a new bank which at this point is only meant to be used for "back office" transactions.[7] This is a different application in its scope than the one filed in California although the ICBA is again opposed to the move for many of the same reasons.[8] This time, the opposition is based on a perceived

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[1] FDIC APPLICATION VOLUME 1, http://www.fdic.gov/regulations/laws/walmart/Pages%20from%20Wal-Mart_Federal_Deposit_Insurance_Application_Public_File_1.pdf

[2] FDIC website, http://www.fdic.gov/regulations/laws/walmart/.

[3] FDIC APPLICATION VOLUME 1, *supra* note 1.

[4] Rob Blackwell, *Wal-Mart After ILC Again, This Time in Utah*, AM. BANKER, Mar. 8, 2005 at 1.

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] Independent Community Bankers of America, Advocacy: Keep Wal-Mart out of Banking,

threat to community banks and the nexus of commercial and financial sectors which they feel is inconsistent with history and harmful for commerce.[9]

An industrial loan company ("ILC"), as defined by federal statute, is a state organized bank that does not transact in demand deposits and is not allowed to incur any overdrafts on its accounts.[10] These banks must have less than $100 million in assets unless the bank was acquired prior to August, 1987.[11] Despite sometimes being referred to as an industrial bank, the Bank Holding Company Act lists ILCs as an example of a financial institution that is not, in fact, a bank.[12] An ILC must have FDIC insurance, but does not have many of the other rights or obligations of typically defined banks and currently is still very lightly regulated.[13]

C. Wal-Mart's Current Application to the FDIC

According to the application filed with the FDIC, the functions of the Bank will be to provide Wal-Mart with access to the Automated Clearing House network so that they can present, process and settle checks as well as present, process and settle point of sale PIN transactions made with authorized debit cards.[14] The application for the Bank intends to offer short-term certificates of deposit to registered 501(c)(3) charitable organizations for the benefit of the local community as well as issuing some certificates to individual investors via deposit brokers.[15] Additionally, the Bank seeks to be a depository institution member of the Visa and Mastercard networks in order to aid in the processing and settling of point of sale credit card transactions.[16]

In practice, permission to perform these functions will mean that instead of Wal-Mart paying a small acquiring fee per transaction to the banks for every check and credit card purchase made, that money will go directly to the Wal-Mart Bank and subsequently back

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http://www.icba.org/advocacy/index.cfm?ItemNumber=14984&sn.ItemNumber=1710 (last visited Nov. 16, 2005).

[9] *Id.*

[10] Bank Holding Companies, 12 U.S.C. § 1841(c)(2)(H) (2000).

[11] *Id.*

[12] *Id.* § 1841(c)(2).

[13] *Id.* § 1841(c)(2)(H).

[14] FDIC APPLICATION VOLUME 1, *supra* note 1.

[15] *Id.*

[16] *Id.*

into the company.[17] This acquiring fee is different than the actual processing of payments, which will still be done by outside banks and produces the vast majority of the profits from transactions.[18] If acquiring fees remain the only practical function of the proposed Bank, as Wal-Mart is currently suggesting, this will bring in between $5 and $50 million annually based on their projected 2005 net income of $10 billion.[19] Some observers have questioned this relatively small benefit in light of the amount of work required by Wal-Mart to gain this charter and suspect that this application is a step in a much larger plan.[20]

At this stage, the Bank does not intend to offer any lending services and consequently does not anticipate competing with existing local banks for loans in the proposed market.[21] For this reason, those applying for the Bank do not believe that it must fit within the guidelines of the Community Reinvestment Act.[22] The Community Reinvestment Act of 1977 is a regulatory statute whereby the regulatory agencies are charged with deciding whether the Bank equally serves consumers of varying incomes and demographics in terms of lending activities.[23]

The application states that Wal-Mart will be the Bank's only customer and the Bank will not seek out additional customers, therefore, Wal-Mart claims that the only possible negative impact is on those organizations who currently provide banking services to Wal-Mart.[24] Wal-Mart executives have also pointed out that it is unlikely that a competitor corporation would want to use Wal-Mart's acquiring services because they would be afraid of having transactional information in the hands of a competitor.[25] The application also points out that the opening of the Bank will provide jobs to the local economy and the headquarters will absorb empty office space in the Salt Lake City area.[26] In addition the application proposes that the Bank will conduct financial planning workshops at

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[17] David Breitkopf, *Wal-Mart's Financial Vision: In Payments Spotlight on an ILC's Role*, AM. BANKER, Oct. 5, 2005 at 1.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] FDIC APPLICATION VOLUME 1, *supra* note 1at 6-7.
[22] *Id* at 8.
[23] JONATHAN MACEY, GEOFFREY MILLER, & RICHARD SCOTT CARNELL, BANKING LAW AND REGULATION 29 (Aspen Publishers 2001).
[24] FDIC APPLICATION VOLUME 1, *supra* note 1 at 7.
[25] Breitkopf, *supra* note 17.
[26] FDIC APPLICATION VOLUME 1, *supra* note 1 at 7.

the expense of its parent corporation for unbanked and underbanked populations in the local community.[27]

The proposed management structure for the Bank includes a five member Board of Directors.[28] The directors are required to be residents of Utah and are required to have neither employment nor any other relationship with Wal-Mart.[29] The Board of Directors will include at least three separate committees comprised of at least three members each: the Audit Committee; the Asset/Liability Management Committee; and the Information Technology Committee.[30]

The Bank's Board of Directors proposes the authorization of 1000 shares of a single class of common stock valued at $1.00 per share to be offered exclusively to Broadstreet, the Bank's parent corporation.[31] Wal-Mart, acting as a parent corporation, promises that the Bank will be well capitalized within the FDIC requirements and that the Bank will not distribute dividends for at least the first three years of its existence in compliance with regulations.[32]

D. Comments

As of October 15, 2005, over 1,100 comment letters have been submitted to the FDIC in reference to this endeavor.[33] This is significantly more than any past application, with the average number of comment letters generally being closer to six per application.[34] The vast majority of these letters arrived after the FDIC extended the deadline for submission one month from August 24 to September 23, 2005.[35] These letters come from a wide variety of sources including local and national banks and trust companies, CEOs and other executives in the financial industry, bankers associations, elected representatives and private citizens concerned

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[27] *Id* at 8.
[28] *Id.* at 1.
[29] *Id.*
[30] *Id.* at 3.
[31] *Id.* at 5.
[32] *Id.* at 6.
[33] Michael Barbaro, *Bankers Oppose Wal-Mart as Rival*, N.Y. TIMES, Oct. 15, 2005, at C1.
[34] *Id.*
[35] Luke Mullins, *Extension: And 14 ILC Comments Become 700*, AM. BANKER, Sept. 27, 2005 at 1.

with the Bank's impact in the local community.[36] Although not unanimous, the vast majority of these letters oppose the issuance of deposit insurance to the proposed Bank.[37] The reasons for this opposition are varied, but consistent themes are issues relating to lack of disclosure about the intentions behind this enterprise, the application (or lack thereof) of the Community Reinvestment Act, the possible impact on the federal deposit insurance system, worries about future forays into other areas of the financial and banking industries, as well as beliefs in the separation of banking and commerce.[38]

Several comment letter writers, including a bipartisan Committee on Financial Services lead by Democratic Congressman Barney Frank and Republican Congressman Paul Gilmor, have called on the FDIC itself to release more information about the application and have called for an extended hearing process in order for the public to weigh in.[39] The congressmen say that Wal-Mart has indicated in the past that it would like to expand into other areas of the banking industry and are concerned that if this intention was carried out it would have a significant impact on the public at large.[40] They say that it is too difficult to tell from the bare bones business plan included in the available sections of the application what the future intentions of the company may be.[41] They also object to the proposed exemption from the Community Reinvestment Act because, the congressmen point out, if the Wal-Mart Bank plans to accept deposits from non-profit organizations through a broker, they will be taking business away from other institutions that are subject to the Act.[42]

The largest demographic represented in the vast collection of comment letters are smaller community banks, such as the Greenville Community Bank in Missouri and the Farmers State Bank in Minnesota, which fear that Wal-Mart will have an adverse effect on

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[36] *See, Wal-Mart Comment Letters,* FDIC WEBSITE, http://www.fdic.gov/regulations/laws/walmart/comment_letters/index.html
[37] *Id.*
[38] *Id.*
[39] Letter from Barney Frank and Pal Gilmor to Donald Powell, Chairman of FDIC (Sept. 23, 2005), *available at* http://www.fdic.gov/regulations/laws/walmart/comment_letters/Congressmen_B_Frank_and_P_Gillmor_September_23.pdf.
[40] *Id.*
[41] *Id.*
[42] *Id.*

community banking.[43] These letters point to the negative effects Wal-Mart will have on local small businesses in its capacity of a retailer by using its size to undercut prices.[44] The authors question whether granting a banking charter could eventually cause similar effects on small banks.[45] Most of these comments are based upon an assumption that if Wal-Mart receives this charter they will inevitably break into more traditional banking activities beyond those that are outlined on the available application.[46]

There have only been a few letters written in support of granting the charter and have mainly been written by non-affiliated members of the public who feel that Wal-Mart has done a good job in the retail sector and should be given the chance to serve their customers' needs for banking products.[47] These writers say that concerns about the risks involved in allowing a commercial enterprise to participate in the FDIC are unfounded because there has never been any indication that Wal-Mart has been or will be financially unsound.[48] Some feel small banks are worried simply about losing the fee income they receive from credit card and check transactions.[49]

ILCs are only permitted to exist in three states: California, Utah, and Colorado and each state has its own interpretation of this model.[50] Utah adopts all the above listed requirements of its ILCs in its own state statute.[51] As a result of not being a widely used

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[43] Letter from Greenville Community Bank to John F. Carter, Regional Director of FDIC (Sept. 20, 2005), *available at* http://www.fdic.gov/regulations/laws/walmart/comment_letters/Greenville_Community_Bank_September_26.pdf; Letter from Mark Nowak, Senior Lender Farmers State Bank, to John F. Carter, Regional Director of FDIC (Sept. 19, 2005), *available at* http://www.fdic.gov/regulations/laws/walmart/comment_letters/Farmers_State_Bank_of_Hartland_3_September_26.pdf.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *See* Letter from Stephen B. Bernthal to John F. Carter, Regional Director of FDIC (Aug. 22, 2005), *available at* http://www.fdic.gov/regulations/laws/walmart/comment_letters/S_B_Bernthal_August_29.pdf ; Letter from Adam Scavone to FDIC (Aug. 20, 2005) *available at* http://www.fdic.gov/regulations/laws/walmart/comment_letters/AScavone_August_20.pdf.
[48] *Id.*
[49] *Id.*
[50] Gerard Comizio, *Bank Chartering Issues in the New Millennium: Comparing Depository Holding Companies and Bank Charters*, 56 CONSUMER FIN. L.Q. REP. 153, 161 (Spring 2002).
[51] UTAH . CODE. ANN. Financial Institutions Act. 1953 § 7-8-21 (2004).

mechanism there are very few regulations and little legislation on ILC's and the recent application by Wal-Mart has coincided with concern in Congress and the Federal Reserve over the future of these institutions.[52] One of the areas of greatest concern is the oversight of these institutions, which represent one of the only methods a commercial entity can attain a bank charter.[53] ILCs are controlled by a commercial parent such as Wal-Mart and although the FDIC may examine the inner workings of the ILC itself, the ILC does not have capital requirements and the FDIC cannot monitor its parent corporation thoroughly.[54] Some lawmakers fear that financial trouble for the parent corporation could trickle down and cause problems and even bank failure for the ILC, which would consequently burden the whole FDIC system.[55]

The FDIC is guided in its decision by Sections 4, 5, and 6 of the Federal Deposit Insurance Act ("FDIA") regarding the admission of banks to the federal deposit insurance and the criteria to be examined.[56] Section 6 of the FDIA lists the factors considered by the FDIC in their evaluation, which include 1) the financial history and condition of the depository institution; 2) the adequacy of the depository institution's capital structure; 3) the future earnings prospects of the depository institution; 4) the general character and fitness of the management of the depository institution; 5) the risk presented by such depository institution to the Bank Insurance Fund or the Savings Association Insurance Fund; 6) the convenience and needs of the community to be served by such depository institution; and 7) whether the depository institution's corporate powers are consistent with the purposes of this Act.[57]

E. Conclusion

A decision is expected from the FDIC in July 2006 and the FDIC is not indicating that there will be any nationwide hearings at this point.[58] It is very rare that the FDIC would deny an application, but even if Wal-Mart passes this hurdle, they will still have to gain

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[52] Ethan Zindler, *More Voices Calling for Closer ILC Oversight*, AM. BANKER, Sept. 23, 2005 at 1.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] FDIC WEBSITE, http://www.fdic.gov/regulations/laws/rules/1000-100.html.
[57] *Id.*
[58] Barbaro, *supra* note 33.

permission from Utah state authorities.[59] Although it is unclear what decision the FDIC will make, it is certain that the outcome of this application will have notable effects on Wal-Mart and the commercial world at large. Even if it has no other consequences, the approval of this application will surely put a few cracks in the wall that separates banking and commerce in America.

Nicola Leiter[60]

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[59] *Id.*

[60] Student, Boston University School of Law J.D. (2007)

XI. CONSUMER PRIVACY LAW

A. Introduction

In today's highly sophisticated global economy, the ability to access information has never been easier. The days of consumer privacy are waning with hackers possessing more tools at their fingertips, using their abilities to snatch thousands of individuals' personal information from computer databases. No one seems to be immune to these attacks - a firm whose primary source of business is securing computer databases and selling anti-theft software to law enforcement agencies recently became a victim of a severe hacker breach.[1] With incidents such as these on the rise in recent years, citizens are beginning to demand prompt federal corrective action.[2]

B. Existing Federal Statutes

Existing privacy protection from a federal perspective begins with the Fair Credit Reporting Act ("FCRA").[3] The statute was enacted in 1970 to promote accuracy, fairness and the privacy of personal information assembled by Credit Reporting Agencies ("CRA").[4] These organizations assemble credit reports on individuals for businesses, including credit card companies, bank employers, landlords and others.[5] The FCRA was the first federal law to regulate the use of personal information by private businesses.[6] The FCRA's primary protection requires that CRA follow "reasonable procedures" to protect the confidentiality, accuracy and relevance of credit information.[7] To comply with this requirement, the statute establishes a framework of Fair Information Practices for personal information that include rights of data quality, data security, use limitations, requirements for data destructions, user participation and accountability.[8] The Federal Trade Commission

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[1] *Hacker Cracks Police Force Network*, TORONTO STAR, Dec. 26, 2005, at A19.
[2] *Financial Data Protection: Hearing on H.R. 3997 Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Financial Services Comm.*, 109th Cong. (2005) (statement of Evan Hendricks, Editor, Privacy Times).
[3] Fair Credit Reporting Act, 15 U.S.C. § 1681 (2004).
[4] Electronic Privacy Information Center, FCRA and Credit Report Privacy Page, http://www.epic.org/privacy/fcra/ (last visited Oct. 7, 2005).
[5] 15 U.S.C. § 1681.
[6] Electronic Privacy Information Center, *supra* note 4.
[7] 15 U.S.C. § 1681.
[8] *Id.*

("FTC") issues commentaries on the statute, but does not engage in any formal rulemaking.[9] The statutory scheme, however, has been ineffective in preventing and stopping privacy breaches.

C. Security Breaches

Unfortunately, 2005 was a banner year for consumer privacy violations. According to the San Diego-based Privacy Rights Clearinghouse, there were more than eighty major data breaches after February 2005 involving the personal information of more than fifty million people.[10] Earlier that year, ChoicePoint, a large data broker, raised public awareness of the problem when it announced that thieves had fraudulently obtained information on 145,000 consumers.[11] In August, the U.S. Air Force reported a data breach in which a hacker may have gained access to a military management database and personal information on 33,000 officers.[12]

The largest data breach of 2005 occurred in June, when information from forty million MasterCard and Visa credit accounts was stolen by hackers who broke into the network of third-party transaction processor, CardSystems Solutions Inc.[13] Most of the other episodes pale in comparison, but they are just as potentially harmful to the people whose information was stolen.[14] But of all the recent, high-profile mishaps, surprisingly, a series of relatively minor incidents has riled many security experts the most.[15] The first was in February 2005, when Bank of America Corp. revealed that credit card information on 1.2 million federal employees had been mislaid en route to a storage facility.[16] One month later, a container of backup computer tapes containing personal information on 600,000 current and former Time Warner Inc. employees was lost in transit

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[9] Electronic Privacy Information Center, *supra* note 4.

[10] *Financial Data Protection: Hearing on H.R. 3997 Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Financial Services Comm.*, 109th Cong. (2005) (statement of Evan Hendricks, Editor, Privacy Times).

[11] Tom Zeller Jr., *Data Theft Prompting A Drive For Legislation; Industry Seeks to Limit Impact of Rules*, INT. HERALD TRIBUNE, Nov. 2, 2005, at 14.

[12] *Id.*

[13] Jeffrey Rothfeder, CIO Insight, Double Identity , http://www.cioinsight.com/article2/0,1397,1855967,00.asp. (last visited Sept. 5, 2005),

[14] *Id.*

[15] *Id.*

[16] *Id.*

between New York City and a storage facility in New Jersey.[17] The tapes included Social Security numbers and other data pertaining to such company celebrities as former CEO Jerry Levin and former Chairman Steve Case.[18] Soon thereafter, backup customer account files belonging to City National Bank also disappeared after they had been put on a truck for shipment to a data repository.[19]

Each of these three cases is still unexplained, and it is still unclear whether the records were actually stolen or simply mishandled.[20] Although little harm appears to have been done by these episodes, they were nonetheless disturbing.[21] Ironically, the culprit in all of these episodes was Iron Mountain Inc., a Boston based records-management company that has built a reputation as the premier protector of essential corporate assets.[22]

D. Consumers Demand Action

This unfortunate string of highly publicized data-security breaches has heightened Americans' concerns as well as their demands for better privacy protections. According to a September poll conducted jointly by CBS News and The New York Times, eighty nine percent of respondents were concerned about the theft of their Social Security number, credit card numbers and other identity numbers.[23]

Not surprisingly, businesses and banks specifically, face a tremendous cost in the face of potential security breaches – losing customers. As the 2005 EDS Financial Services Privacy and Customer Relationship Management Survey revealed, banks face greater risks of losing customers when they do not secure customers' personal information.[24] According to a survey of 610 American consumers, 30% said that if there were security breaches at their banks, they would close all their accounts at their banks and move

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[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Financial Data Protection: Hearing on H.R. 3997 Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Financial Services Comm.*, 109th Cong. (2005) (statement of Evan Hendricks, Editor, Privacy Times).
[24] Joe Fleischer, *Safeguard Customers' Data and You Secure Customers' Trust*, CALL CENTER, Nov. 1, 2005, at 18.

their assets elsewhere.[25] Respondents also cited security breaches and misuse of their personal information as the primary risks of banking on-line.[26]

E. Recent State Legislation in Action

Fortunately, some states are fighting back, enforcing recently passed statutes in order to protect consumers. Kentucky Attorney General Greg Stumbo announced on September 29 the filing of a consumer protection lawsuit which alleged violations of the Telemarketing No Call List as well as violations of the state's Consumer Protection Act.[27] In addition, the Attorney General reported that complaints in Kentucky have declined for the third straight year since the law's passage in 2002.[28]

Besides Kentucky, California has also taken the initiative to protect consumers at large. In 2005, California's security breach notification law has alerted experts to 100 breaches in the state.[29] Because states have demonstrated such leadership on security breach notification laws, Ed Mierzwinski, the consumer program director of the United States Public Interest Research Group, believes the federal government should only pass legislation that would maintain a federal floor, and would not pre-empt states from continuing to go further with tougher legislation.[30]

F. The States or the Federal Government: Who Should Protect Consumers?

Current federal legislation in the form of the Fair and Accurate Credit Transactions ("FACT") Act allows states to go further in security and identity theft areas.[31] Under the FACT Act, a

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[25] *Id.*
[26] *Id.*
[27] *Attorney General Stumbo Sues for Violations of Kentucky No Call List*, STATE NEWS SERVICES, Sept. 29, 2005, *available at* 2005 WLNR 15412360.
[28] *Id.*
[29] *Hearing of the Senate Banking, Housing and Urban Affairs Comm: The Financial Service Industry's Responsibilities and Role in Preventing Identity Theft and Protecting Sensitive Financial Information*, 109th Cong. (2005) [hereinafter *Hearing*] (statement of Ed Mierzwinski, Consumer Program Director, U.S. Public Internet Research group).
[30] *Id.*
[31] The Fair and Accurate Credit Transactions Act, 15 U.S.C. § 1601 (2004).

dozen of states have enacted credit freeze legislation.[32] Credit freezes give consumers the right to freeze access to their credit report for any new creditors.[33] It essentially leaves the thieves out in the cold, but an individual's existing creditors can still look.[34]

In support of a federal standard, Ira Hammerman, Senior Vice President and General Counsel of the Securities Industry Association, urged that the problem of data security is a distinct federal responsibility.[35] He believes that the expanding patchwork of state and local laws affecting data security and notice will make effective compliance very difficult for the industry and equally confusing for consumers.[36] The American Bankers Association ("ABA") has also come out in support of a federal, uniform approach to information security.[37] The ABA believes that state laws are widely inconsistent, resulting in both higher costs and uneven consumer protection.[38]

Reversing an earlier position, Microsoft Corp. has also come out in support of a single federal consumer privacy statute, saying that there are too many privacy provisions in other laws and states that are hampering American business.[39] In a speech and in an accompanying white paper, Microsoft general counsel Brad Smith said a "bewildering jumble of overlapping state and federal laws" is creating consumer confusion and "major challenges for businesses trying to comply."[40] Microsoft believes that any federal law should pre-empt any state law that purports to do the same thing.[41] The company previously backed industry self-regulation, but in light of the recent fears of privacy leaks among consumers, they believe a federal statute is in order.[42]

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[32] Hearing, *supra* note 29 (statement of Ira Hammerman, Senior Vice President, Securities Industry Association).
[33] *Id.*
[34] *Id.*
[35] *Id.*.
[36] *Id.*
[37] Hearing, *supra* note 29 (statement of Oliver Ireland, Partner, Morisson Foerster).
[38] *Id.*
[39] *Microsoft Lobbies for U.S. Privacy Law*, DATAMONITOR, Nov. 4, 2005.
[40] *Id.*
[41] *Id.*
[42] *Id.*

G. Proposed Federal Legislation

In response to proponents of federal legislation, more than a dozen bills addressing privacy have been introduced in Congress this year.[43] Some have failed to gain bipartisan support, such as a far-reaching bill introduced by Senator Charles Schumer.[44] Others have been underwhelming, such as a bill introduced by Senator Jeff Sessions that simply requires businesses to improve security on the data they carry and to notify consumers only if there is a significant risk of identity theft.[45] Whether any bill will pass is an open question although the public pressure is on.[46]

1. The Data Accountability and Trust Act

On October 26, Representative Clifford Stearns introduced the Data Accountability and Trust Act ("DATA"), which proposes tough new regulations for data brokers.[47] The bill would force companies handling consumer data to, among other things, appoint a data security officer, draft explicit security policies and submit them to the FTC, offer consumers access to their own files and create a produce for correcting errors.[48] DATA would also require companies to notify not just consumers of a breach but also the FTC, which would then be permitted to audit the company's security program.[49] However, according to Joseph Ansanelli, the Chief Executive Officer and co-founder of Vontu, an information security company in California, DATA still needs to refine its enforcement language.[50]

2. The Personal Data and Security Privacy Act of 2005

The most far-reaching of the dozen or so proposed federal bills is the Personal Data and Security Privacy Act of 2005 cosponsored by Republican Senator Arlen Specter, chairman of the

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[43] Zeller Jr., *supra* note 11.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*, H.R. 4127, 109th Cong. (2005).
[48] Zeller Jr., *supra* note 11.
[49] *Id.*
[50] *Id.*

Judiciary Committee, and Senator Patrick Leahy, the committee's ranking Democrat.[51] If this bill passes in anything like its current form, it could affect companies in much the same way Sarbanes-Oxley affected the accounting industry.[52] The Specter-Leahy bill would require new and sometimes expensive procedures and systems to protect confidential data, just as Sarbanes-Oxley does in the realm of accounting.[53] While the price tag to safeguard private information will not be as high as it was to reorganize accounting systems, the change in the way companies operate could just be as radical.[54] Senator Leahy stated, "Reforms like these are overdue. Insecure databases are now low-hanging fruit for hackers looking to steal identities and commit fraud. The Specter-Leahy bill provides tough monetary and criminal penalties for compromising personal data or failing to provide necessary protections. This creates an incentive for companies to protect personal information."[55]

Businesses are paying the closest attention to Title IV of the Specter-Leahy bill.[56] This section requires that companies involved in interstate commerce and have at least 10,000 files on individuals in digital form, design a data security program that ensures confidentiality of sensitive records and protects against unauthorized access and use of personally identifiable information.[57] Such companies must publish their data privacy procedures and regularly conduct tests to assess system vulnerabilities.[58] Businesses that violate these rules could face fines and government prosecution.[59]

3. The Financial Data Protection Act

As opposed to the Specter-Leahy Bill, the most controversial proposed legislation, the Financial Data Protection Act, H.R. 3997, has a rather lenient notice requirement.[60] A consumer would be notified of a breach only if the company decides that the information obtained is reasonably likely to be misused in a manner causing

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[51] Rothfeder, *supra* note 13, S. 1789, 109th Cong. (2005).
[52] Rothfeder, *supra* note 13.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] H.R. 3997, 109th Cong. (2005).

substantial harm or inconvenience against consumers to commit either identity theft or to make fraudulent transactions on financial accounts.[61] Privacy supporters argue that the fact that the companies do not yet know whether or how the information will be misused should not be enough to excuse notice.[62] Besides the notice requirement, another area in which privacy experts assert H.R. 3997 is deficient is in the proposed law's definition of substantial harm or inconvenience.[63] As currently written, the definition does not include changing a financial account number or closing a financial account.[64]

An overwhelming majority of state attorney generals have opposed this bill.[65] Their complaint is the fact that H.R. 3997 would preempt state power to enact and enforce existing state breach notifications and security freeze laws.[66] Attorney Generals from forty-seven states and the Hawaii Office of Consumer Protection wrote to House leaders, asserting that Rep. LaTourette's legislation fails to meet standards for a strong national law.[67] The group wants consumers to get notice anytime a breach occurs, without proof of potential for actual harm.[68] Banks and credit card firms respond to this opposition, claiming mailboxes would be stuffed with notices, causing consumers to ignore an important notice about their data being hijacked.[69]

Vermont Assistant Attorney General Julie Brill disagrees with the industry, arguing "the benefit of the doubt should be given to the consumer."[70] Attorney Generals also want the ability to enforce any federal law, but H.R. 3997 does not give them that right.[71] They claim that this is inconsistent with the aforementioned FACT Act, which gives state attorney generals some enforcement

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[61] *Financial Data Protection: Hearing on H.R. 3997 Before the Subcomm. On Financial Institutions and Consumer Credit of the H. Financial Services Comm.*, 109th Cong. (2005) (statement of Evan Hendricks, Editor, Privacy Times).
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] Andrew Noyes, *State Preemption Problems Posed by Data Security Bill*, WASHINGTON INTERNET DAILY, Nov., 10, 2005 at 218.
[66] H.R. 3997, 109th Cong. (2005).
[67] Noyes, *supra* note 64.
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] H.R. 3997.

powers.[72] The FACT Act also lets states enact security freezes when necessary, a provision LaTourette's bill would also preempt.[73]

However, other witnesses endorsed H.R. 3997. The U.S. Chamber of Commerce said it offers a "sound framework for development of stronger consumer protection."[74] Chamber attorney Karl Kaufmann said that Congress should set a uniform national standard on data security, customer notice and related issues to be enforced solely by the appropriate federal agencies.[75] Witnesses from America's Community Bankers ("ACB"), the American Financial Services Association, and the Financial Services Coordinating Council also supported H.R. 3997.[76] The cost of protecting consumers from a breach worried ACB's Josie Callari, Senior Vice President of Astoria Federal & Loan.[77] Callari believes the congressional committee has taken the right first step, proposing to require the party responsible for the breach bear the cost of sending notices, but notices are only a small part of the cost.[78] Callari said that other costs include reissuing credit and debit cards and closing accounts at risk.[79] For a community bank with thousands of cards affected, those costs can mount quickly and fall upon in the institution.[80]

H. Conclusion

The debate continues on what mix of regulations will balance the needs of privacy, security and costs. Industry representatives and privacy experts continue to clash over whether a single federal law is the optimal structure, ensuring consistency across the board, or whether a combination of state and federal regulations will better serve the needs of the public.

Stephen Schauder[81]

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[72] Noyes, *supra* note 64.
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] Stephen Schauder, Boston University School of Law, (J.D. 2007).

XII. SECURITY WITH ONLINE BANKING

A. Introduction

With the increase in use of online banking, there has been an increase in the frequency and complexity of online criminal conduct aimed at persuading unsuspecting people to divulge their personal information.[1] This includes data such as social security numbers, bank account numbers and credit card information.[2] Therefore, banks and other businesses that provide online services, both independently and as a result of political pressure, have increased the sophistication of their security systems. As this area of law is in its infancy, there is an ongoing development of regulations and security practices in order to secure the personal information of online banking customers. In 2005 there were several significant advances in this area, including proposed legislation, Federal Trade Commission ("FTC") recommendations, new security tactics employed by the private sector and lawsuits by individual customers against breaching companies.

B. Background Information

Over fifty-three million people, approximately forty-four percent of all internet users, habitually view their bank statements online.[3] Almost half the customers of large financial institutions pay bills online.[4] However, about half of U.S. consumers are reluctant to bank online for fear of losing their personal information.[5] Loss of personal information can result in identity theft and access theft.[6] Identity theft occurs when identity data is stolen and used for a fraudulent purpose, like applying for a credit card.[7] Access theft occurs when a thief steals access data and uses it to move money in online banking.[8] Access theft tends to cause more instantaneous

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[1] Matthew T. Mangino, *Phishing for Victims: Prosecuting Internet Scam Could Protect Millions of Consumers*, PA. L. WKLY., Jan. 17, 2005, at 8.
[2] *Id.*
[3] Eric Dash, *Personal Business; Paper or Online? Many Bank Customers Still Pick the Old Way*, N.Y. TIMES, Sept. 3, 2005, at C4.
[4] *Id.*
[5] Isabelle Lindenmayer, *Security Watch*, AM. BANKER, Sept. 9, 2005, at 5.
[6] Andy Cottrell, *Technology Can Make Life Hard for Phishers,* AM. BANKER, Sept. 9, 2005, at 12.
[7] *Id.*
[8] *Id.*

damage than identity theft.[9] Phishing, an example of access theft, "uses spoofed e-mails, purporting to be from reputable companies, requesting unsuspecting consumers to provide personal financial information."[10] Information, including a consumer's social security number, date of birth, credit card, and banking information, is provided to criminals who "use that information to access bank accounts, open credit cards and obtain bank loans."[11] The average loss per individual from phishing is $2,320.[12] Despite the alarming rise in online theft, criminals are still more likely to access account information through non-electronic means, such as stealing mail or wallets.[13] For example, a report from Javelin Strategy & Research revealed that where the source of the theft was known, it was almost seven times more likely that the information was obtained offline rather than online.[14] Moreover, the data showed that traditional crimes lead to greater losses.[15] Contrary to popular belief, online bill paying is considered more secure than paying bills via traditional mail because fewer people handle the transaction.[16]

Nevertheless, banks are concerned about the rise in online theft because online customers bring in more profits.[17] Also, the Federal Reserve Board's banking rule, Regulation E, requires banks to reimburse consumers for losses resulting from a bank's unauthorized electronic transfers.[18] It is estimated that large banks spend over one million dollars each month, while the largest banks may be spending over ten million dollars each month in meeting their fraud-protection promises.[19] Both these factors provide banks with great incentives to prevent online theft of their customers' personal information and data. Studies show that eighty-five percent of the forty largest banks have web sites warning customers about online

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[9] *Id.*
[10] Mangino, *supra* note 1, at 8.
[11] *Id.*
[12] Chris Costanzo, *Does Touting Web Safety Build Trust or Fear? Product/Service Evaluation*, AM. BANKER, June 21, 2005, at 14A.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] M.P. Dunleavey, *Basic Instincts; What to Do After Your Data is Stolen*, N.Y. TIMES, July 16, 2005, at C6.
[17] Dash, *supra* note 3, at C4.
[18] Will Wade, *Who's Liable in Web Fraud? Some Say Rules Lack Clarity*, AM. BANKER, March 9, 2005, at 13.
[19] *Id.*

risks.[20] Unfortunately, however, as the public becomes more educated about phishing and identity theft, criminals have become more adept at accessing personal information.[21] Now, criminals "phish" consumers who visit legitimate web sites.[22] For example, consumers may be directed to a phishers fraudulent site by entering a slight mistake in a valid web site address.[23] Alternatively, in some cases, even if the consumer enters the correct web address and gets to the legitimate site, a pop-up appears directing the person to a fraudulent web site where information is stolen.[24] Most recently, phishers scam online banking customers simply by having the customers open a fraudulent e-mail.[25] Even though a consumer does not click on one of the links, "once the email is opened, a script is run which will redirect the customer to a fraudulent website the next time the customer attempts to access his bank's legitimate website."[26] With these sophisticated developments in online banking identity and access theft, banks and consumers seek a uniform and effective method of prevention is necessary for all online service providers.[27]

C. Security Breach Prevention Measures

1. Government Driven Prevention

Government regulation is a major force in the advancement of security measures used to protect consumers from online theft. In October 2005, the Federal Financial Institutions Examination Council stated that banks will have to adopt increased security measures to prevent identity theft.[28] Federal regulators will require banks to examine specific transactions, such as "address changes, requests for replacement credit cards, and attempts to reactivate dormant credit card accounts," which are susceptible to security breaches [29] The Federal Deposit Insurance Corporation ("FDIC")

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[20] Costanzo, *supra* note 12, at 14A.
[21] Mangino, *supra* note 1, at 8.
[22] *Id.*
[23] Dash, *supra* note 3, at C4.
[24] Mangino, *supra* note 1, at 8.
[25] *Id.*
[26] *Id.*
[27] *See* Costanzo, supra note 12, at 14A.
[28] Isabelle Lindenmayer, *Security Watch*, AM. BANKER, Oct. 21, 2005, at 5.
[29] Isabelle Lindenmayer, *Inevitable: Rising Price Tag For Banks' Data Security*, AM. BANKER, Oct. 3, 2005, at 1.

also issued guidance for online identification.[30] Some of these guidelines include mandating use of both multifactor authentication and scanning software to guard against phishing.[31] Multifactor authentication has been termed the "gold standard of online security . . . [and] requires another piece of customer identification beyond user names and passwords."[32] Multifactor authentication uses "something you have and something you know" in order to access online resources.[33] To enforce compliance of these guidelines, it is likely that banks will face larger penalties for noncompliance; e.g., from $117 per breached file in 2002 to $1,500 per breached file in 2005.[34] In terms of legislation, a group of House Financial Services Committee members introduced legislation in October 2005requiring all entities handling sensitive consumer data to investigate breaches data and to notify a customer if such breach may result in identity theft.[35]

In addition to providing guidance to banks, the FTC provides information for individual consumers.[36] The FTC's brochure, "Take Charge: Fighting Back Against Identity Theft" advises consumers about different actions they can take to protect themselves, such as placing a fraud alert on their credit report, reviewing their credit report and freezing their credit reports.[37]

2. Market-Driven Prevention

Banks generally oppose legislative actions produced by high-profile identity theft cases.[38] Thus, market-driven innovation is another force in the development of this law.[39] For example, "Visa USA and MasterCard International have consolidated standards for merchants and banks to follow in securely storing customer data and testing websites for security holes."[40] Any merchant or bank that

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[30] Lindenmayer, *supra* note 28, at 5.
[31] Lindenmayer, *supra* note 29, at 1.
[32] Costanzo, *supra* note 21, at 14A.
[33] Cottrell, *supra* note 6, at 12.
[34]Lindenmayer, *supra* note 29, at 1.
[35] Isabelle Lindenmayer, *Security Watch*, AM. BANKER, Oct. 7, 2005, at 6.
[36] Dunleavey, *supra* note 16, at C6.
[37] *See id.*
[38] Byron Acohido & Jon Swartz, *Industry, Congress Develop Tactics to Reduce Online Risks*, USA TODAY, Nov. 3, 2005, at 2B.
[39] *See* Cottrell, *supra* note 6, at 12..
[40] Acohido & Swartz, *supra* note 38, at 2B.

does not comply could be assessed fines or denied the ability to process transactions with those credit card companies.[41]

In addition to market-driven innovation for the industry at large, individual companies established new security guidelines for themselves. Wells Fargo & Co. provides security warnings for customers, both online and offline.[42] In its prevention checklist, it advises people to use online statements and shred documents.[43] E-Trade Financial Corporation provides an alert to the consumer each time an account is used.[44] America Online announced that it has several new strategies to prevent phishing attacks.[45] Its methods include "analyzing suspicious URLs, Web crawling to look for suspicious sites, checking new domain names to see if they mimic legitimate site names, and blocking member access to phishing sites."[46]

Multifactor identification has advanced rapidly, using physical second factors, like password tokens or USB sticks.[47] In March of 2005, E-Trade Financial Corporation began offering multifactor authentication, by giving password tokens to retail customers that generate new six-digit codes every minute.[48] Similarly, in January of 2005, Stanford Federal Credit Union ("the Credit Union") started to offer a two-factor authentication system to its customers.[49] Its system makes note of the computer that the customer usually logs on from and if a different computer is used, the system asks questions to ensure that no fraud is being attempted.[50] Finally, the Credit Union's customers will be assured that they are logged into the Credit Union's real site, and not a phony phishing site, when images that they selected appear on the screen.[51] Bank of America also uses pictures in its sign-in process to reduce fraud.[52] Bank of America customers identify a photo assigned to their account in addition to using their password.[53] Additionally, those

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[41] *Id.*
[42] Costanzo, *supra* note 12, at 14A.
[43] *Id.*
[44] Dash, *supra* note 3, at C4.
[45] Lindenmayer, *supra* note 35.
[46] *Id.*
[47] Cottrell, *supra* note 6, at 12.
[48] Costanzo, *supra* note 12, at 14A.
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] Dash, *supra* note 3, at C4.
[53] *Id.*

customers write a phrase that they previously chose and answer three challenge questions.[54] These new security features have already been implemented in Tennessee, Maryland, Virginia, and Washington D.C., and will soon be available nationwide.[55] However, there is some concern that the new security services being sold to prevent identity theft could actually promote it, because consumers are forced to disclose a great deal of personal information that could be breached.[56]

Because the largest banks have learned to fight online fraud, phishers target smaller banks.[57] However, with smaller security budgets, community banks attack prevention through customer education and warnings.[58] For example, Naugatuck Savings Bank of Connecticut's convey warnings via its Web site, e-mails, statement stuffers, branch posters, CD-ROMs, and special events at branches.[59] Additionally, criminals also target universities.[60] In September, 2005, City University of New York admitted that hundreds of students and employees social security numbers, names, and direct-deposit bank account information were available online because of an unsecured computer link.[61] The University asserted that it will institute new security and testing procedures to prevent future occurrences like this.[62] Similarly, in September, 2005, the University of Georgia stated that 1,600 employees' personal information may have been compromised by a hacker.[63]

3. Lawsuit Driven Prevention

In addition to government regulation and market innovation, pending lawsuits in courts "are likely to set precedents . . . and will probably define accountability on a much more tangible level."[64]

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[54] Ian Katz, *BOFA Banking on Layered Security*, SUN-SENTINEL (Fort Lauderdale, FL), July 18, 2005, at 12.
[55] *Id.*
[56] Lindenmayer, *supra* note 35, at 6.
[57] Steve Garmhausen, *As Phishers Refocus, Small Banks Regroup*, AM. BANKER, May 3, 2005, at 8A.
[58] *Id.*
[59] *Id.*
[60] Isabelle Lindenmayer, *Security Watch; CardSystems Solutions Inc.*, AM. BANKER, SEPT. 30, 2005, at 5.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] Cottrell, *supra* note 6, at 12.

For example, consumer cases are currently pending against CardSystems Solutions Inc. and Lexis-Nexis.[65] In fact, the case against Lexis-Nexis is seeking class actions status and the plaintiffs are each demanding $1,000 in damages.[66] Also, in February of 2005, Bank of America Corp. became the first defendant sued by a customer for "damages from online banking fraud."[67] Although federal law protects consumers against online theft, Bank of America is attempting to shield itself from liability in this case by claiming that the plaintiff acted as a business customer engaging in a commercial transaction.[68] It is employing this tactic because the Uniform Commercial Code limits banks' liability when providing online services to businesses if certain safeguards are used.[69] The outcome will certainly set precedent for similar occurrences.[70]

D. Notification of Breach

If a thief breaches security and compromises sensitive data, new legislation will require notification to potentially affected consumers. In October, 2005, a group of House Financial Services Committee members "introduced legislation that would require any entity holding sensitive consumer data to . . . notify customers if a breach is likely to result in identity theft or transaction fraud."[71] This legislation came after California enacted a similar statute that requires companies to notify consumers if their personal information has been breached.[72] This comes in the wake of announcements by companies like ChoicePoint Inc., which, in February, 2005, admitted to compromising 145,000 Americans' personal data.[73]

E. Prosecution

When criminals retrieve sensitive data, prosecution is important because it not only punishes the thieves, but also serves to

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[65] Lindenmayer, *supra* note 29, at 1.
[66] *Id.*
[67] *Id.*
[68] Byron Acohido & Jon Swartz, *Cyber Safecrackers Break into Online Accounts with Ease*, USA TODAY, Nov. 3, 2005, at 1A.
[69] *Id.*
[70] *Id.*
[71] Lindenmayer, *supra* note 35, at 6.
[72] Cottrell, *supra* note 6, at 12.
[73] Lindenmayer, *supra* note 35 at 6.

deter future fraudulent activity. The FTC stated that investigations and prosecutions of online thieves is an "enforcement priority."[74] For instance, the FTC stated that it is "investigating at least five cases in which companies may have deceived consumers into downloading spyware or made false claims about the existence of spyware on their computers to sell spyware-removal products."[75]

Law enforcement has been forced to evolve as criminals grow more sophisticated.[76] Now, in order to control online fraud, state and local police work alongside the FBI, college students, professors and employees from high-tech companies, all sharing an expertise in computers.[77] A problem with the current federal law is that officials must prove that a victim has suffered a loss.[78] Since phishing is a two-part crime (i.e., the fraudulent e-mail and then the identity theft), new legislation was introduced in the summer of 2004 that criminalizes simply sending out the e-mail.[79]

More stringent penalties can also be seen in the banking industry. Fines issued by the Office of the Comptroller of the Currency to banks for noncompliance have increased more than ten-fold.[80] Furthermore, in October, 2005, Superior Mortgage Company ("Superior") settled with the FTC after the FTC filed "charges that [Superior] violated the Gramm-Leach-Bliley Act's security requirements by inadequately securing sensitive consumer data and falsely claiming that it encrypted data submitted online."[81] The settlement "requires Superior to establish new data security procedures and hire independent auditors to assess its security systems every two years for the next decade."[82] In addition to regulatory pressures, banks face lawsuits when their security is breached, like CardSystems Inc., Lexis-Nexis and Bank of America Corp.[83]

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[74] *Id.*
[75] *Id.*
[76] Bill Husted, *Mob, Crooks Feed Off Phishing; Amateur No More: Cyber Racket Yields Easy Money with Minimal Risk for Crime Groups*, THE ATLANTA J. CONST., July 17, 2005, at 1A.
[77] *Id.*
[78] Mangino, *supra* note 1, at 8.
[79] *Id.*
[80] Lindenmayer, *supra* note 29, at 1.
[81] Lindenmayer, *supra* note 60, at 5.
[82] *Id.*
[83] Lindenmayer, *supra* note 29, at 1.

F. Conclusion

The need to prevent the increased complexity and frequency of online criminal conduct is apparent. A number of different channels force prevention upon our society. Government, market-driven innovation, and individual lawsuits constantly shape laws and security features used in the industry. These forces not only compel businesses to change their systems, but also implore individuals to change their behavior. In 2005 there were several significant advances in this area, including proposed laws, recommendations by the FTC, new security tactics employed by the private sector, and lawsuits of breached companies. All of the above will continue to shape this ever-changing arena of law and commerce.

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XIII. COMBATING IDENTITY THEFT

A. Introduction

Identity theft has gained much attention over the past few years. In 2003, the Fair and Accurate Credit Transactions Act ("FACTA"), emphasizing the prevention and remedying of identity theft, made many changes to the Fair Credit Reporting Act ("FCRA").[1] As more FACTA provisions became effective, including eight during December of 2004, financial institutions and regulators faced many challenges. Two such challenges were the implementation of two new policies designed by regulators in 2005, namely the model forms and procedures and the Disposal Rule.[2] The model forms and procedures went into effect on May 2, 2005, and are available for identity theft victims' use in informing creditors and credit reporting agencies of theft.[3] One month later, on June 1, 2005, the Disposal Rule, requiring businesses to determine reasonable measures for disposal of consumer information, went into effect.[4]

Additionally, many identity theft trends emerged throughout 2005 and encouraged financial institutions to take certain preventative and remedial action. Financial institutions' responses to the rise of identity theft instances included: joining identity theft groups, securing data via two-factor authorization methods, partnering with identity scoring companies to assess the likelihood of theft in consumer applications, recommending that consumers abandon paper statements in favor of online statement viewing, offering protections to consumers after institutional security breaches, and engaging in certain offensive measures aimed at thwarting identity fraud. Also, 2005 was a year of many recommendations for different ways to combat identity theft in the future as identity theft evolves and technologies improve.

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[1] Nessa Eileen Feddis, *Fact is, FACTA is fractious*, ABA BANKING JOURNAL, Jan. 2005, at 59.

[2] FTC, FACTA DISPOSAL RULE GOES INTO EFFECT JUNE 1 (June 1, 2005), http://www.ftc.gov/opa/2005/06/disposal.htm; Notice of Federal Trade Commission Publication Incorporating Model Forms and Procedures for Identity Theft Victims; Notice of Federal Trade Commission Publication Incorporating Model Forms and Procedures for Identity Theft Victims, 70 Fed. Reg. 21792 (Apr. 27, 2005).

[3] Notice of Federal Trade Commission Publication Incorporating Model Forms and Procedures for Identity Theft Victims, 70 Fed. Reg. at 21792.

[4] FTC, *supra* note 2.

B. FACTA Provisions that went into Effect on December 1, 2004

On December 1, 2004, eight FACTA provisions went into effect, thus changing the regulatory landscape during 2005.[5] Those eight provisions had the following effects on the FCRA: (1) identity theft victims can now place blocks and three types of alerts on their files that are maintained by credit reporting agencies; (2) the Federal Trade Commission ("FTC") and other regulators were required to implement red flag guidelines that require financial institutions and creditors to establish policies and procedures for implementing identity theft regulations; (3) consumers are now permitted to request the withholding of the last five digits of their social security numbers in credit reports; (4) debt collectors are now required to notify creditors of fraudulent debt; (5) businesses must now provide victims with fraudulent transaction information; and (6) furnishers of fraudulent information are now prevented from refurnishing that information.[6]

C. FTC Rules that Became Effective during 2005

1. Model Forms and Procedures

Section 153 of FACTA, which went into effect on December 1, 2004, required the FTC along with other regulators to develop model forms and procedures for identity theft victims to use when informing both creditors and credit reporting agencies of instances of identity theft.[7] To fulfill this statutory requirement, the FTC collaborated with federal banking agencies and the National Credit Union Administration.[8] As a result, on May 2, 2005, the FTC's booklet, *Take Charge: Fighting Back Against Identity Theft* ("*Take Charge* booklet") for identity theft victims, went into effect.[9] The *Take Charge* booklet is continuously updated by the FTC and

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[5] Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, §§ 112, 114, 115, 151-155, 117 Stat. 1952 (2003).

[6] Fair Credit Reporting Act, 15 U.S.C.S. §§ 1681c-1, c-2, g, m, s-2 (LexisNexis 2005).

[7] Fair Credit Reporting Act, 15 U.S.C.S. § 1681s (LexisNexis 2005).

[8] Notice of Federal Trade Commission Publication Incorporating Model Forms and Procedures for Identity Theft Victims, 70 Fed. Reg. at 21793.

[9] *Id.* at 21792.

includes descriptions of many different types of identity theft along with potential remedies, an ID Theft Affidavit and sample letters.[10] The ID Theft Affidavit is a generic form that numerous creditors will accept from identity theft victims disputing fraudulently opened accounts.[11] Additionally, the sample letters can be used by victims when disputing fraud on existing accounts, or in tandem with Identity Theft Reports issued by enforcement agencies when requesting that credit reporting agencies block fraudulent transactions from credit reports.[12]

2. Disposal Rule

Section 216 of FACTA, which became effective on December 4, 2003, required the FTC, the federal banking agencies, and the National Credit Union Administration to issue regulations regarding the disposal of consumer information.[13] After much collaboration, the FTC issued its Disposal Rule as effective on June 1, 2005.[14] The Disposal Rule applies to any entity using credit report information, including such information used for employment, credit or insurance purposes.[15] Also, financial institutions that are subject to the Gramm-Leach-Bliley Safeguards Rule must incorporate their disposal procedures into their Safeguard Rules.[16]

The Disposal Rule is flexible and requires organizations, businesses and individuals using credit reports to determine their own reasonable measures for disposal in an effort to protect against unauthorized use of or access to consumer information.[17] Such reasonable measures for proper disposal must be "based on the sensitivity of the information, the costs and benefits of different disposal methods, and changes in technology."[18] Reasonable

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[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, § 216 (2003).

[14] FTC, *Disposing of Consumer Report Information? New Rule Tells How* (June 2005), *available at* http://www.ftc.gov/bcp/conline/pubs/alerts/disposalalrt.htm.

[15] FTC, *supra* note 2.

[16] *Id.*

[17] *Id.*

[18] FTC, *supra* note 14.

measures for disposal include: burning and pulverizing papers, erasing media files and using due diligence in employing a document destruction contractor.[19] Additionally, the FTC describes due diligence in hiring destruction contractors as either: reviewing the contractor's independent audit and compliance with the Disposal Rule, interviewing the contractor's references, evaluating the contractor's security policy and procedures or requiring that the contractor be certified by a recognized trade association.[20]

D. Trends in Identity Theft during 2005

The FTC estimates that identity theft affects roughly five percent of American adults and costs our country $53 billion annually.[21] Unfortunately, statistics regarding the actual number of cases are unavailable since most victims do not report identity theft to the police.[22] However, studies indicate that in 2005, data security breaches in financial institutions affected more than 56.2 billion consumers.[23]

In March 2005, the research firm Financial Insights concluded that people are willing to pay for stronger security, after its research indicated that six percent of bank customers switched banks due to identity theft alone.[24] However, despite the increasing trend in seeking security via methods like obtaining identity theft insurance, some argue that such insurance is unnecessary and should not be obtained unless it is free, because identity theft victims can monitor their own credit records and federal law protects victims from having to pay for fraudulent transactions on their records.[25] Alternatively, insurers argue that identity theft insurance provides victims with invaluable guidance and credit monitoring services.[26]

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[19] FTC, *supra* note 2.

[20] *Id.*

[21] Robin Sidel, *Identity Theft—Unplugged: Despite the High-Tech Threat, When You Get Ripped Off It's Usually Still the Old Way*, WALL ST. J., Oct. 8-9, 2005, at B1, B4.

[22] *Id.*

[23] Isabelle Lindenmayer, *Security Watch*, AM. BANKER, Sept. 9, 2005, at 5.

[24] *Let's Stop ID Theft, Not Just Talk About It*, AM. BANKER, July 8, 2005, at 10.

[25] Elayne Demby, *Identity Theft Insurance—Is It Worthwhile?*, AM. BANKER, Nov. 2005, at 34.

[26] *Id.*

Additionally, 2005 marked a year of increased identity theft attacks on insurance companies, credit unions, payment services, ATM networks and European financial institutions.[27] Also, banks began finding it difficult to prevent check fraud.[28] Moreover, social security number fraud, which is far more detrimental than credit card theft, became more popular among thieves.[29]

E. Financial Institutions' Responses to Identity Theft during 2005

1. Identity Theft Groups

During 2005, some financial institutions joined identity theft groups, such as the Identity Theft Assistance Center, where they began to work with law enforcement officials and other financial institutions to develop streamlined procedures to deal with identity theft.[30] Participating institutions, including Citigroup, Inc. and Bank of America Corp, send weekly information regarding identity theft cases to the FTC which in turn enters such information into a database viewable by over 1,300 law enforcement agencies.[31] In addition, in order to simplify the process for identity theft victims, members of the Identity Theft Assistance Center distribute standard forms to victims and streamline their procedures so that victims are able to discuss their situation with as few financial institution representatives as possible.[32]

2. Two-factor Authorization

Also during 2005, many experts began advising companies to better secure consumer data using encryption and two-factor

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[27] Kevin Woodward, *Losing the User Name and Password*, AM. BANKER, Nov. 2005, at 26.

[28] Sidel, *supra* note 21, at B1, B4.

[29] Isabelle Lindenmayer, *Equifax, ID Analytics Go After ID Theft at Application Point*, AM. BANKER, July 21, 2005, at 9.

[30] Daniel Wolfe, *ID Theft Group Members Say Collaboration Helps*, AM. BANKER, Feb., 17, 2005, at 12.

[31] Hannah Bergman, *In Brief: FTC to Get ID-Theft Info from Big Banks; Federal Trade Commission; Brief Article*, AM. BANKER, July 6, 2005, at 3.

[32] Wolfe, *supra* note 30, at 12.

authorization methods that make data less useful for thieves.[33] Two-factor authentication involves one factor known by the user, such as a password or username, and another factor physically held by the user, such as a token or smart card.[34] The issue gained support by the Federal Deposit Insurance Corporation ("FDIC"), which in turn issued a requirement in October, 2005 that all U.S. banks have two-factor authentication implemented by the end of 2006.[35]

3. ID Scoring

Some financial institutions, including Equifax and VISA, entered into a partnership with ID Analytics Inc. and began sending their consumers' credit applications to ID Analytics to be scored, based on many variables, according to their likelihood of resulting from identity theft.[36] Specifically, the scores identify a type of identity fraud called synthetic identity fraud, which often goes undetected because of its combination of both valid and invalid data.[37] The institutions began using those scores to help determine which applications required further verification.[38]

4. Abandoning Paper Statements

During the year, statistics and studies showing that most identity theft cases result from theft originating in traditional rather than electronic channels led some financial institutions, including E*Trade Financial Corp, to encourage their customers to abandon paper statements in favor of electronic account viewing.[39] Also supporting this theory is the consulting firm, Javelin's, finding that internet fraud is less severe and less costly than previously believed.[40] Furthermore, Javelin recommended that consumers

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[33] Michelle Heller & Isabelle Lindenmayer, *Call to Make Stolen Data Less Usable*, AM. BANKER, Aug. 1, 2005, at 1.

[34] Woodward, *supra* note 27, at 26.

[35] *Id.*

[36] Ann McDonald, *Thwarting Fraud Before It Happens*, AM. BANKER, Nov. 2005, at 40.

[37] *Id.*

[38] *Id.*

[39] Sidel, *supra* note 21, at B1, B4.

[40] Erick Bergquist, *Pipeline; Daniel W. Porter and Bear Stearns Merchant Banking; identity theft; prepayment penalties*, AM. BANKER, Jan. 27, 2005, at 16.

monitor accounts online because studies show that people monitoring accounts online detect fraud sooner and save more money than do those using paper statements.[41]

5. Responses to Security Breaches

In response to security breaches in early 2005, Wachovia Corp. and Bank of America Corp. offered free credit reports and monitoring services to possible victims.[42] Wachovia offered possible victims a one-year subscription to a service that monitors, insures and gives consumers unlimited access to their credit reports.[43] On the other hand, Bank of America offered free credit reports to affected customers and allowed them to add 90-day fraud alerts to their consumer reports.[44] In May 2005, and not in response to any security breach, National City Corp. of Cleveland offered its customers identity theft monitoring and insurance products and services, including emails with links to credit reports and access to counselors.[45]

6. Additional Offensive Measures

During 2005, larger banks employed various technologies to thwart check fraud including: storing digital signatures for verification; rules-based systems that find anomalies in fraudulent checks; and services to ensure that new accounts are not opened by thieves.[46] Therefore, identity thieves began targeting smaller banks because smaller banks use less check fraud thwarting technology than their larger competitors.[47] As a result, smaller banks began investing in check imaging, software that encrypts information into check bar codes, rules-based software and other software to help identify fraudulent checks.[48]

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[41] *Id.*

[42] Daniel Wolfe, *Nat City is Latest Offering Security Tools to Customers; National City Corp*, AM. BANKER, May 24, 2005, at 12.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] Chris Costanzo, *In Fraudster's Sights, Small Banks Secure Systems*, AM. BANKER, Apr. 5, 2005, at 6A.

[47] *Id.*

[48] *Id.*

Furthermore, in the later part of 2005, Diebold, an ATM manufacturer launched the industry's first consumer ATM security website that educates consumers about types of and protections against ATM fraud.[49] In addition, Diebold offered advanced ATM security to financial institutions.[50]

Moreover, banks, brokerage firms and credit unions began employing image recognition technology that presents images that require consumer verification.[51] In addition, financial institutions began monitoring online traffic to determine how customers use their websites so they can better detect fraudulent patterns.[52] Such monitoring software is expected to be used in the future by customers to block suspicious transactions.[53]

F. Future Plans to Combat Identity Theft

Many experts expressed the belief "that the increase in identity theft will have the effect of slowing the growth of online banking and commerce."[54] As a result, the FBI section chief recommended that banks institute a two-factor authorization process to access their systems, conduct risk and penetration tests and bar employees from using wireless technology to access bank systems.[55] Also, a study performed by the FDIC recommends that financial institutions and regulators take steps to reduce online fraud including: implementing two-step authentication procedures; employing scanning software; strengthening consumer education programs to prevent susceptibility to online fraud; and sharing online fraud information with other financial institutions, the government, and online technology providers.[56]

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[49] *Diebold Launches First-of-Its-Kind, Consumer ATM Security Web Site; Web Site Offers Tips to Keep Consumers and Their Money Safe*, PR NEWSWIRE U.S., Nov. 2, 2005.

[50] *Id.*

[51] Woodward, *supra* note 27, at 26.

[52] Daniel Wolfe, *Software Monitors Surfers' Tracks for Hints of Fraud*, AM. BANKER, Oct. 25, 2005, at 12.

[53] *Id.*

[54] *FDIC Issues Study on Identity Theft and Seeks Comments on Possible Guidance to Bankers*, THE MONITOR: BANKING & FIN. SERVICES POL'Y REP., Mar. 2005, at 16.

[55] Heller & Lindenmayer, *supra* note 33, at 1.

[56] *FDIC Issues Study on Identity Theft and Seeks Comments on Possible Guidance to Bankers, supra* note 54, at 16.

Moreover, multiple bills were presented to Congress throughout the year in the form of legislation requiring financial institutions to follow certain guidelines when notifying potential victims of when those institutions have experienced certain data security breaches.[57]

Furthermore, it was suggested that the U.S. replace credit cards with smart cards that require pin authorization instead of signatures, making the smart cards more difficult for thieves to use.[58] Another suggestion required implementing the use of tokens, which customers would use to generate one-time passwords for authentication purposes.[59] In addition, one security consulting firm urged banks to modify the presentation of check images online so that thieves are unable to obtain information necessary to forge checks.[60]

G. Conclusion

During 2005, both financial institutions and their regulators made many advancements regarding preventative and remedial measures in tackling identity theft. In 2005, two notable FTC rules mandated by FACTA went into effect, the model forms and procedures and Disposal Rule. Moreover, it became clear that as identity theft instances increase in number, identity theft itself continues to mutate and plague financial institutions.

Furthermore, the initiatives taken by financial institutions during 2005 were plentiful. Some institutions began implementing security measures such as two-step authorization and ID Scoring. Additionally, some institutions became members of identity theft groups that share information and protection techniques with other financial institutions and government officials. Also, institutions that suffered security breaches during the year implemented procedures to protect their customers. Some institutions even made recommendations that their customers view accounts online instead

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[57] *See, e.g.*, Michele Heller, *House Tries 'Reasonable' Risk Trigger*, AM. BANKER, June 29, 2005, at 1; Michele Heller, *ID Theft Bill Gets Senate Commerce Committee's OK*, AM. BANKER, July 29, 2005, at 3.

[58] David Breitkopf, *Is Data Security Problem A Smart Card Opportunity?*, AM. BANKER, June 30, 2005, at 5.

[59] Woodward, *supra* note 27, at 26.

[60] Daniel Wolfe, *Check Images A New Frontier For Forgery?*, AM. BANKER, Oct. 26, 2005, at 1.

of via paper statements for protection and monitoring purposes. Financial institutions also began taking multiple offensive measures to monitor customer accounts and protect customers from identity theft.

Moreover, government officials became involved in preventing identity theft via collaboration with financial institutions. Even as the year ended, Congress was in the process of passing legislation providing financial institutions with guidelines regarding potential victim notification. Overall, 2005 marked a year of much change for financial institutions with regard to identity theft awareness, procedures, recommendations and policy setting.

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XIV. ANTI-MONEY LAUNDERING

A. Introduction

A money laundering scandal can be so damaging to a banking institution that it requires clear and concise guidelines. The American Banker Association has complained that there is a dramatic level of inconsistency in the application of the Bank Secrecy Act and anti-money laundering regulations.[1] Organizations have pointed out that examiners in the field apply a "zero tolerance policy" on compliance.[2] In some cases, banks say examiners have declared internal controls deficient because a bank did not file enough suspicious activity reports even though there were no violations to report.[3] This zero tolerance policy has given banking institutions no choice, except "when in doubt," to file a report in order to avoid a fine, resulting in a surge of filings on behalf of the institutions causing a major problem for the regulators.[4]

These unclear guidelines and inconsistent decisions have created immense pressure on banks to adjust compliance with regulations without knowing for certain the exact way to proceed.[5] Banks started filing "defensive suspicious activity reports" by the hundreds of thousands just to avoid the possibility of overlooking any regulations.[6] Federal regulators weary of these concerns released a 330 page long "Bank Secrecy Act Anti-Money Laundering Examination Manual" on June 30, 2005 that will hopefully ease banking institutions compliance with regulations.[7]

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[1] Hannah Bergman, *Easing of BSA Enforcement Sought,* AM. BANKER, Jan. 13, 2005, at 20.
[2] *Id.*
[3] *New Guidelines Should Soothe BSA Headaches*, AM. BANKER, June 29, 2005, at 10.
[4] Rob Blackwell, *SAR Mess: Banks, Agencies Disagree on Who's at Fault*, AM. BANKER, Apr. 26, 2005, at 4.
[5] Bergman, *supra* note 1.
[6] William M. Isaac, *Harsh Approach to Regulation is Backfiring*, AM. BANKER, Oct. 4, 2005, at 1A.
[7] Bank Secrecy Act, Anti-Money Laundering Examination Manual, June 2005, http://www.occ.treas.gov/handbook/BSA-AMLintro-overview.pdf.

B. History and Background

Money laundering is the practice of filtering money obtained through illegitimate activities.[8] The purpose is to conceal illegal sources of income.[9] Criminals can use different techniques to launder their illicit money, including "anything from buying a simple cashier's check to extremely complex schemes involving the high-volume purchase and sale of real estate or bonds."[10] Money laundering, no matter what the technique is, usually involves three steps: placement, layering and integration.[11] These different steps do not have to occur successively and can all happen at the same time depending on what type of money laundering technique is used.[12] Placement involves dividing deposits into small accounts to escape reporting.[13] Layering occurs when the money is moved around the financial system in a very complicated fashion in order to create a confusing paper trail.[14] Integration, the last and most important step in the money laundering process, is used to "create the appearance of legality" by buying real estate, investment securities, foreign trusts and other types of assets.[15]

The anti-money laundering system in the U.S. began in 1970 as part of the Currency and Foreign Transactions Act also known as the Bank Secrecy Act which was "designed to help identify the source, volume, and movement of currency . . . in or our of the Untied States."[16] In recent years, the Bank Secrecy Act was modified to help in the fight against terrorism and better identify money laundering schemes. Since 1970, the Bank Secrecy Act has been augmented by four other pieces of legislation.

The first is the Money Laundering Control Act of 1986, which imposed criminal liability "on a person or institution that knowingly assists in money laundering or who structures transactions so as to avoid reporting it."[17] Second is the Annuzio-Wylie Anti-

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[8] BSA INFOBASE, http://www.ffiec.gov/bsa_aml_infobase/presentations/media/Pres2.pdf.
[9] *Id*. at 2.
[10] *Id*.
[11] *Id.* at 3.
[12] *Id.*
[13] *Id.*
[14] *Id*.
[15] *Id.* at 4.
[16] *Id.* at 6.
[17] *Id*. at 7.

Money Laundering Act of 1992, which strengthened the sanctions for Bank Secrecy Act violations and increased the role of the U.S. Treasury.[18] The third piece of legislation is the Money Laundering Suppression Act of 1994, which required regulators to increase examiner training to improve the identification of many laundering schemes in financial institutions.[19] Finally, there is the Patriot Act of 2001, which was the most significant anti-money laundering legislation since the Bank Secrecy Act itself. It provided, among other things, the expansion of the anti-money laundering program requirements to all financial institutions.[20]

Four organizations are mainly in charge of enforcing the Bank Secrecy Act.[21] First is the United States Treasury; under the Bank Secrecy Act, the Secretary of the Treasury is authorized to "require financial institutions to file certain reports and keep certain transaction records."[22] Second is the Financial Crimes Enforcement Network and it serves as "the delegated administrator of the BSA."[23] Next are the five Federal Banking Agencies which are "charged with oversight of the various banking entities operating in the United States."[24] Last is the Office of Foreign Assets Control.[25]

Since these anti-money laundering regulations were confusing and hard to follow, banking institutions urged the federal banking regulatory agencies to take measures to achieve more consistency in examinations.[26] For example, the American Community Bankers asserted that "inconsistent interpretation of the implementing regulations by examiners and a lack of regulatory guidance have made it increasingly difficult for community banks to comply with anti-money laundering demands and have produced a plethora of unintended consequences."[27]

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[18] *Id*. at 8.
[19] *Id*.
[20] *Id*.
[21] *Id*. at 10.
[22] *Id.* at 9.
[23] *Id.*
[24] *Id.* at 10.
[25] *Id.*
[26] *Anti-Money Laundering Rules Need More Consistency*, AMERICA'S COMMUNITY BANKER, June 1, 2005, at 14.
[27] *Id.*

C. New Anti Money Laundering Regulations

On June 30, 2005, federal regulators released the "Bank Secrecy Act Anti-Money Laundering Examination Manual."[28] The manual was developed by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency and Office of Thrift Supervision in collaboration with the Financial Crimes Enforcement Network, the delegated administrator of the Bank Secrecy Act.[29] The manual was in response to the fears banking institutions have been expressing with regards to compliance issues and was the first comprehensive set of anti-money laundering guidelines for examiners and bankers.[30]

The manual is divided into four main parts: an introduction, a core overview and procedures section, an expanded overview and procedures section and an appendix.[31] The core procedures section sets forth minimum examination requirements and guides examiners through the scoping process.[32] The expanded procedures are designed to assist examiners in assessing Anti-Money Laundering compliance in banks that offer specialized services or products.[33]

1. Introduction

The introduction provides some background information on the Bank Secrecy Act and the government's role in enforcing and implementing the Act; including the role of the U.S. Treasury Department and various federal banking agencies.[34] The Act allows the Secretary of the Treasury to force "financial institutions to establish Anti Money Laundering programs, file certain reports, and

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[28] FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL (June 2005), http://www.occ.treas.gov/handbook/BSA-AMLintro-overview.pdf.
[29] *Id*. at 9.
[30] Rob Blackwell, *SAR Mess: Banks, Agencies Disagree on Who's at Fault*, AM. BANKER, Apr. 26, 2005, at 4.
[31] BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL, supra note 28.
[32] BSA INFOBASE, http://www.ffiec.gov/bsa_aml_infobase/presentations/media/Pres3.pdf.
[33] *Id*.
[34] BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL, supra note 28, at 13.

keep certain records of transactions."[35] Also, certain Bank Secrecy Act provisions "have been extended to cover not only traditional depository institutions, such as banks, savings associations, and credit unions, but also non-bank financial institutions, such as money services businesses, casinos, brokers/dealers in securities, and futures commission merchants."[36]

"The federal banking agencies are responsible for the oversight of the various banking entities operating in the United States, including foreign branch offices of U.S. banks."[37] These agencies "may" use their authority to enforce compliance with banking rules and regulations, and in fact these agencies do require each bank under their supervision to establish and maintain a Bank Secrecy Act compliance program.[38]

The introduction section also describes the Bank Secrecy Act's duty as to safeguard the "U.S. financial system and the financial institutions that make up that system from the abuses of financial crime, including money laundering, terrorist financing, and other illicit financial transactions."[39] In addition, this section asks banking institutions to "develop, implement, and maintain effective Anti-Money Laundering programs that address the ever changing strategies of money launderers and terrorists and that attempt to gain access to the U.S. financial system."[40]

2. Core Overview and Procedures

Next in the manual is the core overview section which is in turn divided into four main topics: (1) Scoping and Planning, (2) Compliance program, (3) Office of Foreign Assets Control compliance and (4) Developing Conclusions and Finalizing the Examination.[41]

1) Scoping and Planning

Examiners should determine a bank's Bank Secrecy Act/Anti-Money Laundering risk profile as part of the scoping and

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[35] *Id*. at 11.
[36] *Id.*
[37] *Id.*at 12.
[38] *Id*.
[39] *Id*. at 14.
[40] *Id*. at 14.
[41] *Id*. at 17-92.

planning process.[42] Whenever possible the scoping and planning part should be done before the bank.[43] "In evaluating the level of risk, a bank should not necessarily take any single indicator as determinative of the existence of lower or higher risk," this assessment process should compare and weigh a bunch of factors, "including the risk identification and measurement of products, services, customers, and geographic locations."[44] An effective risk assessment should be a composite of multiple factors, and depending upon the circumstances, "certain factors may be weighed more heavily than others."[45]

2) Compliance Program

The main objective of the examination process is to determine whether the bank has developed, administered and maintained an effective program.[46] To be effective, this program must provide for: (a) a system of internal controls, (b) independent testing of compliance, (c) a specially-designed officer responsible for managing compliance and (d) adequate training for appropriate personnel.[47]

(a) System of Internal Controls

Internal controls refer to the bank's policies and procedures.[48] Among other things, these controls should point out "banking operations more vulnerable to abuse by money launderers and criminals, identify a person or persons responsible for BSA/AML compliance and provide for program continuity despite changes in management or employee composition or structure."[49] To be adequate, these controls should also "identify a person or persons responsible for BSA/AML compliance and provide for program continuity despite changes in management or employee composition or structure."[50]

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[42] *Id.* at 16.
[43] *Id*. at 16.
[44] *Id*. at 17.
[45] *Id*. at 18.
[46] *Id*.
[47] *Id*. at 25.
[48] *Id*.
[49] *Id*.
[50] *Id*.

(b) Independent Testing of Compliance

The manual dictates that "independent testing should be conducted by the internal audit department, outside auditors, consultants, or other qualified independent parties."[51] This testing should provide an overall evaluation of the banking institution's compliance with the Bank Secrecy, Anti Money Laundering Act and especially a review of the "effectiveness of the suspicious activity monitoring systems."[52]

(c) Bank Secrecy Compliance Officer

The bank's board of directors is required to designate a Bank Secrecy Act compliance officer who is "fully knowledgeable of the BSA and all related regulations" and will be in charge of "coordinating and monitoring day-to-day compliance."[53]

(d) Training

The bank is responsible to make sure that all relevant employees are adequately trained in every aspect of the Bank Secrecy Act.[54] This training program should always be updated in accordance with changes in the Act.[55]

The compliance part of the manual also attempts to reduce "defensive suspicious activity reports" by eliminating the zero tolerance policy and replacing it with a policy that would look at the banks record and procedure in filing suspicious activity reports in general as opposed to one particular report.[56]

This section provides that "banks should not be criticized for the failure to file a suspicious activity report unless the failure is significant or accompanied by evidence of bad faith."[57] In addition, the compliance part includes statutory and regulatory requirements for special information sharing procedure to deter money laundering

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[51] *Id*. at 26.
[52] *Id*. at 27.
[53] *Id*.
[54] *Id*.
[55] *Id*. at 27.
[56] *Id*.
[57] *Regulatory Roundup*, AM. BANKER, July 14, 2005, at 4.

and terrorist activity.[58] Banking institutions are also required to assess risks posed by foreign financial institution customers and should direct resources at the accounts that pose the most significant money laundering risk.[59]

3) Office of Foreign Assets Control

This section requires an assessment of the "bank's risk-based Office of Foreign Assets Control program to evaluate whether it is appropriate for the bank … taking into consideration its products, services, customers, transactions and geographic locations."[60] The Act requires blocking "accounts and other property of specified countries, entities, and individuals."[61] The Act also forbids certain "unlicensed trade and financial transactions with specified countries, entities and individuals."[62]

4) Developing Conclusions and Finalizing the Examination

This is the final stage of the examination and the examiner should "formulate conclusions, communicate findings to management, prepare report comments, develop an appropriate supervisory response, and close the examination."[63]

D. Conclusion

On July 28, 2005, the Federal Financial Institutions Examination Council announced the release of its Bank Secrecy Act/Anti-Money Laundering Examination InfoBase. This automated tool provides information on the 330 page manual with an automated search function and video presentations. The InfoBase is available online at *www.ffiec.gov/bsa_aml_infobase*.

A sound Anti Money Laundering compliance program is a financial institution's best offense and defense against criminal activity. Financial institutions must be able to demonstrate to

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[58] BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL, supra note 28, at 55.
[59] *Id*. at 70.
[60] *Id*. at 84.
[61] *Id*. at 85.
[62] *Id.* at 85.
[63] *Id.* at 93.

regulators that they have a rational antimony laundering strategy, put into effect through efficient, documented, auditable, enterprise-wide processes. Banks have long been frustrated with anti-money laundering regulations and more specifically, with the Bank Secrecy Act. The federal banking agencies' 330 page long "Bank Secrecy Act Anti-Money Laundering Examination Manual" should make it easier for banks to comply with the law and ease the frustration banking institutions have had with complying with the regulations, saving both time and money.

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XV. GSE FRAUD

A. Introduction

Fannie Mae and Freddie Mac are charted by the U.S. government but owned by private shareholders.[1] They are afforded special privileges by the government, such as a credit line with the U.S. Treasury, and as a result they are referred to as Government Sponsored Entities ("GSE").[2] Through the process of securitization, they buy mortgages, put them together into trusts and sell securities from these trusts.[3] These are known as mortgage-backed securities ("MBS").[4] The two companies hold a large number of MBS in their own portfolios, as well as other mortgages that they buy.[5] In aggregate, the liabilities of the two companies are around $3.7 trillion, a major percentage of the U.S. economy.[6] As a result of their large market share, those in Congress responsible for GSE oversight believed that a more robust regulation scheme was needed to limit the potential catastrophe that would ensue should the GSEs fail.[7] Although there were efforts in 2004 to reform the GSE regulation regime, nothing took hold.[8]

In the wake of the Enron and WorldCom accounting scandals, Fannie and Freddie replaced Arthur Anderson and appointed new auditors.[9] These auditors conducted an investigation and determined Fannie and Freddie had manipulated their earnings to make it appear as though their considerable holdings were more stable than they were.[10] This brought more scrutiny and attention to the regulation regime of the GSEs and created fresh momentum for reform.[11]

However, at the end of 2004, a Congressional bill which would have more strictly regulated the GSEs was defeated, due in

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[1] Peter J. Walliston, *Regulating Fannie Mae and Freddie Mac: Now It Gets Serious*, AM. ENTERPRISE INST. FIN. SERV. OUTLOOK, May 2005 at 1.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id*. at 2.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*

large part to extensive lobbying on the part of Fannie and Freddie.[12] The reason for their opposition was that this legislation would create a receiver - someone who could take control of their assets and pay off their creditors in the event that they collapsed.[13]

B. Developments in 2005

Fannie Mae and Freddie Mac changed their position in January of 2005 and agreed to accept a receivership.[14] Their initial decision to oppose the bill may have been based upon a belief that John Kerry would be elected President, and he would go easier on them than President Bush.[15] Their change of position about the receivership might also have been precipitated by the positions taken by Fannie Mae Chair, Franklin Raines, at a Congressional hearing, who said that Fannie was in fact the victim of an out of hand regulator.[16] Shortly after his testimony, Raines resigned as more evidence of the accounting fraud surfaced.[17]

Although Fannie and Freddie were prepared to accept a receivership, those concerned with their regulation had move on to thinking about more significant reforms.[18] Due to the ongoing scandals, the White House had greater leverage over the GSEs than it did during prior negotiations.[19] In fact, Housing and Urban Development Secretary ("HUD"), Alphonso Jackson suggested that the White House might roll back some of the special treatment afforded to GSEs.[20] This included severing their $4.5 billion credit line with the U.S Treasury.[21]

In February 2005 Alan Greenspan testified before the House Financial Services Committee.[22] He suggested that the size of the GSE portfolios did not need to be bigger than what was necessary to cover their basic needs.[23] Greenspan warned that allowing them to

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[12] *Id.*
[13] *Id.*
[14] *Id.* at 3.
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] Rob Blackwell, *For GSE Reformers, Déjà vu All Over Again*, AM. BANKER, Jan. 13, 2005 at 9.
[20] *Id.*
[21] *Id.*
[22] Wallsiton, *supra,* note 1.
[23] *Id.*

keep their portfolios at current levels created a deep risk within the American economy.[24]

In that same month, a federal regulator identified further problems with the way Fannie Mae accounted for its $890 billion mortgage portfolio,[25] resulting in a drop of its stock prices.[26] This led some analysts, including the Wall Street Journal, to suggest that Fannie Mae could lose $2.8 billion,[27] in addition to the $9 billion lost since the start of its accounting troubles.[28]

As a response to further pressure from its current regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO"), Fannie Mae restructured its pay system in March 2005.[29] Instead of basing executive compensation on profits, the executives would be paid based on how well they achieve their mission of providing affordable mortgages.[30] Further, Fannie Mae decided to separate the jobs of chairman and chief executive officer.[31] This separation had been long resisted by the company,[32] but was taken in response to the accounting problems that have plagued it.[33] It was made as part of an agreement with OFHEO as part of its process of restructuring its corporate governance.[34]

At the end of March, Freddie Mac finally announced the results of its 2004 earning year.[35] Their earnings had fallen forty one percent due to a drop in the value of its portfolio.[36] Contemporaneously, important reform measure initiatives were being taken up in Congress.[37] One such reform, backed by the White House, would impose limits on Fannie Mae and Freddie Mac's

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[24] *Id.*
[25] Terence O'Hara, *Speculation Drops Fannie Stock*, WASH. POST., Mar. 4, 2005 at E05.
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] Terence O'Hara, *Fannie Mae Restructures Pay System*, WASH. POST., Mar. 12, 2005 at E01.
[30] *Id.*
[31] Terence O'Hara, *Fannie Mae To Separate 2 Top Jobs*, WASH. POST., Mar. 9, 2005 at E05.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] Terence O'Hara, *Freddie's Profit Drops, but Share Of Market Rises*, WASH. POST., Apr. 1, 2005 at E01.
[36] *Id.*
[37] Rob Blackwell, *A Pivotal Week for GSE's: Testimony Could Dictate Fate of Reform Bills*, AM. BANKER, Mar. 31, 2005 at 61.

mortgage portfolio.[38] Reform legislation had been previously considered by Congress, including plans to either strengthen their regulator, OFHEO or to replace it.[39] However, nothing ultimately became of those plans.[40] Congressman Christopher Shays of Connecticut suggested that such reform would have been politically impossible.[41] However, things had changed due to the accounting scandals that rocked the companies.[42] Also, Franklin D. Raines, the former CEO of Fannie Mae was ousted.[43] Representative Richard H. Baker, Chairman of the House Financial Services Subcommittee, supported a bill to create replace OFHEO with a new, independent regulator.[44] This regulator would have the ability to put a GSE into receivership without prior Congressional approval.[45] Furthermore, the regulator would be able to limit the size of Fannie and Freddie and would have to approve any new products they intended to offer.[46]

Cabinet Secretaries John Snow (Treasury) and Alphonso Jackson (HUD) testified before the Senate Banking Committee and said they supported new legislation to tightly regulate the GSEs.[47] Snow called for a regulator with the power to force the GSEs to reduce their investments in mortgages.[48] Jackson also supported the limits.[49] They urged the creation of a new regulatory agency, which could require them to hold more cash as insurance against potential losses.[50] This position aligned the cabinet secretaries with the position taken by Federal Reserve Board Chairman Alan Greenspan, who also backed this type of legislation when he testified in front of the same Congressional committee.[51]

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[38] *Id.*
[39] Terence O'Hara & Kathleen Day, *Legislators to Take Replacing OFHEO*, WASH. POST., Apr. 6, 2005 at E01.
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] Kathleen Day, *Cabinet Leaders Back Bid for New Regulator*, WASH. POST., Apr. 8, 2005 at E04.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*

Fannie and Freddie took the position that while they supported a new regulatory scheme, they were opposed to many aspects of the tough bill being advocated in Congress.[52] In particular, they objected to proposed restrictions limiting the value of the assets contained in their portfolios and requiring regulatory approval before the issuance of new products.[53] They also opposed restrictions on the areas of the mortgage market that they would be allowed to participate in. [54]

At this same time, Fannie Mae Interim chief executive Daniel H. Mudd ("Mudd") apologized for the Fannie Mae accounting problems.[55] This was a notable change from the position of his predecessor, Franklin D. Raines, who had always maintained that no mistakes were made.[56] In addition, during testimony before the Senate Banking Committee, OFHEO chair Armando Falcon ("Falcon") said that Fannie Mae had shifted the focus of the GSEs in recent years.[57] They were more focused on raising the stock price and dealing with investment strategy, and less committed to the original mission to promote home ownership.[58] Falcon also endorsed the position taken by Alan Greenspan and the White House, which is that the GSEs should be limited in the size of their portfolios.[59]

In April 2005, it was revealed that employees of Fannie Mae falsified signatures in 1998.[60] This led to a reporting of larger profits than actually received.[61] The accounting error occurred when expenses totaling $200 million were deferred in 1998 to "future periods."[62] This resulted in an increase in their 1998 earnings,[63] which in turn led to much larger compensation for executives of the

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[52] Kathleen Day & Annys Shin, *Fannie, Freddie Back Regulator But Will Fight Portfolio Limits*, WASH. POST., Apr. 20, 2005 E01.
[53] *Id.*
[54] *Id.*
[55] Annys Shin & Kathleen Day, *Fannie Mae Apologizes for Accounting Failures*, WASH. POST., Apr. 21, 2005 at E01.
[56] *Id.*.
[57] Kathleen Day & Annys Shin, *Falcon Say Fannie Neglected Its Mission*, WASH. POST., Apr. 22, 2005 at E10.
[58] *Id.*
[59] *Id.*
[60] Kathleen Day & Terence O'Hara, *False Signatures Aided Fannie Mae Bonuses, Falcon Says*, WASH. POST., Apr. 7, 2005 at E01.
[61] *Id.*
[62] *Id.*
[63] *Id.*

company.[64] Freddie also released its 2004 accounting, showing a sharp drop in its share of the mortgage-related securities market.[65]

In May 2005, it was reported that the Bush administration did not like key provisions of the reform bill that was making its way through the House of Representatives.[66] The White House felt that the bill being proposed by Richard Baker and Michael Oxley ("Oxley") did not go far enough.[67] The White House advocated a must stricter relationship between the regulator and the GSEs.[68] Under that plan, the regulator would require that the GSEs keep only enough assets for liquidity and to further their mission of providing housing.[69] However, the GSEs have argued in response that a restriction on the types of portfolios that they are allowed to have would interfere with their ability to respond to certain crises situations, like the terrorist attacks of September 11, 2001.[70] Oxley was reported as believing that despite their differences, the White House would nonetheless be able to support the less strict version of the bill.[71] Additionally, Fannie announced that it would no longer allow its employees to trade in company stock, as a way to protect for accidentally violating securities law.[72]

In late May, Oxley announced that the new GSE regulator would have the ability to oversee the GSE investment portfolios, but would not require them to divest their assets.[73] It would, however, authorize the new regulator to force Fannie and Freddie to buy or sell from the holdings in their portfolios if they judge it to be important for financial soundness.[74] The White House reiterated that the bill did not go far enough but expressed approval that the issue was being dealt with.[75]

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[64] *Id.*
[65] Annys Shin, *Fannie Mae's Market Share Fell Last Year*, WASH. POST., May 12, 2005 at E04.
[66] Rob Blackwell, *GSE Bill Not Enough for White House*, AM. BANKER, May 12, 2005 at 91.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] Kathleen Day & Annys Shin, *supra* note 52.
[71] Rob Blackwell, *supra* note 66.
[72] Carrie Johnson & Terence O'Hara, *Fannie Mae Bans Workers From Trading In Its Stock*, WASH. POST., May 5, 2005 at E01.
[73] Annys Shin, *Bill Considers Oversight of Loan Holding*, WASH. POST., May 24, 2005 at E01.
[74] Annys Shin, *House Take Up Bill on Fannie Oversight*, WASH. POST., May 25, 2005 at E02.
[75] *Id.*

On May 25, the House Financial Services Committee passed Oxley's legislation to create a new regulator for the GSEs.[76] This bill gave the new regulator power to put the companies into receivership, change their investment portfolios to maintain fiscal soundness and approve new programs from the GSEs.[77] This passage represented a significant change.[78] Two years prior, there had been another reform bill which was never taken up due to the lobbying power of the GSEs.[79] It became clear that things had changed;[80] nonetheless, the White House wanted something stricter, which would limit the types of assets it could have.[81]

In June 2005, Mudd was appointed president and CEO of Fannie Mae.[82] His mission was to repair relations with Congress.[83] He had already been serving as interim chief of Fannie at the time of his appointment.[84] Mudd was more attentive to members of Congress than previous heads of Fannie.[85] Mudd, however, lacked the political connections and experience of his predecessor, Franklin Raines.[86] In addition, his style tended to be more low-profile, preferring to change the organization's culture from within.[87] One of the ways in which Mudd attempted to accomplish this change of culture was to hire a chief ethics and compliance officer.[88]

In late June 2005, Senator Richard Shelby ("Shelby") said he wanted the new reform legislation to be stricter than what the House Committee passed.[89] His plan would actually allow the regulator to roll back the size of the organizations if their investments were not in line with their mission.[90] This provision was more in

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[76] Annys Shin, *House Panel Approves New Fannie Regulator*, WASH. POST., May 26, 2005 at E01.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] Annys Shin, *Fannie Mae's Mudd Elevated to CEO*, WASH. POST., June 2, 2005 at D01.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] Annys Shin, *Mudd Vows to Change Fannie Mae Culture*, WASH. POST., June 3, 2005 at D04.
[89] Annys Shin, *Shelby Seeks Regulator With More Power to Limit Mortgage Giants*, WASH. POST., June 24, 2005 at D04.
[90] *Id.*

line with the reforms advocated by the White House.[91] However, it did not go as far as the White House wanted because it would not require a reduction in the size of GSE portfolios.[92] It is also out of step with the legislation that had already passed in the House.[93] Shelby argued that the new regulator should require that the companies' holdings be consistent with their mission.[94]

In late October, the U.S. House of Representatives voted 331 to 90 for oversight reform legislation for Fannie Mae and Freddie Mac.[95] This bill allowed the regulator to change their portfolio holdings, in order to keep the companies afloat.[96] However, the bill was sharply at odds with Senator's Shelby's reform bill, which would force the GSEs to sell a sizable portion of their investments in order to make them smaller.[97]

After passage of the House legislation, the White House issued a statement: "[g]iven the size and importance of the [GSEs, Fannie Mae and Freddie Mac] Congress must ensure that their large mortgage portfolios do not place the U.S. financial system at risk. [The bill] fails to provide critical policy guidance in this area."[98] Notably, the position advocated by both the Senate and the White House failed to garner support in the House of Representatives.[99] An amendment to the House legislation, which would have created the stricter type of reform, failed in the House.[100] These differences have led some commentators to conclude that, once again, GSE reform will not happen in 2006.[101] In that same statement of policy issued after the House vote, the White House said in stark terms, "[t]he administration opposes the bill."[102]

With no clear indication how these differences of policy preference can be resolved, at least one observer has called this

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[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] Annys Shin, *House Passes Bill on Fannie and Freddie Oversight*, WASH. POST., Oct. 27, 2005 at D01.
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] Michelle Heller, *Barring Disaster, GSE Reform Unlikely in 2006*, AM. BANKER, Dec. 5, 2005 at 245.
[102] *Id.*

showdown a "political stalemate."[103] In addition, bad news appears to be looming on the horizon.[104] Currently, there are two investigations underway of Fannie Mae.[105] One is being done by its current regulator, the OFHEO.[106] The other is an internal investigation initiated by Fannie, being done by former U.S. Senator Warren Rudman, currently a partner at Paul Weiss Rifkind Wharton and Garrison LLP.[107] These investigations are expected to unmask even more accounting and corporate governance infractions.[108] However, even if new revelations of fraud come to light, unless there is a "bombshell,"[109] it is unlikely that the current stalemate will be broken.[110]

C. Conclusion

As 2005 began, the scandals that had rocked Fannie Mae and Freddie Mac gave momentum to reform initiatives that had previously seemed impossible due to GSE lobbying clout and a lack of political will. However, as the year ended it appeared that, at least for the time being, meaningful reform has been stalled. So long as the parties remain entrenched in what appears to be irreconcilable positions, it remains unclear whether that momentum will go anywhere. Nonetheless, there still appears to be political desire to pass some type of reform legislation. The question that remains is whether or not a consensus can be reached to unlock the stalemate.

Judah Skoff[111]

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[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] Student, Boston University School of Law (J.D. 2007)

XVI. DOMESTIC AND INTERNATIONAL TAXATION

A. Introduction

State legislatures considered various proposals during the year addressing tax loopholes and adjusting taxes on financial institutions through deductions, credits and new taxes. Although Congress passed no major federal tax law changes directed at financial institutions, the Internal Revenue Service ("IRS") issued guidance on certain types of bank income and insurance investments. International developments generally involved tax revisions designed to encourage competition, promote development of financial markets, liberalize retirement investments and generate revenue.

B. Domestic Taxation – States

1. North Dakota

On March 25, 2005, North Dakota Governor John Hoeven signed into law Senate Bill 2158 ("S.B. 2158") authorizing income tax credits for financial institutions making contributions to tuition scholarships.[1] The law provides an income tax credit for qualifying financial institutions equal to fifty percent of their aggregate contributions to tuition scholarships.[2] The credit is limited to the lesser of $2,500 or 5.7 % of pre-credit tax liability and is available for tax years beginning on or after January 1, 2005.[3]

2. Tennessee

In a notice issued on February 10, 2005, the Tennessee Department of Revenue provided guidance on a change to the net worth calculation for state franchise tax purposes.[4] State law P.A. 04-932, signed into law in 2004, repealed an existing deduction,

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[1] S.B. 2158, 59th Leg. Assem., Reg. Sess. (N.D. 2005); Mark Wolski, *House Endorses Bill Allowing Credits for Banks' Scholarship Contributions*, [Jan. – June] 84 Banking Rep. (BNA) No. 12, at 534 (Mar. 21, 2005).

[2] *Id.*

[3] *Id.*

[4] Andrew M. Ballard, *Revenue Agency Guidance Outlines Change to Net Worth Calculation for Franchise Tax*, [Jan. – June] 84 Banking Rep. (BNA) No. 7, at 284 (Feb. 14, 2005).

which allowed taxpayers to deduct from their net worth base the value of stock held in companies doing business in the state.[5] In place of the deduction, taxpayers that are members of an affiliated group or a financial institution affiliated group may elect to calculate their net worth base for franchise tax purposes on a consolidated basis.[6] Under Tennessee law, "a financial institution affiliated group is defined as any affiliated group in which more than fifty percent of the group's aggregate gross income is derived from the business of a financial institution."[7] The net worth base for members of the affiliated group is their proportional share of the difference between total assets and total liabilities of the group at year end.[8]

3. Texas

House Bill 17, currently in the Texas legislature, would close a loophole in Texas law that permits corporations to avoid the corporate franchise tax by setting up as partnerships.[9] The bill would require corporations that do business or own property in Texas, including savings and loan associations, banking corporations, limited liability companies and business trusts, to pay the corporate franchise tax.[10] If passed, the "bill would take effect for tax reports due on or after January 1, 2006."[11]

4. Michigan

On January 27, 2005, Michigan Governor Jennifer Granholm proposed The Michigan Jobs and Investment Act, which would restructure and simplify business taxes and add a two-percent tax on insurance premiums.[12] Although the proposal would lower taxes for most businesses subject to the single business tax, it would nearly

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[5] *Id.*
[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] H.B. 117, 79th Leg. Assem., Reg. Sess. (Tex. 2005); Kurt Fernandez, *Texas Bill Would Widen Scope of Businesses Required to Pay Corporate Franchise Tax*, [Jan. – June] 84 Banking Rep. (BNA) No. 2, at 50 (Jan. 10, 2005).
[10] *Id.*
[11] *Id.*
[12] S.B. 0296, 2005 Leg., Reg. Sess. (Mich. 2005); H.B. 4476, 2005 Leg., Reg. Sess. (Mich. 2005); Sheila Schimpf, *Granholm Proposal Would Cut Tax Rate for Business but Add New Insurance Tax*, [Jan. – June] 84 Banking Rep. (BNA) No. 5, at 195 (Jan. 31, 2005).

double the tax burden on insurance companies operating in the state, according to the Insurance Institute of Michigan.[13] Granholm defended the new tax premium, claiming it would bring the insurance tax rate in line with other states.[14] Michigan currently has the 47th lowest state insurance tax in the country.[15]

C. Domestic Taxation – Federal

1. Government Liable for Damages Resulting from Retroactive Withdrawal of Tax Breaks

In *Centex Corp. v. U.S.*, the U.S. Court of Appeals for the Federal Circuit upheld a lower court ruling that Congress cannot revoke tax benefits promised as part of an agreement to acquire troubled savings and loan associations.[16] The benefits in question arose when Centex Corp. contracted with the Federal Savings and Loan Insurance Corporation ("FSLIC") to acquire a number of troubled thrifts.[17] The contract provided that the government would make "payments to Centex to cover bad loans held by the institutions."[18] In addition, Centex was permitted "to deduct the losses that were the basis for the assistance payments."[19] Believing the benefits of this deal were excessive, Congress passed a law barring "acquiring institutions from claiming deductions for specific kinds of losses covered by assistance agreements between investors and the [FSLIC]."[20]

The trial court and the Federal Circuit both agreed with Centex that the government violated a contractual duty to act in good faith when it retroactively disallowed the benefits to which Centex was entitled under the contract with the FSLIC.[21] Although

[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] Centex Corp v. U.S., 395 F.3d 1283 (Fed. Cir. 2005); R. Christian Bruce, *Court Says Government Must Pay Damages for Legislation Targeted at Contract Benefits*, [Jan. – June] 84 Banking Rep. (BNA) No. 5, at 195 (Jan. 31, 2005).
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*

Congress may enact or alter generally applicable tax legislation, it cannot retroactively target specific contractual rights.[22]

2. IRS Issues Guidance on Segregated Asset Account Diversification Requirements

On January 19, 2005, the IRS issued guidance on the application of the look-though rule of IRC Section 817(h)(4) to regulated investment companies owned by variable life insurance contracts and variable annuity contracts ("variable contracts").[23] The assets of variable contracts are held in segregated asset accounts that must meet the diversification requirements of Section 817(h) of the Code and Section 1.817-5(b) of the regulations.[24] The diversification requirements prohibit segregated asset accounts from investing more than fifty five percent of total account assets in any one investment, seventy percent in any two investments, eighty percent in any three investments and ninety percent in any four investments.[25] For purposes of determining compliance with the diversification requirements, Section 817(h)(4) allows segregated asset accounts to look-through to the underlying investments of a regulated investment company ("RIC") owned by the segregated asset account.[26] If the look-through provision applies, a *pro rata* portion of the individual assets of the investment company will be treated as assets of the segregated asset account.[27]

In order to qualify for look-through treatment, all the beneficial interests in the RIC must be owned by insurance company segregated asset accounts or other qualifying beneficial interests, and "public access to the investment company must be available solely through the purchase of a variable contract."[28] If the RIC invests in another RIC, however, and the value of the second tier RIC exceeds fifty five percent of the value of the total assets of the first tier RIC, then the segregated asset account would not be adequately diversified unless it was able to look through to the individual assets of the

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[22] *Id.*
[23] Rev. Rul. 2005-7, 2005-6 I.R.B. 464; Jon Almeras, *IRS Allows Insurers a Deeper Look-Through for RICs*, 106 TAX NOTES 397 (Jan. 24, 2005).
[24] Rev. Rul. 2005-7, 2005-6 I.R.B. 464.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*

second tier RIC.[29] Revenue Ruling 2005-7 stated that as long as the second tier RIC meets the look-through requirements regarding ownership and public access, then the segregated asset account will be treated as owning a *pro rata* share of the assets of the first tier RIC, including a *pro rata* share of the assets of the second tier RIC.[30]

3. IRS Announces Tax Shelter Settlement Initiative

On October 27, 2005, the IRS announced a broad tax shelter settlement initiative aimed at resolving thousands of cases of abusive tax avoidance.[31] Although the IRS will continue to pursue litigation when necessary, IRS Chief Counsel Donald Korb stated that settlement initiatives are "the most effective way" of targeting tax shelters.[32] The recent settlement initiative covers more than 4,000 taxpayers who participated in 21 different transactions.[33] The terms of the settlement offer require the taxpayer to pay 100 % of the taxes due and any accrued interest.[34] In addition, the taxpayer must pay a reduced penalty of twenty-five to fifty percent of the normal penalty, depending on which of the transactions they participated in.[35] The eligible "transactions cover a wide spectrum of shelters involving funds used for employee benefits, charitable remainder trusts, offsetting foreign currency option contracts, debt straddles, lease strips and certain abusive conservation easements."[36]

Some tax practitioners question the effectiveness of settlement proposals because their harsh terms "pose a disincentive for taxpayers to resolve [their] disputes with the service."[37] However, unlike previous settlement offers, this settlement initiative permits taxpayers to take their case to appeals.[38] Taxpayers who wish to settle must file an election form with the IRS by January 23,

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[29] *Id.*
[30] *Id.*
[31] Alison Bennett, *IRS Unveils Sweeping Shelter Settlement Covering 21 Abusive Deals, 4,000 Taxpayers*, [July – Dec.] 85 Banking Rep. (BNA) No. 16, at 713 (Oct. 31, 2005).
[32] Kurt Ritterpusch, *Government Armed with New Tools, Settlement Models in Fight Against Shelters*, [Jan. – June] 84 Banking Rep. (BNA) No. 2, at 80 (Jan. 10, 2005).
[33] Bennett, *supra* note 31.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] Ritterpusch, *supra* note 32.
[38] Bennett, *supra* note 31.

2006.[39] Tax shelter "promoters, their partners, and other related persons are ineligible" for the settlement offer.[40]

4. IRS Rules Third Party ATM Fees to be Treated as Part of Loan to Cardholder

In Revenue Ruling 2005-47, the IRS ruled that for federal income tax purposes, credit card issuers should treat fees charged to cardholders by operators of third party automated teller machines ("ATM's") as part of the amounts loaned.[41] This treatment applies whether the card issuer reflects the surcharge on the cardholder's statement as part of the cash advance or as a separate amount.[42] This transaction falls under Income Tax Regulations Section 1.1273-2(g)(4), which states that payments made by lenders to third parties as part of a lending transaction should be "treated as an additional amount loaned to the borrower and then paid by the borrower to the third party."[43] The IRS also "provided automatic consent procedures for credit card issuers to change their method of accounting for credit card advance fees to treat these fees as creating or increasing original issue discount on a pool of credit card loans that includes the cash advances that give rise to the fees."[44]

5. IRS Issues Final Rules Limiting Insurance and Annuity Contract Partnership Investments

On February 28, 2005, the IRS issued final rules governing the look-through treatment of assets held by partnerships owned by life insurance and annuity contracts.[45] Treasury Decision 9185 removes §1.817-5(f)(2)(ii) of the Federal tax regulations, which permitted look through treatment for investments in partnerships without specifically limiting ownership in those partnerships to

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[39] *Id.*
[40] *Id.*
[41] Rev. Rul. 2005-47, 2005-32 I.R.B. 261; *Third-Party ATM Surcharge Fee Treated as Part of Card Issuer's Loan to Holder*, [July – Dec.] 85 Banking Rep. (BNA) No. 6, at 231 (Aug. 8, 2005).
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] Alison Bennett, *IRS Gives More Compliance Time for Rules Limiting Insurance Contract Tax Avoidance*, [Jan. – June] 84 Banking Rep. (BNA) No. 10, at 431 (Mar. 7, 2005).

variable insurance contracts.[46] This loophole permitted investors to turn "otherwise taxable hedge funds and other entities into tax-deferred or tax-free investments merely by purchasing the investments through a life insurance or annuity contract."[47] Although existing investments in non-qualifying partnerships will not be grandfathered in, the final rules extended the deadline for compliance by six months.[48]

The IRS said that a number of public comments were still being considered and might be addressed in future guidance.[49] These comments included: expanding "the list of certain permitted investors who would be eligible for look-through treatment;" addressing "criticism of a proposal that the return on a manager's interest be computed in the same manner as the return on a segregated asset account's interest;" "providing guidance on the consequences for both a variable contract and its holder when permitted investors in an asset lose that status;" clarifying "the treatment of certain fund arrangements for testing of diversification;" providing "guidance concerning the use of independent investment advisors;" and extending "the special diversification rules for Treasury securities under Section 817 to variable annuity contracts."[50]

6. IRS Issues Guidance on Treatment of Bank Fees as Interest Income

The IRS issued a technical advice memorandum on August 19, 2005 stating that credit card late fees charged by a bank to the cardholder are to be treated as interest income for federal income tax purposes.[51] The example provided in the memorandum addressed cards issued by a bank to customers of a retail business operated by the taxpayer.[52] The bank was a wholly owned subsidiary of the taxpayer and the cards could only be used at the taxpayer's retail stores.[53]

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[46] T.D. 9185, 2005-12 I.R.B. 749.
[47] Bennett, *supra* note 45.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] I.R.S. Tech. Adv. Mem. 2005-33-022 (Aug. 19, 2005); Karen L. Werner, *Late Fees Charged by Institution Interest Income, IRS National Office Says*, [July – Dec.] 85 Banking Rep. (BNA) No. 8, at 338 (Aug. 29, 2005).
[52] *Id.*
[53] *Id.*

In a separate memorandum released on the same day, the IRS ruled that over-the-limit fees, cash advance fees and non-sufficient funds fees received by banks are to be treated as interest income as well.[54] Annual fees charged by banks to cardholders and interchange fees set by credit card associations, however, are not considered interest income for federal income tax purposes.[55]

D. International Taxation

1. Argentina

Argentina's tax agency reported that numerous domestic and foreign banks misstated income following the 2002 currency devaluation in order to evade an estimated $240 million in taxes.[56] Although the names of individual banks suspected of tax evasion were not made public, a representative of the Federal Administration of Public Revenues ("AFIP") said that "virtually all banks operating in Argentina were on the watch list."[57]

According to AFIP, the banks involved overstated their losses while hiding gains associated with the devaluation.[58] The devaluation of the Argentine peso in 2002 forced banks in the country to pay back approximately 1.4 pesos (48 cents) for every dollar they owed, but only allowed them to collect 1 peso (34 cents) for every dollar they had lent.[59] This asymmetric devaluation, coupled with "a prolonged deposits freeze ordered by the government," caused banks operating in Argentina to incur total losses estimated at $10 billion.[60]

If attempts by AFIP to settle the tax evasion claims directly with the banks are not successful, the disputes may move into non-binding arbitration.[61] The arbitration results may then be challenged

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[54] I.R.S. Tech. Adv. Mem. 2005-33-023 (Aug. 19, 2005); Werner, *supra* note 51.
[55] *Id.*
[56] David Haskel, *Argentina Probe Concludes Banks Evaded $240 Million in 2002 Income Tax Payments*, [Jan. – June] 84 Banking Rep. (BNA) No. 14, at 630 (April 4, 2005).
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*

in the courts.[62] AFIP estimates that it may take up to two years to settle all the cases.[63]

2. Venezuela

The Venezuelan National Assembly voted on November 8, 2005 to extend the bank transfer tax, or IDB, through 2006.[64] The IDB imposes a 0.5 percent tax on all bank transfers by individuals exceeding 40 tributary units, or approximately $548, per month.[65] The IDB has been repeatedly extended since its inception in 2002 as an emergency measure.[66] The bill still needs to be approved by the National Assembly a second time and then signed by the President to become law.[67]

3. Indonesia

Indonesia's tax authority announced plans to equalize the application of the value added tax ("VAT") between banks and nonbank financial institutions.[68] Under the current tax structure, all services offered by banks are exempt from VAT.[69] Nonbank financial institutions, however, must charge VAT on all their services.[70] This disparity has placed nonbank institutions at a disadvantage.[71] The recent proposal would impose VAT on certain nonfinancial products and services offered by banks, such as safe deposit box rentals.[72] At the same time, it would exempt all financial services provided by nonbank institutions from VAT.[73] This proposal is designed to "encourage[e] healthy competition between banks and nonbank financial institutions."[74]

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[62] *Id.*
[63] *Id.*
[64] *Venezuela Approves Legislation to Extend Bank Transfer Taxes*, [July – Dec.] 85 Banking Rep. (BNA) No. 18, at 824 (November 14, 2005).
[65] *Id.*
[66] *Id.*
[67] *Id.*; *Venezuela Budget Bill Would Extend Bank Transfer Taxes Through 2006*, [July – Dec.] 85 Banking Rep. (BNA) No. 15, at 693 (Oct. 24, 2005).
[68] Jonathan Hopfner, *Indonesian Authorities Mull New Taxes for Bank Services*, [July – Dec.] 85 Banking Rep. (BNA) No. 6, at 260 (Aug. 8, 2005).
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*

4. Singapore

The Singapore Parliament announced a number of tax revisions aimed at attracting financial institutions.[75] The plan includes lowering the tax rate on income earned from securities borrowing and lending activities to ten percent.[76] It would also waive the duties levied on transfers of Singapore properties into Singapore registered real estate investment trusts for a period of five years.[77] "In order to encourage exchange traded commodity derivative trading, the government plans to initiate a five percent concessionary tax rate on qualifying income from exchange traded commodity derivatives."[78] The new tax measures also contain tax reductions targeted at Islamic financial products.[79] Islamic product transactions involving real estate would no longer be subject to double stamp duties.[80] Income from "Islamic bonds would also be treated . . . the same way as interest derived from conventional financing."[81]

5. France

The government of France issued rules on November 4, 2005, expanding the types of qualifying investments that may be made with personal portfolio bonds.[82] Personal portfolio bonds are a form of single premium insurance policy popular in France due to their favorable tax treatment.[83] Previously, these insurance policies were limited to Euro denominated cash and bond investments.[84] The new rules allow investors to purchase publicly traded stocks and mutual funds while retaining the tax benefits of the insurance policy.[85]

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[75] Rafael D. Frankel, *Singapore's Proposed Budget Raises Tax Exemptions for Institutions*, [Jan. – June] 84 Banking Rep. (BNA) No. 9, at 411 (Feb. 28, 2005).
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] Lawrence J. Speer, *France Expands Investment Options for Tax-Advantaged Savings Plans*, [July – Dec.] 85 Banking Rep. (BNA) No. 19, at 873 (Nov. 21, 2005).
[83] *Id.*
[84] *Id.*
[85] *Id.*

E. Conclusion

Many of the tax developments from 2005 were modifications or clarifications of existing laws and regulations. As always, tax evasion through the use of tax shelters, tax loopholes and outright fraud continues to be a concern for domestic and international tax authorities.

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XVII. KETRA: TAX RELIEF & HURRICANE KATRINA

A. Hurricane Katrina's Effects and KETRA's Economic Response

On Monday, August 29, 2005, the eye of Hurricane Katrina struck Louisiana, collapsing New Orleans' levee system and ravaging the Gulf Coast and sections of Florida. The severe and widespread damage, estimated at over $100 billion, qualifies Hurricane Katrina ("the Hurricane" or "Katrina") as the most expensive natural disaster in the history of the United States.[1] In response, President Bush declared a 90,000 square mile area covering Alabama, Mississippi, Louisiana and Florida to be a federal disaster zone and authorized the Federal Emergency Management Agency ("FEMA") to provide individual and public assistance to counties and parishes in each state.[2]

The President called for tax relief to rebuild the affected regions and aid recovery of the affected families, communities and businesses. On September 21, 2005, Congress responded by unanimously passing H.R. 3768, the Katrina Emergency Tax Relief Act of 2005 ("KETRA"), which the President signed into law on September 23, 2005.[3] The bill defines the "Hurricane Katrina disaster area" to include designated areas of Alabama, Florida, Louisiana and Mississippi and the "core disaster area" to include that part of the Hurricane Katrina disaster area warranting individual and/or public assistance from the federal government.[4] KETRA appropriates $6.1 billion in tax relief to individuals and businesses directly and indirectly affected as well as to relief workers and

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[1] Press Release, Risk Mgmt. Solutions, RMS Expects Economic Loss to Exceed $100 Billion from Hurricane Katrina and the Great New Orleans Flood (Sept. 2, 2005) (on file with author), *available at* http://www.rms.com/NewsPress/PR_090205_HUKatrina.asp. RMS is the world's leading provider of products and services for the quantification and management of catastrophe risks. *See also* Wikipedia, *Hurricane Katrina*, Nov. 14, 2005, http://en.wikipedia.org/wiki/Hurricane_Katrina#Effects_outside_the_immediate_region.

[2] I.R.S. Notice 2005-73, I.R.B. 723; Wikipedia, *supra* note 1

[3] CCH, CCH TAX BRIEFING: KATRINA EMERGENCY TAX RELIEF ACT OF 2005 SPECIAL REPORT (2005), http://tax.cchgroup.com/tax-briefings/2005-Katrina.

[4] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., TECHNICAL EXPLANATION OF H.R. 3768 (2005), *available at* http://www.house.gov/jct/x-6905.

charitable contributors.[5] The tax relief aims to increase personal disposable income, help with immediate cash flow problems and provide incentives for charitable donations of goods and services.[6]

KETRA is a vital step in rebuilding the disaster areas due to the monstrous economic costs of Katrina. Total employment in the eighty-six hardest hit counties is 2.4 million, and estimates of privately-insured damage range from $40 to $60 billion, as compared to $32.5 billion resulting from the World Trade Center attacks in 2001.[7] Business has been equally affected. For example, the somewhat stabilized construction industry is again experiencing inflationary pressures as experts estimate annual price escalation at ten to twenty percent due to the Hurricane.[8] Moreover, damage sustained by New Orleans has shut down approximately ten percent of U.S. refining capacity and eighteen percent of U.S. crude oil production.[9]

Since KETRA's provisions primarily apply to the 2005 and 2006 tax years, the majority of revenue effects will be realized in 2006 and 2007.[10] As a result of KETRA, the Joint Committee on Taxation ("JCT") estimates that this legislation will cause a $3.2 billion decrease in federal revenues and a corresponding $128 million increase in direct spending in 2006 alone.[11] Global Insight's September 2005 U.S. Macroeconomic Model reveals "small, but positive" economic effects resulting from KETRA.[12] Between 2006 and 2008, on average, U.S. real Gross Domestic Product will increase $1.2 billion; U.S. real personal consumption expenditures will be $1.6 billion higher; U.S. real disposable personal income will

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[5] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., ESTIMATED REVENUE EFFECTS OF THE KATRINA EMERGENCY TAX RELIEF ACT OF 2005, *available at* http://www.independentsector.org/programs/gr/JCTest.pdf.

[6] TRACY L. FOERTSCH, PH.D., AND RALPH A. RECTOR, PH.D., THE HERITAGE FOUNDATION, THE ECONOMIC AND BUDGETARY EFFECTS OF KETRA OF 2005, http://www.heritage.org/Research/Taxes/wp20050921.cfm.

[7] Foertsch, *supra* note 6.

[8] William J. Angelo & Tim Grogan, *Katrina Keeps Inflation Roaring*, ENGINEERING NEWS-RECORD, Sept. 26, 2005, AT 66-67.

[9] Foertsch, *supra* note 6.

[10] G. THOMAS WOODWARD, CONGRESSIONAL BUDGET OFFICE, COST ESTIMATE: H.R. 3768 (2005), http://www.cbo.gov/showdoc.cfm.

[11] Woodward, *supra* note 10.

[12] Foertsch, *supra* note 6. Global Insight is a private provider of economic and financial coverage and analysis. Fortune-500 companies and numerous government agencies use Global Insight's U.S. Macroeconomic Model to forecast how important changes in the economy and in public policy will likely affect hundreds of major economic indicators.

be $2.8 billion higher; and, total non-farm employment will increase by 11,000 jobs.[13]

B. KETRA Provisions

1. Retirement Funds

Generally, a ten percent penalty applies to early distributions from Individual Retirement Accounts ("IRAs"), 401(k) plans and pensions if made before a certain age in order to discourage premature use of funds intended to finance life after retirement.[14] KETRA provides an exception to the penalty for a qualified Hurricane Katrina distribution, defined as a distribution from an eligible retirement plan made on or after August 25, 2005 and before January 1, 2007 to a qualified individual, a person whose principal residence is located in the Hurricane Katrina disaster area and who has sustained economic loss by reason of Katrina.[15] Victims may withdraw up to $100,000 (in contrast to the usual $50,000 cap) free of the ten percent withdrawal tax.[16] Taxpayers have three years to re-contribute the funds in order to avoid income tax.[17] Similarly, taxpayers who withdrew funds from a retirement savings vehicle after February 28, 2005 and before August 29, 2005 for a first-time home purchase in the Hurricane Katrina disaster area, but were unable to consummate the purchase, can repay the funds tax-free before February 28, 2006.[18] Moreover, a qualified individual obtaining a loan from a qualified employer plan with a repayment date between August 25, 2005 and December 31, 2006 can delay repayment by one year.[19]

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[13] Foertsch, *supra* note 6.
[14] B. JANELL GRENIER, BENEFITSBLOG, A TAX, BENEFITS AND ERISA LAW COMMENTARY AND NEWS FILTER (2005), http://www.benefitscounsel.com/archives/001602.html.
[15] Katrina Emergency Tax Relief Act of 2005, H.R. 3768, 109th Cong. § 201 (2005).
[16] *Id.* § 101.
[17] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[18] CCH, *supra* note 3.
[19] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.

2. Employment Relief and Business Recovery

The Work Opportunity Tax Credit ("WOTC") is a maximum credit per employee of $2,400 available to employers who hire employees from one of eight targeted groups of economically-challenged individuals or those who face barriers to employment.[20] The targeted groups are: 1) eligible families under the Temporary Assistance for Needy Families Program; 2) high-risk youth; 3) qualified ex-felons; 4) vocational rehabilitation referrals; 5) qualified summer youth employees; 6) qualified veterans; 7) families receiving food stamps; and 8) those receiving Supplemental Security Income benefits.[21] KETRA creates a new targeted group for application of the WOTC that includes Katrina victims and waives the current expiration date of January 1, 2006.[22] In place of the certification requirement from a local agency designating bona fide targeted group membership, Hurricane Katrina victims need only present their employers with reasonable evidence that they are members of the new targeted group.[23]

KETRA creates a tax credit to encourage small employers to maintain employees on their payrolls. Eligible employers can recoup forty percent of the first $6,000 in wages paid to each employee whose principal place of employment on August 28, 2005 was within the core disaster area.[24] An eligible employer is one whose business in the core disaster area became inoperable after August 28, 2005 and before January 1, 2006 due to the Hurricane.[25] Eligible employers can employ no more than an average of two hundred employees on any business day during the taxable year.[26]

3. Charitable Gift Incentives

Currently, contributions by individuals to charitable, tax-exempt organizations are limited to fifty percent of the taxpayer's adjusted gross income with a five-year carry-forward provision for

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[20] CCH, *supra* note 3.
[21] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[22] H.R. 3768, 109th Cong. § 201 (2005).
[23] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[24] H.R. 3768, § 202.
[25] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[26] CCH, *supra* note 3.

excess contributions.[27] KETRA removes the fifty percent limitation for all qualified contributions, and the corresponding deduction is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions.[28] Taxpayers may carry over excess contributions to succeeding taxable years.[29] Qualified contributions are cash contributions made during the period beginning August 28, 2005 and ending December 31, 2005 to a charitable organization, but these contributions require no connection with Hurricane Katrina.[30]

Charitable contributions by corporations are not deductible beyond ten percent of the corporation's taxable income; excess contributions can be carried over for up to five successive years.[31] KETRA waives the ten percent limitation for corporations and allows a deduction for qualified cash contributions up to the amount by which the corporation's taxable income exceeds the deduction for other charitable contributions, with excess contributions carried over to succeeding taxable years.[32] To qualify for KETRA's tax treatment, corporations must specifically contribute to Hurricane Katrina relief efforts and substantiate these contributions.[33]

Taxpayers who house Hurricane Katrina-displaced individuals in their principal residence for at least sixty consecutive days free of charge can claim an exemption of $500 for each individual up to a maximum of four individuals.[34] The individuals must have been in the Hurricane Katrina disaster area on August 28, 2005.[35] In order to claim the maximum exemption of $2,000, a taxpayer must not receive any remuneration from any source.[36]

If a taxpayer operates a personal vehicle to perform charitable work, the taxpayer can either deduct out-of-pocket expenses or use the charitable standard mileage rate, set by statute at $.14 per mile.[37] The charitable standard mileage rate covers gas and oil, but does not include general repair or maintenance expenses,

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[27] *See id.*
[28] H.R. 3768, § 301.
[29] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[30] CCH, *supra* note 3.
[31] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[32] H.R. 3768, § 301.
[33] CCH, *supra* note 3.
[34] H.R. 3768, § 302.
[35] CCH, *supra* note 3.
[36] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[37] *See id.*

depreciation, insurance or registration fees, which are considered in the standard business mileage rate.[38] The taxpayer must record number of miles driven, time, place and purpose of the mileage.[39] KETRA allows a taxpayer claiming vehicle mileage related to Katrina relief work to use a reimbursement rate equal to seventy percent of the business mileage rate effective on the date of contribution.[40] Through August 31, 2005, the business mileage rate was $.405 per mile; from September 1 through December 31, 2005, the rate was $.485 per mile.[41] Taxpayers claiming this deduction must retain evidence that the charitable services rendered were related to Hurricane Katrina relief efforts.[42]

Prior to KETRA, a taxpayer's deduction for charitable contributions of inventory was limited to the lesser of cost and fair market value.[43] Corporations could claim an enhanced deduction equal to the lesser of a) basis plus one-half of excess of fair market value over basis, and b) two times basis for donated property appropriately used by the donee.[44] KETRA allows any taxpayer, regardless of corporate designation, to claim the enhanced deduction for donations of food inventory between August 28, 2005 and January 1, 2006.[45] Food must qualify as "apparently wholesome" and must meet all quality and labeling standards imposed by federal, state and local laws.[46] Deductions for small business corporations ("S corporations"), sole proprietorships and partnerships cannot exceed ten percent of the taxpayer's net income for the applicable tax year.[47]

KETRA extends the current enhanced deduction for corporations ("C corporations") to qualified book contributions. C corporations may claim an enhanced deduction equal to the lesser of a) basis plus one-half of excess of fair market value over basis, and b) two times basis for contributions made after August 28, 2005 and before January 1, 2006.[48] A qualified book contribution is a

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[38] *See id.*
[39] *See id.*
[40] H.R. 3768, 109th Cong. § 303 (2005).
[41] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[42] CCH, *supra* note 3.
[43] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[44] *See id.*
[45] H.R. 3768, § 305.
[46] CCH, *supra* note 3.
[47] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[48] *See id.*

charitable contribution of books to an elementary or secondary public educational organization with a regular faculty, curriculum and enrolled body of students.[49] The recipient school must certify that the books are suitable for its purposes and that it will use the books in its programs.[50]

4. Additional Miscellaneous Tax Relief Provisions

Gross income includes income realized by a taxpayer from the discharge of indebtedness, which is taxable.[51] If the Federal Deposit Insurance Corporation or other applicable entity discharges the non-business debt of a Katrina victim, KETRA does not include the debt when calculating the victim's gross income.[52] This provision applies to discharges made between August 25, 2005 and January 1, 2007, but it does not apply if any real property securing such debt is located outside of the Hurricane Katrina disaster area.[53]

In general, non-business casualty losses are deductible only if they exceed $100 and ten percent of the taxpayer's adjusted gross income.[54] KETRA removes these limitations on losses in the Hurricane Katrina disaster area on or after August 25, 2005.[55] Taxpayers can choose to claim these losses either on a 2004 amended return by filing Form 1040X or as part of 2005's return.[56]

KETRA provides tax relief by extending tax deadlines. Generally, individuals make quarterly estimated tax payments during the following taxable year, although the Secretary of the Treasury ("Secretary") has the authority to extend deadlines for a period of up to one year to accommodate a Presidentially-declared disaster.[57] KETRA allows the Secretary to suspend the time period for certain required acts including filing and payment requirements for employment and excise taxes.[58] Specifically, taxpayers affected by the Hurricane have until February 28, 2006 to comply with required

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[49] H.R. 3768, § 306.
[50] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[51] *See id.*
[52] *See id.*
[53] *See id.*
[54] CCH, *supra* note 3.
[55] H.R. 3768, § 402.
[56] I.R.S., FAQS ABOUT YOUR TAX RELIEF, http://www.irs.gov/newsroom/article/0,,id=147240,00.html.
[57] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[58] H.R. 3768, § 403.

acts such as filing tax returns or paying taxes including employment and excise taxes.[59] For taxpayers in designated areas of Alabama, Louisiana and Mississippi, the relief applies to any return due on or after August 29, 2005; the applicable date in designated areas of Florida is August 24, 2005.[60] Congress has granted businesses a similar extension to make federal tax deposit ("FTD") payments in the form of social security, Medicare and federal income taxes withheld from employee paychecks.[61]

Certain state and local bonds providing financing to non-governmental persons are excluded from income if they are qualified private activity bonds such as qualified mortgage bonds or qualified home improvement loans.[62] Qualified mortgage bonds facilitate mortgage loans to first-time homebuyers placing specific income limits on the buyers and purchase price limits on the homes.[63] Qualified mortgage bonds cannot finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years prior to the execution of the subject mortgage.[64] This first-time homebuyer requirement does not apply to targeted area residences defined as residences located in a) a census tract where seventy percent of the families have an income level at or below eighty percent of the statewide median income, or b) an area of chronic economic distress.[65] KETRA waives this requirement for a mortgagor whose principal residence was rendered uninhabitable by Katrina and the residence being financed before January 1, 2008 is located in the same state as the affected residence.[66] KETRA also increases the $15,000 limit on qualified home improvement loans to $150,000 to repair damage caused by Hurricane Katrina.[67]

Similar to the handling of property involuntarily converted as a result of the 2001 terrorist attacks in New York, KETRA extends the period during which a taxpayer can replace involuntarily converted property due to Hurricane Katrina from two to five years.[68]

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[59] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[60] I.R.S. FAQS, *supra* note 56.
[61] *See id.*
[62] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[63] *See id.*
[64] *See id.*
[65] *See id.*
[66] H.R. 3768, 109th Cong. § 404 (2005).
[67] *See id.*
[68] H.R. 3768, § 405.

Damage from the Hurricane has caused many victims to temporarily relocate to live with friends, family or good Samaritans. A prolonged change in victims' living situations could affect their eligibility for various tax benefits.[69] Currently, eligible taxpayers can claim an earned income and refundable child credit, the amount of which depends on the amount of the earned income of the taxpayer and whether the taxpayer has children.[70] Workers with income below certain amounts are eligible for a $1,000 credit for each child. [71] Income used to calculate the credit is capped at fifteen percent of the taxpayer's earned income in excess of $11,000 for 2005.[72] Qualified taxpayers include those who were displaced from their homes in the core disaster area or the Hurricane Katrina disaster area.[73] KETRA also authorizes the Secretary to adjust the application of the federal tax laws for the taxable years beginning in 2005 or 2006 to ensure that taxpayers do not lose deductions or credits or experience an adverse change of filing status due to temporary relocations caused by Hurricane Katrina.[74] Any adjustments may not allow the same tax benefits attributed to an individual to accrue to more than one taxpayer.[75]

C. Conclusion

Most of the provisions of the Katrina Emergency Tax Relief Act of 2005 are specific to Hurricane Katrina victims. Although victims of future disasters will receive tailored treatment, concomitant relief legislation will most likely leverage relief strategies from KETRA similar to the way in which KETRA has borrowed from legislation enacted pursuant to the September 11, 2001 terrorist attacks. KETRA is an immediate and vital investment in financial and human capital to rebuild New Orleans and the Gulf Coast and to make the country whole again.

Laura Rosiecki.[76]

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[69] *H.R. 3768, Katrina Emergency Tax Relief Act of 2005, House amend. to Senate amend.,* 109th Cong. (2005) (statement of Rep. Thomas, Chairman, Committee on Ways and Means).
[70] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[71] *See id.*
[72] *See id.*
[73] STAFF OF JOINT COMM. ON TAX'N, 109TH CONG., *supra* note 4.
[74] H.R. 3768, 109th Cong. § 407 (2005).
[75] *See id.*
[76] Student, Boston University School of Law (J.D. 2007).

XVIII. SECURITIES OFFERING REFORM

A. Introduction

On November 3, 2004, the Securities and Exchange Commission ("SEC") proposed new rules and forms regarding securities offerings and communication processes under the Securities Act of 1933 and the Securities Exchange Act of 1934.[1] The SEC adopted the proposals on June 29, 2005.[2] The new rules went into effect on December 1, 2005.[3] The Securities Offering Reform of 2005 ("SOR") principally affects three areas: (1) communications related to registered securities offerings, (2) registration and other procedures in the offering and capital formation process, and (3) delivery of information to investors, including delivery through access and notice, and timeliness of that delivery.[4] In short, among other changes, the SOR streamlines the offering process, and facilitates communications between investors, issuers and underwriters.[5]

The SOR was enacted as a response to advances in technology and in recognition of the Exchange Act's reporting standards.[6] Technology advances have not only increased the market's demand for more timely corporate disclosure, but also the ability of issuers to communicate with the capital market.[7] The Exchange Act's improved reporting standards provide a sufficient disclosure system for investment decisions.[8] In addition, although the SEC understands the regulatory tension between ongoing corporate communications to investors and a regulatory framework designed to limit those communications, it came down in favor of the

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[1] Securities Offering Reform; Final Rule, 70 Fed. Reg. 44,722, 44,724 (Aug. 3, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, & 274) [hereinafter Final Rule].
[2] Press Release, SEC (July 1, 2005), *at* http://www.sec.gov/news/press/2005-99.htm.
[3] Final Rule, *supra* note 1, at 44,722.
[4] *Id.* at 44,725.
[5] Cynthia M. Krus et al., *As SEC steps back, new pressure falls on private counsel for offerings*, LEGAL TIMES, Nov. 21, 2005 at 36.
[6] Final Rule, *supra* note 1, at 44,726.
[7] *Id.*
[8] *Id.*

ongoing communications.[9] The new rules focus less on whether an offer is legal, but more on whether it was an honest, accurate offer.[10]

B. Well-Known Seasoned Issuer

The SOR creates a new category of issuers, the Well-Known Seasoned Issuers ("WKSIs"), who benefit the most from the reform.[11] First, the SOR allows WKSIs to engage in oral and written communications at any time, including the use of a free writing prospectus.[12] Second, the SOR provides WKSIs with the automatic shelf registration, a more streamlined offering registration process with greater flexibility.[13] These two benefits will be discussed in the Communication Rules and Registration Rules sections.

According to the added definition in Securities Act Rule 405, a WKSI must meet the registrant requirements of Form S-3 or Form F-3 and must either have at least $700 million common equity in the worldwide market, or at least $1 billion non-convertible securities other than common equity.[14] The reason for this requirement is that there is a sufficient degree of disclosure for those issuers who have a reporting history under the Exchange Act and are presumptively the most widely followed in the market place.[15] Between 1997 and 2004, there were on average 12 analysts following issuers with market capitalizations in excess of $700 million prior to the offering.[16] In addition, during the same period, issuers that met the $1 billion threshold usually provided debt offerings that were mostly highly rated with low yield spreads.[17] These characters reflect low default risk, high liquidity and transparency of the issuers.[18]

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[9] Fenwick & West LLP, *Sweeping New Rules Apply to Securities Offerings by Technology and Life Science Companies*, MONDAQ BUS. BRIEFING, Oct. 14, 2005.
[10] *Id.*
[11] Final Rule, *supra* note 1, at 44,727.
[12] *Id.* at 44,734.
[13] *Id.* at 44,726 n.40.
[14] *Id.* at 44,727.
[15] *Id.* at 44,726.
[16] *Id.* at 44,728.
[17] *Id.* at 44,729.
[18] *Id.*

C. Communication Rules

Prior to the new rules, the Securities Act prohibited any offer before the registration statement was filed.[19] Between the filing of the registration statement and its effectiveness, offers made in writing, by radio, or by television were limited to a Securities Act Section 10 statutory prospectus.[20] Violations of these two restrictions are generally referred to as gun jumping.[21] The SOR provides safe harbors or exemptions for issuers or other offering participants to avoid violating the gun-jumping provisions in the following three sections.[22]

1. Permitted Continuation of Ongoing Communications during an Offering

During the pre-filing period, the SOR provides two separate and non-exclusive safe harbors from the gun-jumping provisions for ongoing business communications under Rules 168 and 169.[23] The first safe harbor permits a reporting issuer to continue publishing regularly released factual business and forward-looking information at any time, including the time around a registered offering.[24] The second safe harbor permits a non-reporting issuer to continue publishing regularly released factual business information for the use of people other than investors.[25] Communications that qualify within one of the two safe harbor provisions do not fall within the definition of an "offer" under Security Act Section 5(c).[26]

Under the first safe harbor provision, factual business information is defined as: (1) factual information about the issuer, its business or financial developments; (2) advertisement of the issuer's products or service; and (3) dividend notices.[27] Forward looking information is defined as: (1) projections of the issuer's financial items, such as revenues; (2) statements about the issuer management's plans and objectives for future operations; (3)

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[19] *See* 15 U.S.C. § 77e(c) (2000).
[20] *See* 15 U.S.C. § 77e(b)(1).
[21] Final Rule, *supra* note 1, at 44,731.
[22] *Id.* at 44,722.
[23] *Id.* at 44,735.
[24] *See* 17 C.F.R. § 230.168 (2006).
[25] *See* 17 C.F.R. § 230.169 (2006).
[26] Final Rule, *supra* note 1, at 44,733.
[27] *See* 17 C.F.R. § 230.168.

statements about the issuer's future economic performance including the management's discussion and analysis of financial condition; and (4) assumptions relating to any of the information above.[28] The second safe harbor for non-reporting issuers, though similar, does not include dividend notices within the definition of "factual business."[29]

2. Other Permitted Communications Prior to Filing a Registration Statement

Rule 163A provides all issuers a 30-day bright-line exclusion from the prohibition on offers prior to filing a registration statement.[30] Certain communications made by an issuer more than 30 days before the filing will not be deemed to be offers under the Securities Act Section 5(c).[31] In addition to the safe harbor provisions made for regularly released factual business, forward-looking information and the exemption from the 30-day bright-line exclusion, the SOR also permits WKSIs to make unrestricted oral and written offers before a registration statement is filed.[32]

3. Relaxation of Restriction on Written Offering-Related Communications

For the post-filing period, the SOR makes two expansions on the safe harbors for written offering-related communications.[33] The first expands the information that Securities Act Rule 134 permits to be communicated, and the second permits the use of a free writing prospectus in a registered offering.[34]

1) Rule 134

When offering participants make an offer in the form of a prospectus, the offering participants must provide certain information in the communication.[35] Rule 134 provides a safe harbor by identifying communications not deemed a prospectus, and all issuers

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[28] *See id*.
[29] *See* 17 C.F.R. § 230.169.
[30] Final Rule, *supra* note 1, at 44,739.
[31] *See* 17 C.F.R. § 230.163A (2006).
[32] *See* 17 C.F.R. § 230.163 (2006).
[33] Final Rule, *supra* note 1, at 44,742.
[34] *Id.*
[35] *See* 15 U.S.C. § 77j (2000).

who want to use this safe harbor must first file a registration statement that includes a statutory prospectus.[36] The SOR permits increased information about an issuer, including the issuer's contact information, terms of the securities, and factual information about the procedure of the offering.[37]

2) Permissible Use of a Free Writing Prospectus

The introduction of the free writing prospectus may be the most significant change in securities offering law.[38] A free writing prospectus, according to the definition in Rule 405, is a written offer outside of the statutory prospectus.[39] After an issuer files a registration statement, the gun-jumping provisions permit the issuer and other offering participants to make written offers exclusively in the form of a statutory prospectus.[40] After the registration statement becomes effective, written offers other than a statutory prospectus may be made if a final prospectus meeting the requirements of Securities Act Section 10(a) is sent prior to or at the same time as the written offer.[41] The new rules permit written offers outside the statutory prospectus if certain conditions are met.[42] The new Rule 164 permits the use of a free writing prospectus when: (1) an eligible issuer has filed a registration statement; (2) the other requirements of Rule 164 are met; and (3) the conditions of Rule 433 are satisfied.[43]

If the issuer is an ineligible issuer, the offering participants will not be able to use a free writing prospectus.[44] The revised Rule 405 provides categories of ineligible issuers, such as: (1) reporting issuers who are not current in their Exchange Act reports and other materials required during the prior 12 months; (2) issuers who are or during the prior three years were blank check companies, shell companies, or issuers for an penny stock offering; and (3) issuers

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[36] *See* 17 C.F.R. § 230.134 (2006).
[37] Final Rule, *supra* note 1, at 44,742–43.
[38] Pillsbury Winthrop Shaw Pittman LLP, *Securities Offering Reform: Communications Rules*, MONDAQ BUS. BRIEFING, Dec. 21, 2005.
[39] *See* 17 C.F.R. § 230.405 (2006).
[40] *See* 15 U.S.C. § 77e(b)(1) (2000).
[41] *See* 15 U.S.C. § 77b(a)(10) (2000).
[42] *See* 17 C.F.R. §§ 230.164, 230.433 (2006).
[43] Final Rule, *supra* note 1, at 44,745.
[44] *See* 17 C.F.R. § 230.164(e).

who have filed for bankruptcy or insolvency during the past three years.[45]

Under Rule 433, there are four kinds of conditions on the use of a free writing prospectus: (1) prospectus delivery or availability; (2) information in a free writing prospectus; (3) filing conditions; and (4) record retention condition.[46]

(a) Prospectus Delivery or Availability

For non-reporting issuers and unseasoned issuers, they have to file the registration statement of the offering and send the free writing prospectus preceded or accompanied by a preliminary prospectus including a price range.[47] For seasoned issuers and WKSIs, they have to file the registration statement with the preliminary prospectus.[48] However, when they use the free writing prospectus, the seasoned issuers and the WKSIs can only provide an access or hyperlink to the preliminary prospectus.[49]

(b) Information in a Free Writing Prospectus

A free writing prospectus may contain new information not included in the registration statement.[50] However, the information must not conflict with the registration statement and Exchange Act reports filed to the SEC.[51] The free writing prospectus must also contain the legend provided by Rule 433.[52]

(c) Filing Conditions

Generally, an issuer must file a free writing prospectus when the issuer prepares or uses it.[53] An issuer also must file the issuer information when the issuer provides material information in a free

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[45] Final Rule, *supra* note 1, at 44,745-46.
[46] *Id.* at 44,722-23.
[47] *Id.* at 44,747, 44,747 n.239-240.
[48] *Id.* at 44,748, 44,748 n.239.
[49] *Id.* at 44,748.
[50] *See* 17 C.F.R. § 230.433(c)(1).
[51] *Id.*
[52] *See* 17 C.F.R. § 230.433(c)(2)(i).
[53] Final Rule, *supra* note 1, at 44,750.

writing prospectus that is prepared or used by other offering participants.[54] Additionally, an offering participant must file a free writing prospectus when the offering participant distributes it unrestrictedly.[55]

(d) Record Retention Condition

Issuers and offering participants must retain all free writing prospectuses they have used, and that have not been filed, for three years following the initial bona fide offering.[56] For example, the record retention policy applies to free writing prospectuses prepared by underwriters and not containing the issuer's material information.[57]

3) Electronic Road Show

After releasing the proposed rules, the SEC received a large number of comment letters specifically focused on the issue of electronic road shows.[58] Issuers and underwriters frequently conduct presentations known as "road shows" to market their offerings to the public.[59] Electronic road shows are conducted or re-transmitted over electronic media, such as the Internet.[60]

All pre-recorded electronic communications are written communications.[61] Therefore, an electronic road show could be a written offer and prospectus, but could also be a free writing prospectus.[62] The filing conditions of Rule 433 do not apply to the electronic road show, unless the issuer is engaging in an initial public offering of common equity or convertible securities and the electronic road show is made to potential investors on a restricted basis.[63]

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[54] *Id.*
[55] *Id.*
[56] 17 C.F.R. § 230.433(g).
[57] Final Rule, *supra* note 1, at 44,753 n.288.
[58] *Id.* at 44,724, 44,724 n.19.
[59] *Id.* at 44,753.
[60] *Id.*
[61] *See* 17 C.F.R. § 230.405.
[62] Final Rule, *supra* note 1, at 44,753.
[63] *Id.* at 44,754.

D. Registration Rules

The SOR provides the most significant liberalization of shelf registration requirements, especially for WKSIs.[64] The shelf registration allows issuers to register securities in advance and sell them when needed.[65] In addition to modifying the shelf registration process, the SOR establishes the automatic shelf registration for WKSIs.[66] An eligible WKSI may register unspecified amounts of different specified types of securities on immediately effective Form S-3 or Form F-3 registration statements.[67] A WKSI can also add new classes of securities at any time before selling those securities.[68] The new rules will provide WKSIs flexibility to take advantage of market windows, structure securities on a real-time basis to accommodate issuer needs or investor demand, and determine the plan of securities distribution in response to changing market conditions.[69]

When using the automatic shelf registration, a WKSI may omit information that is unknown and not reasonably available from the base prospectus.[70] A WKSI may also omit other information such as: (1) whether the offering is a primary or secondary; (2) the description of the securities; (3) the names of selling securities holders; and (4) the distribution plan.[71] A WKSI may virtually omit all information about the company and any offering from the base prospectus, and add it on later by a post-effective amendment, prospectus supplement or Exchange Act filing.[72] The filing fee is on a "pay-as-you-go" basis at the time of each takedown off the shelf registration.[73]

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[64] John T. Bostelman & Eric J. Kadel, *The SEC's New Securities Offering Rules: Implications for Shelf Issuers*, INSIGHTS, Oct. 2005, at 2.
[65] LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 66 (2nd ed. Foundation Press 2004) (1998).
[66] Final Rule, *supra* note 1, at 44,777.
[67] *Id.*
[68] *Id.* at 44,779.
[69] *Id.* at 44,777.
[70] *See* 17 C.F.R. § 230.430B(a) (2006).
[71] *Id.*
[72] Fenwick & West LLP, *supra* note 9.
[73] Final Rule, *supra* note 1, at 44,777.

E. Prospectus Delivery Rules

Many comment letters and market participants encouraged the SEC to adopt an "access equals delivery" model for final prospectus delivery.[74] The Securities Act requires a Section 10(a) prospectus, known as a "final prospectus," be delivered along with a written confirmation of sale.[75] Under the new Rule 172(b), filing a final prospectus to the SEC will provide an access for investors and equal delivery.[76] The new rules therefore eliminate the prior link between the delivery of a final prospectus and the delivery of a written confirmation of sale and ease the obligation of the final prospectus delivery.[77]

F. Conclusion

The SOR liberalizes the timing and content of permissible communications that an issuer may publish before and during a registered offering.[78] The SOR improves certain registration procedures, particularly in the context of shelf registrations, and creates an "access equals delivery" model for final prospectus delivery.[79] It should be noted that many of the SOR rules, particularly in the context of shelf registrations, are directed to a new category of issuers, the WKSIs.[80]

Steven Hsu[81]

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[74] *Id.* at 44,783.
[75] *Id.* at 44,782.
[76] *Id.* at 44,783.
[77] *Id.*
[78] MATTHEW BENDER & COMPANY, INC., SECURITIES LAW TECHNIQUES § 4.02(1)(b)(iii) (2005).
[79] *Id.*
[80] *Id.* at n.26.
[81] Student, Boston University School of Law (LL.M. 2006).

XIX. SOFT DOLLAR PRACTICES

A. Introduction

"We have got to . . . insure that there can be no mistake about how this thirty year old law applies in today's world," declared Christopher Cox, Chairman of the U.S. Securities and Exchange Commission ("SEC") at the Commission's open meeting on September 21, 2005.[1] Indeed, 2005 marks thirty years since Congress' addition of Section 28(e)[2] to the Securities Exchange Act of 1934.[3] The SEC revisited Section 28(e) in October 2005 with the issuance of a new interpretive release which seeks to provide "crystal-clear guidance" regarding the precise definition of research and brokerage services protected under the safe harbor provision of Section 28(e).[4] The SEC's latest soft dollar release arrives on the heels of the Financial Services Authority's ("FSA") adoption of new soft dollar rules in July 2005 with the publication of Policy Statement 05/9 ("PS05/9").[5]

B. Background

After the SEC eliminated fixed brokerage commissions, Congress established Section 28(e) in an effort to calm the fears of investment managers and broker-dealers who worried that the new system of competitive rates would result in a breach of fiduciary duty "if managers caused a client account to pay anything but the lowest commission rate available" in exchange for research services – a

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[1] Christopher Cox, Chairman, SEC, Speech by SEC Chairman: Statement at the Commission Open Meeting Regarding the Proposed Soft Dollar Interpretive Release (Sept. 21, 2005), *at* http://www.sec.gov/news/speech/spch092105cc2.htm.

[2] 15 U.S.C. § 78bb(e) (2000).

[3] 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 15.02[D], at 15-53 (2d ed., Aspen Law & Business 2003).

[4] Christopher Cox, Chairman, SEC, *supra* note 1; *see* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-52635, 70 Fed. Reg. 61,700 (Oct. 25, 2005) (to be codified at 17 C.F.R. pt. 241) [hereinafter Proposed Interpretation].

[5] FSA, POLICY STATEMENT 05/9: BUNDLED BROKERAGE AND SOFT COMMISSION ARRANGEMENTS; FEEDBACK ON CP05/5 AND FINAL RULES (July 2005) [hereinafter PS05/9], *at* http://www.fsa.gov.uk/pages/library/policy/policy/2005/05_09.shtml.

practice known as "paying up."[6] In this way, Section 28(e) was established to provide a safe harbor and thus assure managers that paying "higher than the lowest commissions charged by any broker or dealer for a similar transaction" with the funds of a client's account would not violate fiduciary principles, provided that Section 28(e)'s conditions were met.[7]

Section 28(e) has since worked to encourage the growth of a sizeable market in soft dollars,[8] estimated at over $1 billion.[9] The SEC specifically defines soft dollars as "arrangements under which products or services other than execution of securities transactions ('soft dollar services') are obtained by an adviser from or through a broker in exchange for the direction by the adviser of client brokerage transactions to the broker."[10] Thus, investment managers generally receive "a bundle of services including research and execution of transactions" from brokers in exchange for paying the broker's commission rate.[11] Rather than leaving it up to individual traders to negotiate soft dollars, large money managers typically maintain formal guidelines detailing the manner in which "soft dollar services will be rendered for expected future commission business."[12]

The hazards of soft dollar arrangements boil down to their inherent conflicts of interest.[13] Critics of soft dollars argue that, a) money managers tend to view research as a "free good" since they can pay for it using commission dollars paid out of a client's account, b) managers rapidly trade or "churn" accounts or pay extremely high commission rates for services that should really be paid for using the managers' own hard dollars, and c) managers conduct trades with

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[6] OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (Sept. 22, 1998) [hereinafter OCIE REPORT], *available at* http://www.sec.gov/news/studies/softdolr.htm.

[7] FRANKEL & SCHWING, *supra* note 3, § 15.02[D], at 15-55.

[8] *Id*. at 15-70.

[9] TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 96 (2d ed., Fathom Publishing Company 2003).

[10] Disclosure by Investment Advisers Regarding Soft Dollar Practices, Exchange Act Release No. 34-35375 (Feb. 14, 1995), 60 Fed. Reg. 9,750 (Feb. 21, 1995).

[11] OCIE REPORT, *supra* note 6.

[12] FRANKEL & KIRSCH, *supra* note 9.

[13] Eric W. Pinciss, Note, *Sunlight Is Still the Best Disinfectant: Why the Federal Securities Laws Should Prohibit Soft Dollar Arrangements in the Mutual Fund Industry*, 23 ANN. REV. BANKING & FIN. L. 863, 871 (2004) (detailing agency cost issues which give rise to conflicts of interest in soft dollar transactions).

brokers based on the fact that commission business is owed to the brokers for research services in spite of "poor or less than ideal execution quality."[14] After a 1998 "inspection sweep" of money managers using soft dollars, the SEC reportedly found managers using soft dollars to pay for a myriad of improper items including office rent and equipment, cellular phone services, personal expenses and even legal expenses.[15] The problem has continued as evidenced by a recent complaint filed by the SEC against hedge fund manager Barry Bingham and Bingham Capital Management Corporation for various soft dollar abuses.[16]

C. Recent Decline in Soft Dollars

Money managers have been anticipating new regulatory action by the SEC within the area of soft dollars ever since both the Commission and Congress began scrutinizing the practice as part of their larger investigation of the mutual fund industry.[17] As the industry awaited specific direction from the SEC, soft dollars used to buy third party research dropped to approximately $1.13 billion in 2005, down from $1.25 billion in 2004.[18] While close to ninety percent of mutual funds reported using soft dollars in 2003, only seventy five percent of funds acknowledged their use of such arrangements in 2005.[19] Indeed, several large mutual fund managers have recently cut back on soft dollar spending.[20] Both MFS Investment Management and Janus Capital Group announced they would cease using soft dollars to pay for third party research.[21] MFS has also ended its practice of using soft dollars to pay for

[14] *Id*. at 871-72.
[15] OCIE REPORT, *supra* note 6.
[16] *SEC Charges Hedge Fund with Soft Dollar Scheme*, COMPLIANCE REP., Sept. 5, 2005, at 6.
[17] Julie Segal, *Scudder Puts Kibosh on Soft Dollars*, FUND ACTION, Dec. 6, 2004, at 1.
[18] Greenwich Associates, *U.S. Institutions Tighten Soft-Dollar Spending Policies*, May 23, 2005, *at* http://www.greenwich.com/WMA/greenwich_reports/report_abstract/1,1622,4668,00.html.
[19] *Soft Dollars in Soft Decline*, FUND DIRECTIONS, July 1, 2005, at 5.
[20] *See* sources cited *infra* notes 21-23.
[21] Josh Friedlander, *Smart Mutual Funds to Seek More Independent Research: Soft-Dollar Disclosure Could Lead to Unbundled Future*, MONEY MGMT. EXECUTIVE, Feb. 21, 2005.

market-data services.[22] Fidelity has trimmed some of its soft dollar spending, crafting deals with both Lehman Brothers and Deutsche Bank Securities to pay separately for trade execution and equity research.[23]

The decision to stop or restrict the use of soft dollars, however, comes with costs; Fidelity's move to pay Lehman hard dollars for research will likely cost approximately $7 million, according to one industry analyst.[24] MFS's decision to stop using soft dollars to pay for "services that do not have intellectual content," such as "plain data feeds," has resulted in a price tag of approximately $7 to $8 million.[25] In addition, the advisor's elimination of third party research from its soft dollar arrangements is costing between $3 and $4 million a year.[26]

A motivating factor behind these announcements may be the desire to appear "clean" and "economical" in the eyes of shareholders, noted one industry analyst.[27] Plagued by scandal, Janus was the first such mutual fund manager to announce soft dollar restrictions, "seen as a bold step in reviving its tainted image."[28] Fidelity has touted its deal to pay Lehman out of pocket for research as a move that will ultimately benefit investors since it will lower trading costs.[29]

Given the high costs associated with reducing soft dollar practices, generally only the largest fund managers have been able to afford to make the switch to paying for research out of firm profits.[30] The bill for smaller mutual funds, should they follow suit, would be "proportionately higher," noted one industry participant.[31] The NASD's Mutual Fund Task Force recognized the phenomenon,

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[22] Lawrence C. Strauss, *A Soft Landing for Soft Dollars?* BARRON'S, June 13, 2005, at 38.

[23] Richard Beales, *Fidelity Hardens Its Stance on Soft-Dollars: Fund Manager Has Decided to Pay Lehman Brothers Separately for Research*, FIN. TIMES ASIA, Oct. 24, 2005, at 20; Susanne Craig, *Fidelity, Deutsche Bank Reach Commissions Deal*, WALL ST. J., Dec. 21, 2005, at C3.

[24] Beales*, supra* note 23.

[25] Julie Segal, *MFS' Price Tag for Quashing Soft Dollars Tops $20 Million*, FUND ACTION, Feb. 21, 2005, at 1.

[26] *Id.*

[27] Tami Luhby, *MFS Abolishes Soft Dollars*, NEWSDAY, Mar. 16, 2004, at A33.

[28] *Soft Dollar Commissions Ban Could Polish Janus' Tarnished Image*, GLOBAL FUND NEWS, Mar. 2004, at 9.

[29] Beales, *supra* note 23.

[30] *Id.*

[31] *Quashing Soft Dollars Could Hurt Small Funds*, FUND ACTION, Jan. 24, 2005, at 2.

noting that “smaller advisers can afford neither a large internal research staff nor extensive hard dollar payments for research.”[32]

D. The Proposed Interpretive Guidance

In its latest interpretive release regarding what products and services are eligible for soft dollar payment, the Commission seeks to “clarif[y] the scope of ‘brokerage and research services’ in the light of evolving technologies and industry practices.”[33] The new release asserts that research services are limited to “‘advice,’ ‘analyses’ and ‘reports’ within the meaning of Section 28(e)(3).”[34] The Commission specifically notes that the safe harbor’s statutory language indicates research services should include “substantive content – that is, the expression of reasoning or knowledge.”[35] The Commission interprets this “content,” however, as meaning “original research or a synthesis, analysis or compilation of the research of others.”[36] The FSA, on the other hand, has taken the slightly different position that “originality” is a critical requirement for any research purchased with soft dollars since “research should provide new insights.”[37]

With respect to “brokerage services” eligible under the safe harbor, the Commission’s latest release introduces a “temporal standard” in order to differentiate brokerage services that qualify for safe harbor from those that do not.[38] Brokerage services eligible for safe harbor are “products and services that relate to the execution of the trade from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account.”[39] This approach closely parallels the new FSA rules regarding permissible goods or services relating to the “*execution* of trades.”[40]

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[32] NASD, REPORT OF THE MUTUAL FUND TASK FORCE: SOFT DOLLARS AND PORTFOLIO TRANSACTION COSTS 4 (Nov. 11, 2004) [hereinafter NASD TASK FORCE REPORT], *available at* http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf.
[33] Proposed Interpretation, *supra* note 4.
[34] *Id*. at 61701.
[35] *Id*. at 61707.
[36] *Id*. at n.81.
[37] PS05/9, *supra* note 5, ¶ 2.18.
[38] Proposed Interpretation, *supra* note 4, at 61708.
[39] *Id*. at 61701.
[40] *See* PS05/9, *supra* note 5, Annex B, at 8.

The Commission explicitly lists examples of items it views as within the scope of the safe harbor, including "market, financial, economic, and similar data."[41] The FSA's new rules, however, do not permit data feeds to be counted as research.[42] Furthermore, the SEC indicates that some "financial newsletters and trade journals" could potentially constitute "research services" as could certain "seminars or conferences."[43] The FSA, alternatively, does not consider seminars or any publication subscriptions to be research-related for the purposes of soft dollars.[44] According to the SEC, "[q]uantitative analytical software and software that provides analyses of securities portfolios" would also constitute research "if they reflect the expression of reasoning or knowledge" covered under the subject matter referenced in the statutory language of Section 28(e)(3)(A) and (B).[45] In terms of brokerage services covered, "[c]learance and settlement services in connection with trades" specifically qualify for safe harbor as "incidental brokerage services."[46]

The latest release reaffirms that physical items like computer hardware are excluded from the safe harbor as are other various overhead items.[47] Such items are ineligible as research services since "they do not reflect substantive content related in any way to making decisions about investing."[48] Within the context of brokerage services, the release specifically mentions "order management systems ('OMS') used by money managers to manage their orders" do not qualify "because they are not sufficiently related to order execution and fall outside the temporal standard."[49] The Commission also declares "trade analytics, surveillance systems" and "compliance mechanisms" ineligible for the same reasons.[50] The FSA has taken a similar stance on post-trade analytics.[51] Yet in response to a rallying cry that such items should be permitted as execution services, the FSA did acknowledge that "there is a limited

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[41] Proposed Interpretation, *supra* note 4, at 61701.
[42] PS05/9, *supra* note 5, ¶ 2.15.
[43] Proposed Interpretation, *supra* note 4, at 61707.
[44] PS05/9, *supra* note 5, Annex B, at 9.
[45] Proposed Interpretation, *supra* note 4, at 61707.
[46] *Id*. at 61708.
[47] *Id*. at 61701, 61707.
[48] *Id*. at 61707.
[49] *Id*. at 61708.
[50] *Id*.
[51] *See* PS05/9, *supra* note 5, ¶ 2.13.

scope for some of these products to be permissible as execution services."[52]

Under the new SEC guidance, third party research remains eligible for safe harbor so long as "the broker-dealer has the direct legal obligation to pay for the research."[53] Provided the broker has the obligation to pay for the research, a third party is allowed to provide the research directly to the money manager.[54] Not only must brokers be "financially responsible" for the research services, but they also "must be involved in 'effecting' the trade."[55] The new release was careful to highlight the benefits of third party research which can offer "greater breadth and depth of research."[56]

Regarding "mixed-use" items, or items that have "both research and non-research uses,"[57] the guidance again restates the framework laid out in the SEC's 1986 interpretive release which mandated "a money manager . . . make a reasonable allocation of the cost of the product according to its use."[58] For example, the new release explains, "portfolio performance evaluation services or reports" could fall under the safe harbor, however, "managers must use their own funds to pay for the allocable portion of such services or reports . . . used for marketing purposes."[59]

E. Comments

The comments the SEC received expressed varying sentiments with some calling for a complete ban on soft dollars, others urging the SEC to broaden the scope of permissible items, and some calling for additional disclosure requirements.[60] Nevertheless,

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[52] *Id*. ¶ 1.13.
[53] Proposed Interpretation, *supra* note 4, at 61710.
[54] *Id*.
[55] *Id*. at 61701.
[56] *Id*. at 61710.
[57] OCIE REPORT, *supra* note 6.
[58] The Scope of Section 28(e) of the Exchange Act and Related Matters, Exchange Act Release No. 23,170 (Apr. 23, 1986), 51 Fed. Reg. 16004, 16006 (Apr. 30, 1986).
[59] Proposed Interpretation, *supra* note 4, at 61709.
[60] *See generally* Comment from Keith L. Shadrick, President, Axia Advisory Corporation to Jonathan G. Katz, Secretary, SEC (Oct. 21, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Gary W. Findlay, Executive Director, Missouri State Employees Retirement System to Jonathan G. Katz, Secretary, SEC (Nov. 28, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Craig Slaughter, Executive Director, West Virginia Investment Management Board to Jonathan G.

despite some particular concerns, a substantial number of commentators expressed overall support for the Commission's latest guidance regarding the scope of Section 28(e).[61]

The most oft-repeated specific complaint among commentators, however, was that the Commission's adoption of a "temporal" standard in its analysis of brokerage services allowable under the safe harbor is in fact too restrictive.[62] The Securities

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Katz, Secretary, SEC (Nov. 10, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Emmett M. Murphy to Jonathan G. Katz, Secretary, SEC (Nov. 15, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Neal J. Dean, Investor to Jonathan G. Katz, Secretary, SEC (Nov. 2, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

[61] *See generally* Comment from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Allan S. Mostoff, President, Mutual Fund Directors Forum to Jonathan G. Katz, Secretary, SEC (Nov. 25, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from James H. Bodurtha, Chairman, Independent Directors Council to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Kristi P. Wetherington, President, Capital Institutional Services, Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Lee A. Pickard, Esq., The Alliance in Support of Independent Research to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Christiana Wood, CFA, Senior Investment Officer – CalPERS to Jonathan G. Katz, Secretary, SEC (Nov. 22, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

[62] *See* Comment from Eric D. Roiter, *supra* note 61; Comment from Dixie L. Johnson, Committee on Federal Regulation of Securities, Business Law Section, American Bar Association to Jonathan G. Katz, Secretary, SEC (Dec. 13, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Christopher Buck, Executive Director, UBS Securities LLC to Jonathan G. Katz, Secretary, SEC (Dec. 6, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association to Jonathan G. Katz, Secretary, SEC (Dec. 1, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Carlos Morales, Senior Vice President and Associate General Counsel, Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 30, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Saul P. Sarrett, Director, Deputy General Counsel, ITG Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 25, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Joseph M. Velli, Senior Executive Vice President, BNY Securities Group on behalf of The Bank of New York Company, Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 25, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Seward & Kissel LLP to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

Industry Association ("SIA") specifically asked that the Commission "reconsider its adoption and application of such a standard" since it "fails to take into account the ongoing relationship between broker-dealers and their customers."[63] The Bank of New York Securities Group maintained that the new temporal standard proposed "does not reflect the realities of the marketplace."[64] Commentators, including Fidelity, urged the Commission "to develop a functional standard" instead which would "tur[n] on whether a service provided by a broker has a direct causal nexus to the placement, execution, clearance or settlement of a securities trade."[65]

A large number of respondents lamented the new guidance's explicit exclusion of OMS from the safe harbor, arguing that such systems should be eligible for payment using soft dollars.[66] One commentator specifically noted that the "trade functionality" which OMS can provide "falls well within the parameter of Section 28(e)(3)(C) by supporting trade execution" and that OMS thus promotes "best execution."[67] Others criticized the Commission for

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[63] Comment from Ira D. Hammerman, *supra* note 62.

[64] Comment from Joseph M. Velli, *supra* note 62.

[65] Comment from Eric D. Roiter, *supra* note 61; *see also* Comment from Seward & Kissel LLP, *supra* note 62.

[66] *See generally* Comment from Christopher Buck, *supra* note 62; Comment from Ira D. Hammerman, *supra* note 62; Comment from Carlos Morales, *supra* note 62; Comment from James A. Duncan, Chairman & John C. Giesea, President & CEO, Security Traders Association to Jonathan G. Katz, Secretary, SEC (Nov. 28, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Saul P. Sarrett, *supra* note 62; Comment from Joseph M. Velli, *supra* note 62; Comment from Monique S. Botkin, Counsel, Investment Adviser Association to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Lee A. Pickard, Esq., *supra* note 61; Comment from Sarah A. Miller, Director, Center for Securities, Trust, and Investments, American Bankers Association to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Barry P. Harris, IV, Ward and Smith, P.A., on behalf of First Citizens Bank & Trust Company to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Grady G. Thomas, Jr., President, The Interstate Group, Division of Morgan Keegan & Company, Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 23, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from David Quinlan, President, Eze Castle Software, Inc. to Jonathan G. Katz, Secretary, SEC (Nov. 22, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Michael E. Bleier, General Counsel, Mellon Financial Corporation to Jonathan G. Katz, Secretary, SEC (Nov. 21, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

[67] Comment from Stephen L Schardin, Managing Director – President, Charles River Brokerage, LLC to Jonathan G. Katz, Secretary, SEC (Nov. 8, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

not properly taking into account the "many aspects of OMSs" which provide both brokerage and research functionality to managers.[68] One OMS provider noted that "[t]he Commission's misperception that an OMS does not provide either 'research' or 'brokerage' services could have a materially adverse cost impact on many money managers, particularly smaller ones."[69] Most of those who encouraged the Commission to reconsider its stance on OMS also urged that the SEC explicitly extend the safe harbor to trade analytics as well, given the usefulness of such analytics in the execution process.[70] In addition, a few commentators asked that the Commission revise its latest guidance to specifically name custody services as brokerage services eligible for payment using soft dollars.[71]

While the Commission indicated that it would soon be weighing the possibility of imposing new disclosure requirements on soft dollar arrangements,[72] several commentators took this opportunity to express a keen desire for such enhanced disclosure requirements.[73] The CFA Centre for Financial Market Integrity ("CFA Centre") specifically called "full and fair disclosure by managers regarding their soft dollar practices . . .the other critical step managers must take to meet their fiduciary duty."[74]

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[68] Comment from Saul P. Sarrett, *supra* note 62; *see also* Comment from Monique S. Botkin, *supra* note 66.

[69] Comment from David Quinlan, *supra* note 66.

[70] Comment from Ira D. Hammerman, *supra* note 62; Comment from Carlos Morales, *supra* note 62; Comment from James A. Duncan & John C. Giesea, *supra* note 66; Comment from Monique S. Botkin, *supra* note 66; Comment from Grady G. Thomas, Jr., *supra* note 66; Comment from Michael E. Bleier, *supra* note 66; Comment from William T. George, Blue Sky Research Services to Jonathan G. Katz, Secretary, SEC (Oct. 28, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml.

[71] Comment from Lee A. Pickard, *supra* note 61; Comment from Sarah A. Miller, *supra* note 66.

[72] Christopher Cox, Chairman, SEC, *supra* note 1.

[73] *See* Comment from Eric D. Roiter, *supra* note 61; Comment from Kurt N. Schacht, CFA, Executive Director, & Jonathan A. Boersma, CFA, Director, Standards of Practice, CFA Centre for Financial Market Integrity, CFA Institute to Jonathan G. Katz, Secretary, SEC (Nov. 25, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Thomas F. Lamprecht to Jonathan G. Katz, Secretary, SEC (Nov. 27, 2005), *at* http://www.sec.gov/rules/interp/s70905.shtml; Comment from Allan S. Mostoff, *supra* note 61; Comment from James H. Bodurtha, *supra* note 61; Comment from Chistiana Wood, *supra* note 61; Comment from Neal J. Dean, *supra* note 60.

[74] Comment from Kurt N. Schacht & Jonathan A. Boersma, *supra* note 73.

Finally, those who commented on the appropriate time period for the industry's adoption of the new guidance generally suggested an implementation period of at least twelve months.[75]

F. Conclusion

The coming months will reveal whether or not the Commission's latest clarification regarding the scope of research and brokerage services falling under the protection of the safe harbor will prompt backpedaling among the larger fund managers whose plans to ban or severely limit the use of soft dollars go well beyond the SEC's latest parameters. To this effect, one lawyer has predicted that money managers who have stopped using soft dollars to pay for independent research would start up again if the SEC erased all doubts as to the permissibility of the practice.[76]

In the end, the industry continues to anticipate the arrival of new soft dollar disclosure requirements. The chief complaint over the years in this regard has been that "[s]oft dollar arrangements are disclosed in a variety of ways on unrelated forms, making it impracticable for a mutual fund investor or director to effectively assess various execution strategies and resulting costs."[77] The SEC may ultimately follow the advice of the NASD Mutual Fund Task Force which recommended, *inter alia*, "enhanced disclosure in fund prospectuses to foster better investor awareness of soft dollar practices."[78]

Amanda Stumm[79]

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[75] Comment from Christopher Buck, *supra* note 62; Comment from Ira D. Hammerman, *supra* note 62; Comment from Joseph M. Velli, *supra* note 62; Comment from Monique S. Botkin, *supra* note 66; Comment from Kristi P. Wetherington, *supra* note 61; Comment from Seward & Kissel LLP, *supra* note 62; Comment from Michael E. Bleier, *supra* note 66.

[76] *Senators Try to Get SEC to Act on Soft Dollars*, FUND ACTION, Mar. 14, 2005, at 6.

[77] Pinciss, *supra* note 13, at 878.

[78] NASD TASK FORCE REPORT, *supra* note 32.

[79] Student, Boston University School of Law (J.D. 2007).

XX. INSIDER TRADING

A. Introduction

The Securities and Exchange Commission ("SEC") aggressively investigates any suspicion of insider trading, in accordance with Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.[1] However, insider trading activities remain notoriously difficult to prove because a "smoking gun" or similar evidence to show the violator's use of inside information to profit is needed to establish an intent to deceive.[2] Courts are careful in finding persons alleged of insider trading guilty because the conviction carries a substantial criminal sentence.[3] This risk, in addition to the sensitive market environment today, has prompted some companies to implement defensive steps to prevent any suspicion of insider trading.[4] General Motors, for example, has issued a blanket prohibition on its officers trading the company's stock as a precaution.[5]

As illustrated below, many individuals still violate insider trading laws regardless of the heightened regulatory sensitivity. However, once charged with insider trading violations by the SEC, most of these individuals do not choose to fully litigate their cases. Instead, they choose to settle the charge, disgorge their estimated profits and pay civil penalties. Despite the continuing violations by individuals, the courts have resisted broadening the scope of insider trading laws without explicit statutory mandate. In two court opinions described below, the courts make a clear delineation between trades that could have been influenced by inside information, and trades that were automatically executed without any triggering act by the defendant.

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[1] 15 U.S.C. § 78j(b) (2005); 17 C.F.R. § 240.10b-5 (2006).

[2] Getahn Ward & Keith Russell, *Insider Trading Notoriously Hard to Prove, Lawyers Say*, THE TENNESSEAN, Sept. 24, 2005, at 4A; United States v. Smith, 155 F.3d 1051, 1066-69 (9th Cir. 1998).

[3] *Smith*, 155 F.3d at 1068 n. 25.

[4] Cormac Doyle, *GM Bars Executives from Trading Stock*, WORLD MARKETS ANALYSIS, June 27, 2005; *GM Forbids 400 Execs from Making Stock Trades*, CHICAGO TRIBUNE, June 28, 2005, at C3.

[5] *Id.*

B. Scope of Insider Trading Laws

1. Bruh v. Bessemer Venture Partners III L.P.

Section 16(b) of the Securities Exchange Act of 1934 imposes blanket liability for short-swing profits, which is defined as capital gains for trades done within a six-month period by a company's officer or beneficial owner on the company's stock or derivative security.[6] This strict liability was designed to discourage company insiders from using their privileged information for their personal benefit.[7] This special feature of insider trading laws is the focus of *Bruh v. Bessemer Venture Partners III L.P.*

In *Bruh*, the defendant owns the plaintiff company's preferred stock.[8] The plaintiff alleged that the defendant "purchased" the plaintiff company's common stock when the defendant's preferred stock automatically converted into common stock upon the company's initial public offering ("IPO").[9] Following this rationale, the defendant is required to disgorge a percentage of its profits when it sold the newly-converted common stock to the public five months after the IPO, in accordance with Section 16(b).[10]

The Supreme Court disagreed with the plaintiff.[11] The Court reasoned that the defendant did not "purchase" the company's stock when its shares converted automatically from preferred stock to common stock.[12] When the company's IPO took place, the defendant already owned the company's shares.[13] The defendant had no input in the board's decision to convert the stock, and thus the defendant could not have used inside information to his advantage in this transaction.[14] The Court ruled that the date the defendant bought the preferred shares is when the defendant "purchased" the

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[6] Bruh v. Bessemer, No. 03-Civ. 7340 (GBD), 2005 U.S. Dist. LEXIS 18543, at *1 (S.D.N.Y. Aug. 29, 2005).
[7] *Id*. at *8.
[8] *Id*. at *2.
[9] *Id.* at *10.
[10] *Id.* at *5-6.
[11] *Id.* at *14-16
[12] *Id.* at *14-15
[13] *Id.* at *14
[14] *Id.* at *14-16.

company's shares, not the date when the preferred shares converted into common stock.[15]

2. Morrison v. Madison

The defendant in *Morrison* owns the plaintiff company's Convertible Redeemable Preferred Stock ("Convertible Stock"), which added to other shares that the defendant previously bought equal to more than ten percent of the company's equity.[16] This level of ownership makes the defendant a beneficial owner, and a company insider under Section 16(b) of the Securities Exchange Act of 1934.[17] If the defendant is indeed a beneficial owner, then the defendant is required to disgorge a portion of any short-swing profit that he gained from buying and selling the company's stock and return it to the company.[18]

Plaintiff argued that when the conversion price for the defendant's Convertible Stock dropped, the defendant effectively purchased the company's common stock because the price drop increased the preferred stock/common stock ratio.[19] If the plaintiff is correct, the defendant would owe the company short-swing insider trading gains when it sold the company stock five months later.[20]

The court disagreed with the plaintiff.[21] The defendant could not use its insider status to influence the conversion price because the price fluctuates automatically.[22] The only time the defendant could take advantage of any insider information is when the defendant originally purchased the Convertible Stock.[23] Therefore, the court held that this original trade is the only recognizable purchase under Section 16(b) and that this reading is consistent with the policy behind the rule.[24]

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[15] *Id*. at *14.
[16] Morrison v. Madison, 389 F. Supp. 2d 596, 597-98 (D. Del., 2005).
[17] *Id.* at 598
[18] *Id.*
[19] *Id*. at 598, 600.
[20] *Id*. at 597-98.
[21] *Id*. at 600.
[22] *Id.* The conversion price rate adjusts automatically according to a predetermined formula to maintain the value of the convertible stock. *Id.* For instance, if the company issues more common stock, the conversion rate of the convertible stock, which derived its value from the underlying common stock, should decrease to account for the common stock's diluted value. *Id.* at 597.
[23] *Id*. at 599.
[24] *Id.*

C. Final Settlements of Insider Trading Cases

1. SEC v. Waksal

On January 15, 2005, the SEC announced that Samuel Waksal and his son, Jack Waksal, agreed to settle the Commission's insider trading charges.[25] Without admitting to any wrongdoing, the Waksals agreed to disgorge over $2 million in insider trading profits, and to pay over $3 million in civil penalties.[26] In its complaint, the SEC charged the Waksals with using insider knowledge to sell a substantial number of their company's stock, ImClone.[27] This sale occurred before the stock price of Imclone's stock dropped in response to an unfavorable decision by the United States Food and Drug Administration.[28] In addition to the monetary settlement, Samuel Waksal also agreed to never act as an officer or director of a public company.[29]

2. SEC v. Curtiss

Richard Curtiss agreed to settle the SEC's insider trading charges against him for $62,384 in disgorgement of profits, prejudgment interest and civil penalties.[30] Curtiss is responsible for identifying opportunities for mergers and acquisitions for Gerber Scientific, Inc., and this position allowed him to become privy to the company's non-public information.[31] The Commission then alleged that Curtiss illegally used this knowledge to profit from an expected stock price increase.[32] On a different occasion, Curtiss also used his inside knowledge to sell his Gerber shares before the public knew that Gerber would miss its quarterly earnings expectations.[33] Thus, Curtiss's timely sale of his Gerber shares allowed him to minimize his loss.[34]

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[25] SEC v. Waksal, Litigation Release No. 19039, 84 SEC Docket 2489, 2005 SEC LEXIS 115, at *1 (Jan. 19, 2005).
[26] *Id.*
[27] *Id.*
[28] *Id.* at *1-2.
[29] *Id.* at *3.
[30] SEC v. Curtiss, Litigation Release No. 19082, 84 SEC Docket 3052, 2005 SEC LEXIS 366, at *3 (February 16, 2005).
[31] *Id*. at *1.
[32] *Id.*
[33] *Id.* at *2
[34] *Id.*

3. SEC v. Hanna

On April 20, 2005, the SEC announced that Dr. Nabil Hanna, former Chief Scientific Officer of Biogen Idec, Inc., agreed to pay $124,000 in disgorgement of profits and $248,000 in civil penalties to settle the SEC's illegal insider trading charges.[35] In addition, Hanna agreed to never again serve as an officer or director of a public company.[36] According to the SEC's complaint, Hanna bought shares of Regeneron Pharmaceuticals, Inc. immediately before the company announced its joint venture with Aventis.[37] The market reacted positively to this venture, and Regeneron's share price increased accordingly.[38] Hanna's timing was auspicious because he had insider knowledge that Regeneron was developing a viable cancer treatment drug and was searching for a financing partner for the drug.[39]

4. SEC v. Levy

On May 4, 2005, the SEC announced that three foreign nationals residing in Panama agreed to settle the Commission's insider trading charges for $1.3 million, without admitting or denying any wrongdoing.[40] In February 2004, the Commission claimed that the defendants traded shares in iDial Networks, Inc. immediately before the company publicly announced its merger deal with GlobalNet, Inc.[41] The SEC claimed that defendants' timely trades were illegally precipitated by insider knowledge obtained by the defendants in their capacity as consultants to the deal.[42]

5. SEC v. Shane

On May 18, 2005, the SEC announced that Hilary Shane, a hedge fund manager, agreed to settle the Commission's insider

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[35] SEC v. Hanna, Litigation Release No. 19194, 85 SEC Docket 794, 2005 SEC LEXIS 882, at *1-2 (April 20. 2005).
[36] *Id.* at *2-3.
[37] *Id*. at *1.
[38] *Id.* at *2.
[39] *Id.*
[40] SEC v. Levy, Litigation Release No. 19217, 85 SEC Docket 1071, 2005 SEC LEXIS 1018, at *1 (May 4, 2005).
[41] *Id* at 2.
[42] *Id.*

trading charges against her without admitting or denying any wrongdoing.[43] The SEC alleged that Shane accumulated a short position for her personal account and for a hedge fund before CompuDyne Corporation announced its private investment in public equity offering ("PIPE offering") to the public.[44] It was widely expected that the market would negatively receive the PIPE offering, which injected twice as many CompuDyne shares into the market, thus driving down the company's stock price.[45] By holding a short position before the sell-off, Shane was guaranteed to profit, in contrast to the average CompuDyne shareholder.[46] Shane obtained her inside information regarding the PIPE issuance in her capacity as a hedge fund manager.[47] Shane's total monetary penalty was $1,075,015.[48] As a further penalty, Shane can no longer practice in the broker-dealer industry.[49]

6. SEC v. Moyes

On September 21, 2005, Jerry Moyes, chairman and chief executive officer of Swift Transportation Co., Inc. settled SEC insider trading charges for approximately $1.25 million in disgorgement, prejudgment interest and civil penalties.[50] Swift Transportation Co., Inc. is one of the largest trucking companies in the United States, with over 20,000 employees and $3 billion in revenues.[51] The complaint alleged that Moyes bought shares of the company two days before the company announced better than expected quarterly earnings and made public that the company would buy-back $40 million of its public shares.[52] These announcements drove the Swift stock price up and Moyes accumulated over $600,000 in unrealized capital gains.[53] As the company's CEO, Moyes would have known of these two developments before they

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[43] SEC v. Shane, Litigation Release No. 19227, 85 SEC Docket 1300, 2005 SEC LEXIS 1158, at *1 (May 18, 2005).
[44] *Id.* at *2-3.
[45] *Id.* at *2.
[46] *Id.*
[47] *Id.*
[48] *Id*. at *1.
[49] *Id.* at *1-2
[50] SEC v. Moyes, Litigation Release No. 19389, 2005 WL 2318425, 2005 SEC LEXIS 2397, at *1 (Sept. 22, 2005).
[51] *Id.*
[52] *Id.*
[53] *Id.*

were announced to the public.[54] Once Swift's board of director learned of Moyes' illegal trades, it developed internal procedures to monitor future trades done by company insiders.[55]

7. SEC v. Champe

Gregory N. Champe, an executive of Martek Biosciences Corporation, agreed to pay $54,825 in relation to a judgment that will permanently enjoin him from violations of Section 10(b) of the Securities Act of 1934 and Rule 10b-5, without admitting any wrongdoing.[56] The SEC filed insider trading charges against Champe after it discovered that Champe sold shares of Martek one day prior to the company's announcement of lower than expected earnings.[57] As a result of the news, Martek's shares dropped as much as 46%, from $60 to $32.50.[58] As an insider, Champe would have known of the announcement beforehand, and the SEC alleged that he used this privileged information for his personal advantage.[59]

8. SEC v. Herwitz and Stanyer

The SEC settled its insider trading charges against Gary D. Herwitz, a certified public accountant, and Tracey A. Stanyer, former executive vice president, of Sirius Satellite Radio Inc. on December 19, 2005.[60] Herwitz and Stayner anticipated that Sirius Inc.'s stock price would rise when the public learned that Howard Stern had signed an agreement with Sirius, Inc.[61] Accordingly, both insiders bought Sirius Inc.'s stock before this information became public.[62] Upon the public announcement Sirius Inc's share price increased and Herwitz and Stanyer profited.[63] Herwitz was ordered to disgorge all his profits of $18,163 and to pay civil penalties of $34,000.[64]

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[54] *Id* at *1-2.
[55] *Id.* at *2.
[56] SEC v. Champe, Litigation Release No. 19514, 2005 WL 3527055, 2005 SEC LEXIS 3288, at *1-2 (Dec. 22, 2005).
[57] *Id.* at *1.
[58] *Id*.
[59] *Id.*
[60] SEC v. Herwitz & Stanyer, Litigation No. 19499, 2005 WL 3465653, 2005 SEC LEXIS 3242, at *1 (Dec. 19, 2005).
[61] *Id*. at *1-3.
[62] *Id.*
[63] *Id.* at *2-3.
[64] *Id.* at *3.

Likewise, Stanyer was ordered to disgorge fully his profits of $17,897 and to pay civil penalties of $17,357.[65]

D. Other News Involving Insider Trading

1. SEC v. Tom

The SEC charged Michael Tom, manager of Massachusetts's hedge fund Global Time Management, LLC, for illegal insider trading involving Citizens Bank's acquisition of Charter One Financial, Inc. in May 2004.[66] It appears that a Citizens employee learned of the Bank's planned acquisition of Charter One before that information became public and shared the information with Tom.[67] Tom subsequently bought Charter One call options and netted $743,505 as a result of his timely trades.[68] The SEC seeks a disgorgement of this profit.[69] The SEC also charged the Citizens' informant, Shengnan Wang who is no longer employed at the bank, for illegal insider trading.[70]

2. SEC v. Anticevic

The United States District Court for the Southern District of New York filed preliminary injunctions against Sonja Anticevic and several other foreign defendants for illegally trading shares of Reebok International Ltd.[71] The trade occurred immediately before Adidas-Salomon AG publicly announced that they were buying the company.[72] The preliminary injunction froze the defendants' assets and ordered them to send back to the United States the proceeds made from the illegal trade.[73] The SEC became aware of the insider dealing when the defendants purchased an unusually high number of Reebok call options for two consecutive days prior to Reebok-Adidas

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[65] *Id.* at *3-4.
[66] SEC v. Tom, Litigation Release No. 19404, 2005 WL 2397232, 2005 SEC LEXIS 2461, at *1 (Sept. 29, 2005).
[67] *Id* at *2-3.
[68] *Id.* at *3.
[69] *Id.* at *4.
[70] *Id.*
[71] SEC v. Anticevic, Litigation Release No. 19374, 2005 WL 2233549, 2005 SEC LEXIS 2347, at *1 (Sept. 14, 2005).
[72] *Id*. at *1-2.
[73] *Id* at *1.

public announcement.[74] These purchases amounted to eighty percent of Reebok's total call option volume for those two days.[75] The SEC estimates that the defendants' combined profits were $6 million.[76]

3. SEC v. Goehring

On February 28, 2005, the SEC announced that it filed insider trading charges against Robert Goehring, former director of corporate communications of Gerber Scientific, Inc.[77] Goehring was responsible for Gerber's press releases.[78] As a byproduct of his duties, Goehring was privy to Gerber's earnings announcements and business deals before that information became public.[79] The SEC alleged that Goehring used this inside information when managing his personal portfolio of Gerber stocks.[80] Goehring bought and sold his Gerber shares before material information was disseminated to the public.[81] As a result, Goehring was able to reap $94,106 in profits.[82] Furthermore, the SEC alleged that Goehring gave tips to a friend on his inside knowledge, allowing his friend to acquire $11,453 in profits.[83] If these allegations are true, Goehring would have violated Section 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5.[84]

4. SEC v. Pollet

The SEC charged Guillaume Pollet, a former managing director at SG Cowen & Co., with insider trading violation in relation to PIPE financings for several public companies[85]. The SEC alleged that Pollet routinely held short positions on PIPE deals to benefit SG Cowen's proprietary account, despite his assurance to his clients that

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[74] *Id* at *2-3.
[75] *Id* at *2.
[76] *Id* at *2-3.
[77] SEC v. Goehring, Litigation Release No. 19105, 84 SEC Docket 3412, 2005 SEC LEXIS 440, at *1 (Feb. 28, 2005).
[78] *Id.*
[79] *Id.*
[80] *Id*.
[81] *Id.*
[82] *Id.* at *1-2.
[83] *Id.*
[84] *Id* at *3-4.
[85] SEC v. Pollet, Litigation Release No. 19199, 85 SEC Docket 797, 2005 SEC LEXIS 898, at *1 (April 21, 2005).

he will not do so.[86] As a result, the firm gained over $4 million in profits.[87] The Commission is suing for injunctive relief, disgorgement of profits and civil penalties.[88]

E. Conclusion

As the Securities and Exchange Commission strives to restore investor confidence in the United States stock market, it follows up on any hint of insider trading impropriety. As the above cases have shown, the potential reputational damages, pecuniary penalties and criminal liabilities often prompt alleged violators to quietly settle their cases with the SEC. As a result, the general public may not be fully aware just how prevalent insider trading is.

Lily Tjioe[89]

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[86] *Id.*
[87] *Id* at *2.
[88] *Id.*
[89] Student, Boston University School of Law (J.D. 2007).

XXI. ANTIFRAUD

A. Introduction

The Securities and Exchange Commission's ("SEC" or the "Commission") enforcement of antifraud provisions of federal securities law covers a broad range of activities. For instance, the Sarbanes-Oxley Act of 2002 ("SOX") added more protections against securities fraud by requiring an entity's chief executive officer to attest to the accuracy of the company's annual financial statements by signing them.[1] Furthermore, SOX increased the Commission's budget by seventy seven percent, much of which went to increasing the SEC's staff of attorneys who investigate fraudulent activities of securities issuers.[2] The newly hired attorneys have also continued the SEC's commitment to working with the Department of Justice by informing them of their fraud investigations, resulting in increased criminal prosecutions for securities fraud.[3] The Commission is also beginning to monitor fraudulent activities of hedge funds, an industry that is becoming increasingly regulated.[4]

B. Antifraud Litigation

1. Final Settlements of Antifraud Cases

1) SEC v. Yuen

On January 20, 2005, Jonathan B. Orlick ("Orlick"), the former general counsel, executive vice president, and a director on the board of Gemstar-TV Guide International, Inc. ("Gemstar"), agreed to be permanently enjoined from violating antifraud and other provisions of the federal securities law.[5] The allegations against Orlick included participating in the fraudulent recording and disclosure of revenue, securities fraud, falsifying Gemstar's books

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[1] *See* John H. Hemann & William Kimball, *More Charges Under Age-Old Securities Laws; Increase in Prosecutions Results From Change Not in Laws, But in DOJ's Priorities and Resources*, 27 NAT'L L.J. P13 (2005).
[2] *Id.*
[3] *Id.*
[4] Jason P. Lee, *The Emerging Evolution of Enforcement Actions Against the Hedge Fund Industry*, HEDGEWORLD DAILY NEWS, July 7, 2005.
[5] SEC v. Yuen, Litigation Release No. 19047, 84 SEC Docket 2599, 2005 SEC LEXIS 132, at *1 (Jan. 21, 2005).

and record, and lying to auditors in violation of Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(5) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13b2-1, and 13b2-2 thereunder.[6] Orlick agreed to the settlement without admitting to or denying the allegations.[7] In addition to injunctive relief, Orlick must also disgorge 305,510.62, an amount representing his bonuses during the relevant period, interest, and a civil penalty.[8] The fine will be placed into a fund for Gemstar shareholders harmed by the fraudulent activity pursuant to Section 308 of SOX.[9]

2) SEC v. Rhino Ecosystems, Inc.

On February 9, 2005, the Commission announced that the United States District Court for the Southern District of Florida had entered a summary judgment ruling against defendant Gordon Novak ("Novak") for violating Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, as well as aiding and abetting violations of Section 13(a) and Rules 12b-20 and 13a-1 thereunder of the Act.[10] Novak had filed materially false and misleading statements and also failed to disclose other material information in filings with the SEC.[11] The Court granted injunctive relief as well as a civil penalty.[12]

3) SEC v. Resource Development International, LLC

The SEC announced on February 17, 2005 that final judgment had been entered against William Whelan ("Whelan"), permanently enjoining him from violating Sections 5(a), 5(c), and 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.[13] Whelan was also ordered to pay disgorgement of $140,026 and

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[6] *Id.* at *2-3.
[7] *Id.* at *1.
[8] *Id.* at *3.
[9] *Id.*
[10] SEC v. Rhino Ecosystems, Inc., Litigation Release No. 19071, 84 SEC Docket 2938, 2005 SEC LEXIS 300, at *1 (Feb. 9, 2005).
[11] *Id.*
[12] *Id.*
[13] SEC v. Resource Development International, LLC, Litigation Release No. 19087, 84 SEC Docket 2938, 2005 SEC LEXIS 387, at *1-2 (Feb. 17, 2005).

interest of $31,400.[14] The SEC, however, waived disgorgement and declined to impose a civil penalty because of Whelan's inability to pay.[15] Whelan had violated antifraud and registration provisions of the federal securities laws by participating in a "Ponzi" scheme that involved the offer and sale of a non-existent "prime bank" trading program.[16] The Commission alleged that Whelan and the principals of Resource Development International made several misrepresentations and omissions to investors regarding the existence of the prime bank trading program and generated over $98 million from more than 1300 investors.[17]

4) SEC v. George

On April 6, 2005, the Commission announced that the District Court for the Northern District of Georgia had entered final judgment against Michael J. Wright ("Wright").[18] The Court ordered Wright to pay disgorgement of $61,329, with prejudgment interest of $22,688, and a civil penalty of $5,000.[19] As a facilitator in Tri-Star Investment Group, LLC, Wright fraudulently offered and sold unregistered securities as part of a larger scheme by Louis M. Lazorwitz and J. Charles Reives to defraud investors by misrepresenting Tri-Star's investment activities.[20] The SEC's complaint also alleged that Wright, along with defendants James L. George and Paul E. Brodhagen, gave investors the impression that after a ninety day waiting period they could expect profits of twenty percent per month in so-called thirteen month trading programs, even though the defendants did not have a reasonable basis for the profit projections.[21]

5) SEC v. Desjardins

On September 12, 2005, the District Court for the District of Columbia entered final judgment against defendants Daryl G.

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[14] *Id.* at *2.
[15] *Id.*
[16] *Id.* at *1.
[17] *Id.*
[18] SEC v. George, Litigation Release No. 19168, 85 SEC Docket 390, 2005 SEC LEXIS 769, at *1 (Apr. 6, 2005).
[19] *Id.*
[20] *See Id.* at *2.
[21] *Id.* at *2.

Desjardins ("Desjardins"), Alnoor Jiwan ("Jiwan"), Ronald D. Brouillette, and Brian A. Koehn.[22] The judgment permanently enjoins the defendants from violating antifraud provisions of federal securities laws and from participating in penny stock offerings.[23] The SEC alleged that the defendants participated in a fraudulent scheme to sell stocks in Pay Pop, Inc. ("Pay Pop").[24] The defendants' scheme of "free trading" of Pay Pop stock gave the false impression that the stocks complied with U.S. registration requirements.[25] Jiwan, senior manager of Pay Pop's transfer agent, was allegedly bribed to issue Pay Pop shares without requiring proof that the shares were registered with SEC or that they were exempt from such registration.[26] Desjardins, along with co-defendant Robert S. Zaba ("Zaba"), created demand for Pay Pop shares through a series of material misrepresentations and omissions concerning Pay Pop's operations.[27] Through this fraudulent scheme, Dejardins and Zaba allegedly made over $3 million from the sale of Pay Pop stock.[28] Defendants were ordered to pay over $7 million in disgorgement, prejudgment interest, and civil penalties.[29] The Commission's case against Zaba is still pending.[30]

6) SEC v. Nabors

In 2004, the SEC filed fraud charges against John Mervyn Nabors ("Nabors"), the former Chief Executive Officer of Aerosonic Corporation ("Aerosonic"), a Florida airplane instrument manufacturer.[31] In the complaint, Nabors and Eric J. McCracken, Aerosonic's former Chief Financial Officer, allegedly inflated the company's reported earnings through various accounting schemes, one of which involved recording of fictitious and premature revenue

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[22] SEC v. Desjardins, Litigation Release No. 19430, 2005 SEC LEXIS 2666, at *1 (Oct. 14, 2005).
[23] *Id.*
[24] *Id.* at *2.
[25] *Id.*
[26] *Id.* at *2-3.
[27] *Id.* at *3.
[28] *Id.* at *4.
[29] *Id.* at *3.
[30] *Id.* at *5.
[31] SEC v. Nabors, Litigation Release No. 18935, Accounting and Auditing Enforcement Release No. 2126, 83 SEC Docket 3107, 2004 SEC LEXIS 2402, at *1 (Oct. 20, 2004).

from January 1999 through December 2002.[32] On March 22, 2005, the SEC announced that Nabors had agreed to final judgment in the District Court for the Middle District of Florida.[33] The order permanently enjoins Nabors from violating sections of the Securities and Exchange Act and from serving as an officer or director of any securities issuer that is subject to Section 12 of the Exchange Act.[34] Nabors is also ordered to pay disgorgement of $200,000, prejudgment interest of $10,200, and a civil penalty of $50,000.[35]

7) SEC v. Sihpol

On October 12, 2005, the Commission announced that it had settled its civil action case against Theodore Charles Sihpol III ("Sihpol"), a former registered representative with Banc of America Securities LLC ("BAS").[36] In the Commission's complaint, the SEC alleged that Sihpol enabled Canary Partners LLP ("Canary"), a hedge fund customer of BAS, to engage in late trading for mutual fund shares of BAS and others.[37] Sihpol allowed Canary to buy or redeem mutual fund shares after the close of trading (4:00 p.m. Eastern Time) for that day's price determination rather than charging Canary the price of the shares at the close of the next day.[38] While enabling the late trading, Sihpol falsified, altered, destroyed and evaded the creation of books and records that BAS was required to accurately create, maintain and preserve.[39] Sihpol agreed to a final judgment ordering him to pay $200,000 in civil penalties without admitting or denying the allegations.[40] Sihpol is also barred from the securities industry for five years.[41]

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[32] *Id.* at *1-2.
[33] SEC v. Nabors, Litigation Release No. 19152, 85 SEC Docket 145, 2005 SEC LEXIS 658, at *1 (Mar. 22, 2005).
[34] *Id.*
[35] *Id.*
[36] SEC v. Sihpol, Litigation Release No. 19422, 2005 SEC LEXIS 2632, at *1 (Oct. 12, 2005).
[37] *Id.*
[38] *Id.* at *1-2.
[39] *Id.* at *2.
[40] *Id.* at *2-3.
[41] *Id.*

8) SEC v. Harris

Charles L. Harris ("Harris"), an Illinois resident, was permanently enjoined from violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.[42] A District Court in Chicago ordered the injunction as well as disgorgement, interest and a civil penalty.[43] The SEC alleged that Harris had fraudulently raised over $10 million for Tradewinds International II, LP ("Tradewinds II) from July 2001.[44] Harris misrepresented Tradewinds II's past rate of return by claiming that the private hedge fund had posted a twelve percent annual profit when it had actually suffered a significant loss.[45] Harris also misrepresented the fund's net asset value and improperly used the investor funds to pay for his own personal and business expenses, as well as to pay the investors at the artificially inflated rates.[46] In a criminal case based on these fraudulent activities, Harris was sentenced to 168 months in prison and was ordered to pay restitution of $13,861,849.[47]

9) SEC v. Buntrock

On August 26, 2005, the District Court for the Northern District of Illinois entered final judgment against defendants Dean L. Buntrock ("Buntrock"), Phillip B. Rooney ("Rooney"), Thomas C. Hau ("Hau"), and Herbert A. Getz ("Getz").[48] Buntrock was Waste Management, Inc.'s ("Waste Management") founder, chairman of the board of directors, and chief executive officer for most of the applicable period; Rooney was president and chief operating officer, director, and chief executive officer for part of the relevant period; Hau was vice president, corporate controller, and chief accounting officer; and Getz was senior vice president, general counsel, and secretary.[49] The defendants agreed to the final judgment without

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[42] SEC v. Harris, Litigation Release No. 19426, 2005 SEC LEXIS 2645, at *1 (Oct. 13, 2005).
[43] *Id.*
[44] *Id.*
[45] *Id.* at *2.
[46] *Id.*
[47] *Id.* at *1.
[48] SEC v. Buntrock, Litigation Release No. 19351, Accounting and Auditing Enforcement Release No. 2298, 2005 SEC LEXIS 2198, at *1 (Aug. 29, 2005).
[49] *Id.*

admitting or denying the allegations.[50] They are barred from serving as an officer or director of a public company, enjoined from future violations of the antifraud and other provisions of the federal securities laws, and were also ordered to pay disgorgement, interest, and civil penalties of $30,869,054.[51] Getz further agreed to an order based on a Rule 102(e) administrative proceeding, suspending him from appearing or practicing before the SEC as an attorney for five years.[52] The Commission alleged that the defendants perpetrated massive financial fraud for over five years by systematically falsifying and misrepresenting Waste Management's financial status.[53] The SEC claimed that the defendants overstated profits by $1.7 billion through false and misleading disclosures and a variety of non-GAAP accounting practices.[54] The purpose of the accounting scheme was to defer current period expenses whenever possible.[55]

10) SEC v. Uncommon Media Group, Inc.

On June 8, 2005, the SEC announced that the District Court for the Southern District of Florida entered judgments against defendants Lawrence Gallo ("Gallo") and Frederick Hornick, Jr. ("Hornick").[56] The defendants agreed to the judgment granting permanent injunction and other relief without admitting or denying the SEC's allegations.[57] In a complaint filed on March 23, 2004, the SEC alleged that the defendants fraudulently offered unregistered securities of Uncommon Media Group, Inc. and 3rd Dimension, Inc. ("3D"), defrauding more than 200 investors of at least $1.4 million.[58] Hornick also allegedly violated Section 15(a)(1) of the Exchange Act.[59] Based on the same fraudulent conduct, Gallo was indicted in criminal proceedings for securities fraud, wire fraud, and mail

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[50] *Id.*
[51] *Id.* at *1-2.
[52] *Id.* at *2.
[53] *Id.* at *1.
[54] *Id.* at *2.
[55] *Id.*
[56] SEC v. Uncommon Media Group, Inc., Litigation Release No. 19257, 2005 SEC LEXIS 1325, at *1 (June 8, 2005).
[57] *Id.*
[58] *Id.*
[59] *Id.*

fraud.[60] He pled guilty to one count of conspiracy to commit mail and wire fraud on July 26, 2004.[61]

The Commission had previously dismissed its action against 3D in 2004.[62]

2. Other News Involving Antifraud Enforcement

1) SEC v. Smith

On February 7, 2005, the SEC filed a complaint in the United States District Court for the Central District of California against Courtney D. Smith ("Smith"), a well-known financial commentator.[63] The Commission alleged that Smith had participated in a scheme to manipulate the stock price of GenesisIntermedia, Inc. ("GENI"), a now defunct public company based in Van Nuys, California.[64] Between September 1999 and September 2001, Smith allegedly received approximately $1.1 million of cash and GENI stocks from GENI's chief executive officer ("CEO") to promote GENI shares on television.[65] According to the Commission's complaint, Smith's public statements on CNBC, CNN, CNNfn, and Bloomberg TV, artificially inflated the price of GENI stocks by creating a demand for them.[66] The price of GENI stocks rose approximately 1400% between September 1, 1999 and June 29, 2001, from $1.67 per share (split adjusted) to $25 per share.[67] The complaint further alleges that Smith's comments, many of which were false or misleading, facilitated the misappropriation of approximately $130 million by GENI's CEO and his accomplice, a Saudi Arabian national considered to be an international arms dealer and financier.[68]

The manipulation was part of a larger scheme by GENI's CEO and his accomplice to lend GENI stocks instead of selling

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[60] *Id.* at *2.
[61] *Id.*
[62] *Id.* at *1.
[63] SEC v. Smith, Litigation Release No. 19064, 84 SEC Docket 2934, 2005 SEC LEXIS 264, at *1 (Feb. 7, 2005).
[64] *Id.*
[65] *Id.*
[66] *Id.* at *2-3.
[67] *Id.* at *3.
[68] *Id.* at *2.

them.[69] In this lending scheme, the Commission alleges that the CEO, through an offshore entity called Ultimate Holdings, loaned approximately fifteen million shares to broker-dealers in exchange for cash.[70] As the price of GENI stocks rose based on the misrepresentations of Smith and others, Ultimate Holdings received additional funds when the stock loans were marked-to-market by the broker-dealers.[71] By lending the shares instead of selling them, the CEO and his accomplice allegedly raised about $130 million without giving up control of the stock or depressing the market.[72]

The Commission charged Smith with violating the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as well as Section 17(b), the anti-touting provision of the Securities Act.[73] The SEC is seeking a permanent injunction, an accounting of all the money that Smith received from his fraudulent conduct, disgorgement, prejudgment interest, and civil penalties.[74] Based on the same activities alleged in the SEC's complaint, the United States Attorney's Office for the Central District of California has also announced criminal charges against Smith.[75]

2) SEC v. Israel

On September 29, 2005, the SEC filed a civil injunctive action against Samuel Israel III and Daniel E. Marino.[76] While acting as managers of Bayou Funds ("Funds"), a group of hedge funds, Israel and Marino allegedly defrauded investors and appropriated millions of dollars from the investor funds for their own personal use.[77] Israel was the founder and investment advisor to Funds, and Marin served as chief financial officer.[78] In the complaint, the Commission alleged that from 1996 through 2005,

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[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.* at *2-3.
[73] *Id.* at *4.
[74] *Id.*
[75] *Id.*
[76] SEC v. Israel, Litigation Release No. 19406, 2005 SEC LEXIS 2463, at *1 (Sept. 29, 2005).
[77] *Id.*
[78] *Id.*

Israel and Marino grossly exaggerated Funds' performance and provided investors with false periodic account statements and performance summaries.[79] Those documents contained fictitious profit and loss numbers and forged audited financial statements, showing that Funds had made a profit when it really suffered multimillion dollar losses.[80] During the relevant period, over $450 million was invested into Funds and its predecessor fund.[81]

The SEC is seeking permanent injunctions against Israel, Marino and Bayou Management, the investment adviser to the Fund, for violations of the antifraud provisions of federal securities laws, as well as disgorgement, prejudgment interest, and civil penalties.[82] The defendants have agreed to have their assets frozen and appointed to a receiver who will organize the remaining assets for the benefit of the defrauded investors.[83] The United States Attorney's Office for the Southern District of New York has also filed criminal fraud charges against Israel and Marino.[84]

C. Conclusion

During 2005, the Commission continued its enforcement of antifraud provisions of federal securities law. Many cases settled during the year through the consent of the defendants, and the cases covered situations ranging from misrepresentations and omissions of annual financial statements to elaborate accounting schemes. Further, the SEC has persisted in its enforcement of antifraud provisions of federal securities law against hedge funds, which were previously unregulated.

Eleen Trang[85]

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[79] *Id.* at *2-3.
[80] *Id.*
[81] *Id.* at *2.
[82] *Id.* at *3.
[83] *Id.* at *2.
[84] *Id.*
[85] Student, Boston University School of Law (J.D. 2007).

XXII. FDIC

A. Introduction

The Federal Deposit Insurance Corporation ("FDIC") underwent several reformations and changes during 2005. These changes resulted both from actions within the FDIC and from Congressional actions. The changes affected the FDIC in the year 2005 and will have lasting effects on the FDIC and deposit insurance for many years to come.

In October 2005, the FDIC named a new acting chairman, Marty Gruenberg, to replace former Chairman Donald Powell[1]; and in December 2005, the White House selected Diana Taylor to replace Gruenberg in 2006.[2] The FDIC also proposed rules to: limit the exemptions for state-chartered banks from state consumer laws[3]; amend its regulations regarding annual independent auditing and reporting requirements for FDIC-insured financial institutions[4]; and allow FDIC-insured, state nonmember banks to offer (without prior FDIC consent) several types of retirement and savings accounts with tax-incentive features.[5] In addition, the FDIC voted against charging premiums to most banks for the first half of 2006[6], approved a lower budget for the fiscal year 2006[7], and implemented a Relationship Manager Program.[8] In 2005, the House of Representatives and the Senate each enacted legislation reforming deposit insurance, H.R.

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[1] Federal Deposit Insurance Corporation, Board of Directors and Senior Executives (2006), http://www.fdic.gov/about/learn/board/board.html.

[2] Michelle Heller, *N.Y. Banking Chief Said Choice for FDIC Top Job*, AM. BANKER, Dec. 7, 2005, at 1.

[3] Luke Mullins, *FDIC & Vote Advances State-Bank Preemption*, AM BANKER, Oct. 7, 2005, at 1.

[4] Christopher Gallagher, *The FDIC and Part 363: Flexibility Without Forbearance*, GALLAGHER, CALLAHAN & GARTRELL, Dec. 12, 2005, http://www.gcglaw.com/resources/financial/part363.html.

[5] Goodwin Procter LLP, *FDIC Amends Rule Authorizing FDIC Insured Banks Without Trust Powers to Offer Additional Tax-Advantaged Accounts*, (Nov. 2, 2005), http://www.mondaq.com/article.asp?articleid=35840&searchresults=1.

[6] Luke Mullins, *FDIC Sees BIF Shortfall but Says no to Premium*, AM. BANKER, Nov. 9, 2005, at 1.

[7] Press Release, Federal Deposit Insurance Corporation, *FDIC Board Approves Lower 2006 Budget* (Dec. 5, 2005), *available at* http://www.fdic.gov/news/press/2005/pr12105.html.

[8] Goodwin Procter LLP, *supra* note 5.

1185 and S. 1562, respectively, which were then incorporated into a compromised package for the 2006 budget.[9]

B. Change in FDIC leadership

On November 16, 2005, Martin J. Gruenberg became acting Chairman of the FDIC Board of Directors upon the resignation of Donald Powell.[10] Mr. Gruenberg is widely considered to be a staunch consumer advocate.[11] Many industry experts believe that Gruenberg, a Democrat and former top aide to Senator Paul Sarbanes, D-Md., opposes the industrial loan charter, which allows commercial firms that are not regulated by a federal banking agency to own FDIC-supervised financial institutions.[12] He is also considered by many experts to be an opponent of preempting state laws in state-bank issues.[13] In December 2005, the White House selected Diana Taylor, the New York State Banking Superintendent, to replace Gruenberg.[14] Taylor, a Republican and former investment banker, has criticized the Office of Comptroller of the Currency ("OCC") for preempting state laws and has criticized the Securities and Exchange Commission for not being proactive enough in its regulation efforts.[15] The White House is expected to announce Taylor's nomination in January or February 2006; if confirmed, Taylor would be the FDIC's nineteenth chairman and the third woman to hold the position.[16]

C. Proposed Rule Changes

1. Proposal to Increase Preemptive Action

On October 6, 2005, the Board of Directors of the FDIC voted 3-2 to issue a proposal to grant limited exemptions for state-

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[9] Legislative Update, AM. BANKER, Dec. 8, 2005, at 5.
[10] Federal Deposit Insurance Corporation, *supra* note 1.
[11] Luke Mullins, *A Change in FDIC's Agenda?*, AM. BANKER, Nov. 2, 2005, at 1.
[12] *Id.*; Supervisory Insights, Federal Deposit Insurance Corporation, The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective (June 25, 2004), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html.
[13] Mullins, *supra* note 11.
[14] Heller, *supra* note 2.
[15] *Id.*
[16] *Id.*

chartered banks from state consumer laws.[17] This signified a reversal from the FDIC's position in July 2005, when its Board voted 4-1 not to proceed with a proposed rule to evaluate whether a state bank operating in multiple states can opt to follow its home-state's rules.[18] Advocates of the preemption proposal noted that state banks were finding it difficult to compete with nationally-chartered banks, given that the nationally-chartered banks had obtained protection from state anti-predator, privacy, and other consumer protection laws through a broad preemption rule in January 2004.[19]

The proposal adopted by the FDIC in October 2005 maintains that host-state laws do not apply to state-chartered banks' out-of-state branches if the OCC or a federal court has concluded that the law is preempted for national banks.[20] Under the same proposal, state banks' operating subsidiaries and loan offices also might not have to act in accordance with host-state laws under certain circumstances.[21]

The newly appointed acting chairman of the FDIC, Martin Gruenberg, opposed the proposal, noting that it would not be in the best interest of consumer protection.[22] Thomas Curry, an independent FDIC board member, also opposed the proposal, noting that it would "effectively establish a new activist policy of aggressive preemptive action by the FDIC."[23] John M. Reich, Director of the Office of Thrift Supervision (and a member of the Board of Directors of the FDIC), supported the proposal, despite having voted against a similar proposal in July 2005.[24] Ultimately, John C. Dugan, the Comptroller of the Currency, cast the deciding vote in favor of the proposal.[25] Dugan voiced his support for the plan on the condition that the FDIC amend the proposal to clarify that host-state laws are only to be preempted in situations where the OCC or a federal court has concluded in writing that the law is preempted for national banks.[26]

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[17] Mullins, *supra* note 3.
[18] Hannah Bergman, *Gauging Odds for Exemption Plan at FDIC*, AM. BANKER, Aug. 2, 2005, at 1.
[19] *Id.*
[20] Mullins, *supra* note 3.
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*

The proposal led to a tumultuous response from those within the banking industry.[27] John Ryan, the Senior Vice President for policy and legislation of the Council of State Bank Supervisors, praised Mr. Dugan and the FDIC for passing the compromised proposal, thereby preserving the dual banking system.[28] Representative Barney Frank, the leading Democrat on the House Financial Services Committee, objected to the proposal, stating that it adds more ambiguity into the banking system by "tying itself to the OCC's overly broad preemption and visitorial rules".[29] Frank believes that Congress will eventually have to intervene to resolve the ambiguity.[30] The National Association of Realtors agreed with Frank in vehemently opposing the proposal, asserting that only Congress has the authority to expand the scope of preemption.[31]

2. Proposal to Amend Annual Independent Auditing and Reporting Requirements

On November 28, 2005, the FDIC amended the annual reporting requirements for depository institutions.[32] Institutions with total assets of $1 billion or more at the beginning of a fiscal year must prepare a management report assessing the effectiveness of the institution's internal control structures and procedures.[33] Management reports involve a costly process, and in 2005 the FDIC raised the asset size of an institution from $500 million to $1 billion for mandatory reporting.[34] Under the new rule, institutions with total assets between $500 million and $1 billion will no longer be required to furnish a management assessment of the effectiveness of the institution's internal controls over financial reporting or to engage the institution's external auditor to examine and attest to management's internal control assertions.[35] The FDIC also relaxed the eligibility criteria for audit committee membership for an

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[27] *Id.*
[28] *Id.*
[29] *Id.* (quoting Barney Frank).
[30] *Id.*
[31] Jerry Giovaniello & David Lereah, *The Washington Report*, NATIONAL ASSOCIATION OF REALTORS, Dec. 19, 2005, http://www.realtor.org/fedistrk.nsf/currwklyrpt/government+affairs+weekly.
[32] Gallagher, *supra* note 4.
[33] 12 C.F.R. § 363.2 (2005).
[34] Gallagher, *supra* note 4.
[35] *Id.*

institution with assets between $500 million and $1 billion.[36] An institution with total assets between $500 million and $1 billion now may maintain an audit committee with only a majority (rather than the previously required 100%) of its outside directors being independent of management.[37] The changed rules will enable the FDIC to provide the needed flexibility to community banks without promoting forbearance that could potentially threaten safety and soundness.[38]

3. Proposal to Allow FDIC-Insured State Nonmember Banks to Offer Individual Retirement Accounts

On October 18, 2005, the FDIC amended an interpretive rule to authorize FDIC–insured, state nonmember banks (which do not exercise trust powers) to offer certain self-directed, tax-advantaged Individual Retirement Accounts ("IRAs") and Keogh Plan Accounts without prior FDIC consent.[39] The amended rule now permits banks to offer the following additional products without prior FDIC consent: (1) IRAs; (2) Self-Employed Retirement Plans; (3) Roth IRAs; (4) Coverdell Education Savings Accounts; (5) Health Savings Accounts; and (6) other similar accounts with tax-incentive features.[40] The amended rule preserves the requirements that a bank's duties must be custodial or ministerial, that the bank must invest funds in the account in its own time or savings deposits or in assets directed solely at the direction of the customer, and that the bank's acceptance of such accounts is not contrary to applicable state law.[41]

D. Vote Against Charging Premiums

On November 8, 2005, the FDIC voted against charging premiums to most banks for the first half of 2006, despite the prediction that the Bank Insurance Fund will soon fall below its

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[36] Powell Goldstein LLP, *FDIC Increases Asset Threshold to $1 Billion For Internal Control Assessment*, http://www.pogolaw.com/articles/1726.pdf (last visited Dec. 21, 2005).
[37] *Id.*
[38] Gallagher, *supra* note 4.
[39] Goodwin Procter LLP, *supra* note 5.
[40] 12 C.F.R. § 333.101(b) (2005).
[41] *Id.*

statutory minimum.[42] Most banks have not paid premiums in a decade.[43] In addition, bank failures resulting from the numerous hurricanes and continued insured deposit growth in 2005 put increased pressure on the FDIC to begin charging premiums.[44] The Bank Insurance Fund's ratio of reserves to insured deposits fell in 2005 to 1.26% in the second quarter from 1.31% the previous year.[45] Historically, if the fund fell below 1.25%, by statute the FDIC had a year to bring it above that level, and if it did not, it was mandated to charge banks a mandatory 23 basis-point premium.[46] The FDIC had been expected to charge a 2 basis-point premium for 2006, so the November 8th vote against charging premiums surprised many experts.[47]

E. Approval of Lower Budget for 2006 and Implementation of Relationship Manager Program

On December 5, 2005, the Board of Directors of the FDIC approved a $1.05 billion

Corporate Operating Budget for 2006, which represents a reduction of 5% from the 2005 operating budget.[48] Since 2002, the FDIC has reduced its annual spending by more than 12%.[49] While the overall budget decreased, funding for identity theft, financial literacy, and corporate privacy and security increased for the 2006 budget, in response to the problems that have emerged in the nation's banking system in recent years.[50]

The FDIC also implemented a Relationship Manager Program on September 30, 2005, for all FDIC-supervised financial institutions.[51] Under the Relationship Manager Program, each financial institution will be assigned a relationship manager who serves as a local liaison to strengthen the communication between the financial institution and the FDIC.[52] The Relationship Manager

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[42] Mullins, *supra* note 6.
[43] Luke Mullins, *After Years as Nonissue, a Premium Vote Toss-up*, AM. BANKER, Nov. 8, 2005, at 1.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] Mullins, *supra* note 6.
[48] Press Release, *supra* note 7.
[49] *Id.*
[50] *Id.*
[51] Goodwin Procter LLP, *supra* note 5.
[52] *Id.*

Program is also expected to improve the FDIC's continuity, coordination, and the effectiveness of its supervisory process.[53]

F. Congressional Reform

On May 4, 2005, the House of Representatives approved deposit insurance reform legislation by passing the Federal Deposit Insurance Reform Act of 2005 ("H.R. 1185").[54] Changes initiated by H.R. included: increasing the maximum coverage per FDIC account from $100,000 to $130,000; merging the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF"); eliminating the mandatory 23 basis-point premium charge that occurs when the ratio of reserves to insured deposits falls below 1.25% for more than one year; doubling the amount of insurance coverage to $260,000 for certain senior citizens' accounts and those of impending retirees; increasing coverage limits for in-state municipal deposits to the lesser of $2 million or the sum of the standard maximum deposit insurance amount ($130,000) and 80% of any deposit over $130,000; and indexing for inflation every five years.[55] Proponents of H.R. 1185 believed that the bill would promote the stability and soundness of the banking system and provide assurance to people who have placed their savings in banks, thrifts, and credit unions.[56]

On November 3, 2005, the United States Senate voted 52 to 47 to approve a deposit insurance bill, the Safe and Fair Deposit Insurance Act ("S. 1562").[57] The Senate's bill, like H.R. 1185, would merge the BIF and SAIF, eliminate the mandatory 23 basis-point premium charge, raise the insurance limit for retirement accounts and index insurance limits for inflation.[58] However, S. 1562 did not raise the general insurance limit for individual accounts to $130,000 and did not change coverage limits for municipal deposits.[59]

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[53] *Id.*

[54] Kennedy Smith, *U.S. House Passes Bachus-Hooley FDIC Reform Bill*, DAILY JOURNAL OF COMMERCE, May 11, 2005, *available at* 2005 WL 7614111.

[55] H.R. 1185, 109th Cong. (1st Sess. 2005); see also Smith, *supra* note 54.

[56] *House Overwhelmingly Approves Deposit Insurance Reform, Again*, U.S. FED NEWS, May 4, 2005 (quoting Subcommittee Chairman Bachus, co-drafter of H.R. 1185), *available at* 2005 WL 7033159.

[57] Legislative Update, *supra* note 9.

[58] Am. Banker Ass'n, FDIC Reform, http://www.aba.com/Industry+Issues/Dep_Ins_Issue.htm (last visited Dec. 21, 2005).

[59] *Id.*

As the Senate and House versions of deposit insurance reform differed slightly, the Senate and House worked out a compromise during the final days of the session.[60] The compromise agrees to merge the BIF and SAIF into a new Deposit Insurance Fund; requires the FDIC and the National Credit Union Association ("NCUA") boards to consider raising the standard maximum deposit insurance (beginning in 2010 and every five years after 2010); eliminates the mandatory 23 basis-point premium charge; and increases the deposit insurance limit for certain retirement accounts to $250,000.[61]

G. Conclusion

Federal deposit insurance was an active topic in banking and financial regulation in 2005. The FDIC underwent several changes and reformations, and the House of Representatives and the Senate passed regulations addressing deposit insurance reform.

Donald Powell, chairman of the FDIC Board of Directors since 2001, left the agency in late 2005 to aid the federal government's rebuilding efforts in the Gulf Coast Region.[62] Powell was succeeded by Martin Gruenberg, and the White House is expected to nominate Diana Taylor to assume the chairmanship position in 2006.[63] In 2005, the FDIC proposed rules to: increase preemptive action for state-chartered banks[64]; amend its regulations regarding yearly independent auditing and reporting requirements for FDIC insured financial institutions[65]; and allow FDIC-insured, state nonmember banks to offer several types of retirement accounts with tax-incentive features without prior FDIC consent.[66] The FDIC voted against charging banks a premium for the first half of 2006, despite the Bank Insurance Fund's ratio of reserves to insured deposits standing at 1.26% in the second quarter of 2005.[67] The FDIC once again lowered its overall budget for the year 2006.[68]

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[60] Credit Union National Ass'n, Deposit Insurance Reform, http://www.cuna.org/gov_affairs/legislative/issues/2005/deposit_ins.html (last visited Dec. 24, 2005).

[61] *Id.*; H.R. 1185, *supra* note 55.

[62] Federal Deposit Insurance Corporation, *supra* note 1.

[63] *Id.*; Heller, *supra* note 2.

[64] Mullins, *supra* note 3.

[65] Gallagher, *supra* note 4.

[66] Goodwin Procter LLP, *supra* note 5.

[67] Mullins, *supra* note 43.

[68] Press Release, *supra* note 7.

However, the FDIC raised funding for identity theft, financial literacy, corporate privacy and security, and furthermore implemented a Relationship Manager Program to help improve the FDIC's effectiveness and coordination.[69]

In 2005, the House of Representatives passed H.R. 1185 and the Senate passed S. 1562 to address federal deposit insurance reform.[70] During the final days of the session, the Senate and House of Representatives hammered out a compromise of the two bills. The compromise agrees to merge the BIF and SAIF into a single Deposit Insurance Fund; eliminates the mandatory 23 basis-point premium charge that occurs when the ratio of reserves to insured deposits falls below 1.25% for more than one year; requires the FDIC and NCUA boards to consider raising the standard for maximum deposit insurance; and increases the deposit insurance limit for certain retirement accounts to $250,000.[71]

These changes will certainly have profound effects on the FDIC and the banking and financial industries for many years to come, and the year 2006 will likely bring about many more changes to the FDIC and to federal deposit insurance law.

David Goldman[72]

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[69] Goodwin Procter LLP, *supra* note 5.
[70] Smith, *supra* note 54; Legislative Update, *supra* note 9.
[71] Credit Union National Association, *supra* note 52.
[72] Student, Boston University School of Law (J.D. 2007)

XXIII. CORPORATE GOVERNANCE

A. Introduction

2005 evidenced two major developments in corporate scandals. First, the fall of another massive and successful company due to the discovery of hidden debt seemed to signify that punishment has not yet had its expected deterrent effect. Second, longer criminal sentences, larger settlements and personal liability of directors indicated that courts are continuing to focus on deterrence as a form of corporate fraud prevention. What follows are brief summaries of various scandals that took place in 2005 or have had significant developments in trials, settlements or sentencing during that year and that manifest the developments above.

B. Refco's Fall: Another Giant Firm Fraud Disclosed

Refco, one of the largest commodities and futures trading firms, went public in August 2005.[1] The company announced on October 10, 2005 that its chief executive officer owed Refco $430 million.[2] Philip R. Bennett hid the debt in a private company he controlled,[3] undisclosed to regulators and investors.[4] That subsidiary, Refco Capital Markets Ltd., is an unregulated offshore broker for stocks, bonds and currencies.[5] Refco has noted that its earnings reports for the past three years are unreliable.[6]

Mr. Bennett became CEO in 1998 and was the principal owner until a private equity firm, Thomas H. Lee Partners, bought control in 2004.[7] Speculation on how or why Mr. Bennett created this debt leads to the price-earnings multiple, whereby his losses

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[1] Jenny Anderson & Landon Thomas Jr., *Picking Up the Pieces; The Fall of Refco Is Providing a Test for Wall Street*, N.Y. TIMES, Oct. 15, 2005, at C1.

[2] Jenny Anderson, *Five Bidders for Remains of Refco*, N.Y. TIMES, Nov. 5, 2005, at C13.

[3] Anderson, *supra* note 1.

[4] *Id.*

[5] Michael J. Martinez, *Accounts Are Frozen at Refco Subsidiary*, PHILADELPHIA INQUIRER, Oct. 14, 2005, at C01.

[6] *Id.*

[7] Floyd Norris, *How to Get Rich By Losing Millions*, N.Y. TIMES, Oct. 14, 2005, at C1.

created inflated profits that were worth much more than his losses.[8] Interestingly, when the firm went public, Sarbanes-Oxley mandated disclosure of important deficiencies in internal controls which investors ignored.[9]

Mr. Bennett was arrested on Tuesday, October 11, 2005 and was charged with securities fraud.[10] Before being arrested, however, he repaid the debt in full,[11] taking out a loan in order to do so.[12] A federal grand jury indicted Mr. Bennett on November 10, 2005.[13] The original complaint accuses Mr. Bennett of using loans of up to $545 million to conceal Refco's debt.[14] Initially, there was concern that Mr. Bennett would flee the country,[15] but a judge eventually eased the terms of his bail by requiring only his wife and two children to be guarantors.[16]

As a result of these events, customers began to flee, sue the company and demand repayment of their assets.[17] Also, Refco immediately closed its unregulated capital markets business, allowing customers to liquidate their accounts.[18] The company filed for bankruptcy on October 17, 2005.[19] While the futures brokerage part of the company cannot be put into bankruptcy, it may be sold through bankruptcy proceedings as an asset of the company.[20] Due to its complex structure, evaluating exactly how much money Refco

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[8] *Id.*

[9] *Id.*

[10] Matthias Rieker, *In Brief: Minimal Fallout Seen from Refco Woes*, AM. BANKER, Oct. 17, 2005, at 23.

[11] Anderson, *supra* note 1.

[12] Michael J. Martinez, *Final Refco Subsidiary to Enter Chapter 7*, WASHINGTON POST, Nov. 9, 2005, http://www.washingtonpost.com/wp-dyn/content/article/2005/11/09/AR2005110901852.html?sub=AR.

[13] *Former Refco CEO Indicted for Fraud*, GLOBE AND MAIL (Toronto), Nov. 11, 2005, *available at* 2005 WL 18236039.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Refco Considers Class Action on Lawsuits*, WASHINGTON POST, Nov. 9, 2005, http://www.washingtonpost.com/wp-dyn/content/article/2005/11/09/AR2005110901148.html.

[18] Anderson, *supra* note 1.

[19] Martinez, *supra* note 12.

[20] Anderson, *supra* note 2.

owes its creditors has been very difficult, but the figure is estimated at about $16 billion.[21]

While on the auction block, potential bidders were concerned about the status of Refco.[22] The bankruptcy court has disclosed that the customer accounts in the regulated Refco unit have decreased from $7.5 billion before the scandal to $3.5 billion.[23] Nevertheless, bidders expect that customers will return to the company once the situation settles.[24] Ultimately, most of Refco's assets were auctioned off on November 10, 2005, after 21 hours of negotiating, to the Man Group of Britain for $282 million in cash.[25] The Man Group, located in England, is the largest publicly traded hedge fund in the world.[26] Its brokerage unit, Man Financial, will acquire almost all of Refco's regulated commodities futures businesses in the United States, Britain, Asia and Canada, valued at approximately $1.25 billion.[27] The Man Group's $282 million offer includes the assumption of roughly $37 million in liabilities, but excludes about $750 million in regulatory capital.[28]

After WorldCom, Enron, Tyco and Adelphia, securities regulators started enforcing stricter accounting rules, hoping to make it more difficult for companies to exclude relevant information from earnings reports.[29] A recent study by Merrill Lynch & Co. Inc.'s market strategist shows that there has not been any improvement in corporate reporting.[30] The other obvious safeguard, the Sarbanes-Oxley Act, did not apply to Refco's initial public offering or other filings to register stock; it only requires executives to attest to the validity of financial results in quarterly and annual reports.[31] The

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[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Eric Dash, *British Offer Wins Bidding for Part of Refco Assets*, N.Y. TIMES, Nov. 11, 2005, at C2.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] Rachel Beck, *Many Corporate Earnings Reports Still Can Mislead Investors*, PHILADELPHIA INQUIRER, Mar. 23, 2005, at C02.

[30] *Id.*

[31] Michael Rapoport, *Refco's Sarbanes-Oxley Loophole*, WALL STREET JOURNAL, Oct. 24, 2005, at C3.

demise of Refco is shocking primarily because it follows on the heels of so many other massive corporate fraud scandals and the adoption of regulatory efforts and judicially created deterrents.

C. Tyco Sentencing: Severe Punishment for Corporate Crime Extends to States

L. Dennis Kozlowski and Mark H. Swartz were found guilty of 22 counts of grand larceny, conspiracy, falsification of business records and violating general corporate law in June 2005.[32] The conviction resulted from a second trial following a mistrial in April 2004, when one juror, holding out for acquittal, received a threat after apparently giving the "O.K." signal to the defense during the trial.[33] The case demonstrated the vastness of corporate greed, including accusations of the misuse of Tyco funds for a lavish birthday party for Mr. Kozlowski's wife on the Italian island of Sardinia and the purchase of a $6,000 shower curtain.[34]

On September 19, 2005, Mr. Kozlowski and Mr. Swartz were sentenced to 8 1/3 to 25 years in state prison.[35] The two men were also required to pay $240 million in fines and restitution.[36] As the first high-profile corporate fraud case tried in state court, experts were curious to find out if state judges would follow the severe federal sentencing trend.[37] The sentence indicates that state judges, who have more sentencing discretion, are just as concerned about white collar crime as are their federal counterparts.[38] Under New York Law, a sentence of more than six years likely will result in incarceration in a maximum security prison, where the men will be mixed among other prisoners, including violent criminals.[39] The State Department of Correctional Services will determine in which

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[32] Grace Wong, *Kozlowski Gets Up to 25 Years*, CNNMONEY, Sep. 19, 2005, *at* http://money.cnn.com/2005/09/19/news/newsmakers/kozlowski_sentence/.

[33] Andrew Ross Sorkin, *Ex-Tyco Officers Get 8 to 25 Years*, N.Y. TIMES, Sep. 20, 2005, at A1.

[34] Wong, *supra* note 32.

[35] Ben White, *Pair Get Up to 25 Years in Prison, Must Pay Almost $240 Million*, WASHINGTON POST, Sep. 20, 2005, at D01.

[36] *Id.*

[37] Wong, *supra* note 32.

[38] *Id.*

[39] Sorkin, *supra* note 33.

prisons Mr. Kozlowski and Mr. Swartz will serve their sentences.[40] While the judge said that he did not consider them a security risk, thereby demonstrating that he was not opposed to sending them to a minimum security prison, there are no facilities in New York comparable to the federal minimum-security prisons, which would practically guarantee the prisoners' physical safety.[41] The two men may be able to reduce their minimum sentence by one-sixth for good behavior and participation in prison programs.[42]

The sentences follow a number of other long criminal sentences for executives involved in the WorldCom, Enron and Adelphia scandals.[43] There is some consensus among prosecutors and shareholder groups that long sentences will have a deterrent effect and will restore the confidence of investors, but defense attorneys question the ability of high profile cases to deter abuses at smaller companies.[44] It is clear, however, that these sentences are much higher than those handed down in the 1980s for similar abuses.[45] Intolerance of corporate crime is now the norm.[46] Increasingly lengthy sentences, on both the federal and state level, serve to demonstrate the judicial system's dedication to the use of deterrence to combat white collar crime.

D. Significant WorldCom Settlements Display Ongoing Importance of Deterrence

In 2002, WorldCom collapsed after disclosing that it had inflated revenue and hidden expenses in order to meet investor expectations.[47] The fraud amounted to about $11 billion.[48] WorldCom's former chief executive, Bernard Ebbers, was convicted

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[40] *Id.*

[41] White, *supra* note 35.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] Sorkin, *supra* note 33.

[46] C. Evan Stewart, *Innocent Mistakes Are Not Criminal*, AM. BANKER, June 24, 2005, at 11.

[47] *Judge Approves $3.56 Billion Settlement for WorldCom Investors*, N.Y. TIMES, Sep. 22, 2005, at C6.

[48] Erin McClam, *Andersen Called 'See-No-Evil' Auditor as Civil Trial Opens*, CHICAGO SUN TIMES, Mar. 30, 2005, *available at* 2005 WL 5298870.

of fraud, conspiracy and false regulatory filings in March 2005.[49] He was sentenced to twenty-five years in prison.[50] Mr. Ebbers's conviction represented the aggressive posture of the Justice Department and SEC to pursue top executives in corporate fraud cases.[51] Also implicated in the fraud were the investment banks that underwrote WorldCom securities.[52]

Following its collapse, investors filed a class-action lawsuit against the banks for either assisting in the fraud or not realizing what was happening.[53] With trial scheduled for February 2005, settlements resolving claims against ten WorldCom directors were announced in January 2005.[54] The directors will personally pay $18 million and insurance will cover another $36 million.[55] The significance of the settlement is that the outside directors are being held partially responsible, hopefully conveying the importance of the fulfillment of corporate duties.[56] The settlement agreements were structured to exhaust insurance coverage, forcing directors to take personal responsibility for part of the payment.[57] On September 21, 2005, the federal District Court in Manhattan raised the total settlement to its final amount of $6.1 billion.[58] This round of settlements includes payments made by J.P. Morgan Chase, Deutsche Bank, Arthur Andersen, and Mr. Ebbers.[59] The only larger settlements in a corporate fraud scandal are those having to do with the collapse of Enron.[60]

Bond holders will receive $426.66 for every $1,000 in bonds they held, while shareholders will receive an average of $.56 per

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[49] *Id.*

[50] White, *supra* note 35.

[51] Ken Belson, *Ex-Chief Of WorldCom Is Found Guilty in $11 Billion Fraud*, N.Y. TIMES, Mar. 16, 2005, at A1.

[52] McClam, *supra* note 48.

[53] *Judge Approves $3.56 Billion Settlement for WorldCom Investors*, *supra* note 47.

[54] Ben White, *Former Directors Agree to Settle Class Actions*, WASHINGTON POST, Jan. 8, 2005, at E01.

[55] *Id.*

[56] *Id.*

[57] Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 426 (2005).

[58] *Judge Approves $3.56 Billion Settlement for WorldCom Investors*, *supra* note 47.

[59] *Id.*

[60] *Id.*

share.[61] In order to collect any money, investors will be required to submit claims.[62] There are more than 830,000 individual and institutional investors involved.[63] The settlements were made in order to prevent liability that the investment banks were facing.[64] There is some question as to whether federal courts should be involved in creating a federal remedy for what amounts to a fiduciary duty claim.[65] Sarbanes-Oxley has not provided a federal remedy for director violations, nor has Congress imposed any other specific liability on them, which may undermine efforts to hold directors federally liable.[66] The United States Supreme Court has asserted its belief that corporations are state-created organizations that should not be interfered with in the absence of a federal responsibility.[67] The general understanding with respect to corporate governance is that it is almost exclusively a matter of state law, thus, it appears that this will remain an issue to be dealt with by the states.[68] Even after the recent rash of major scandals pushed corporate governance into the limelight, the SEC has not reviewed the effectiveness of the Sarbanes-Oxley Act.[69]

Prior to the recent settlements in Enron and now WorldCom, it was rare for officers and directors to be held personally responsible for their official actions because insurance customarily covered director liability.[70] Another significant aspect of the settlements is their size; the District Court judge wrote that the settlements "are, in virtually each instance, of historic proportions."[71] Both the personal responsibility and the size of the settlements demonstrate the use of deterrence as a tool used by the federal courts to attempt to stay corporate crime.

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[61] *Id.*

[62] *Id.*

[63] *Judge OK's $3.6B WorldCom Settlement*, CNNMONEY, Sep. 21, 2005, *at* http://money.cnn.com/2005/09/21/news/midcaps/worldcom.reut/.

[64] *Id.*

[65] Fairfax, *supra* note 57, at 426.

[66] *Id.* at 427.

[67] *Id.*

[68] Joel Seligman, *The SEC at 70: A Modest Revolution in Corporate* Governance, 80 NOTRE DAME L. REV. 1159, 1169 (2005).

[69] *Id.* at 1185.

[70] White, *supra* note 54.

[71] *Judge OK's $3.6B WorldCom Settlement*, *supra* note 63.

E. Criminal Investigation of KPMG's Allegedly Fraudulent Tax Shelters Displays Government's Sensitivity to Large Firms

In August 2005, nine former executives of KPMG were charged with conspiracy to create and sell fraudulent tax shelters.[72] In September, federal prosecutors announced that they planned to file more charges in connection with the tax shelters.[73] The defendants are mostly former partners of KPMG.[74] Ultimately, nineteen individuals were indicted in the criminal proceedings, including an outside attorney and an investment adviser.[75] Costing the government approximately $1.4 billion in unpaid taxes, the tax shelters were sold to about 350 people over a six year span ending in 2002.[76] KPMG allegedly earned $124 million in fees for the sale of the shelters.[77] Other financial institutions were also involved in the transactions.[78] In particular, investors have sued Deutsche Bank, who bought tax shelters that the Internal Revenue Service ("IRS") did not accept.[79] The criminal trial is expected to commence in September 2006 in District Court for the Southern District of New York.[80]

In late August 2005, the company reached a settlement agreement with the government in form of a $456 million penalty.[81] Also, KPMG admitted to wrongdoing to help itself avoid criminal charges, stating that "a number of KPMG tax partners engaged in conduct that was unlawful and fraudulent…" including preparing false tax returns, issuing falsified opinions and impeding IRS

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[72] Jonathan D. Glater, *U.S. to Widen Inquiry of KPMG Tax Shelters*, N.Y. TIMES, Sep. 7, 2005, at C1.

[73] *Id.*

[74] *Id.*

[75] Lynnley Browning, *Civil Suit over Tax Shelter is Delayed for Criminal Case*, N.Y. TIMES, Nov. 8, 2005, at C4.

[76] Glater, *supra* note 72.

[77] *Id.*

[78] Lynnley Browning, *Tax Inquiry is Moving Past KPMG*, N.Y. TIMES, Sep. 16, 2005, at C1.

[79] *Id.*

[80] Browning, *supra* note 75.

[81] Glater, *supra* note 72.

investigation into the shelters.[82] Also, Presidio Growth filed a civil suit in San Francisco against the IRS.[83] Presidio Growth is one of the firms that worked closely with KPMG and is arguing that the shelters are proper.[84] The IRS estimates that Presidio helped investors hide up to $2.4 billion in income from taxes.[85] On November 7, 2005, a federal judge delayed the civil suit until the criminal case goes to trial in the fall of 2006.[86] This delay may help the government defend against the civil suit because the evidence from the criminal trial will be available to it.[87] Federal prosecutors were concerned that the judge presiding over the civil case would rule on the legality of the tax shelters and are pleased that the two cases are now disabled from undercutting each other.[88]

An indictment of KPMG itself might have caused KPMG to fall apart like Arthur Andersen did after Enron, reducing the number of global accounting firms to three.[89] The justice department's decision not to prosecute was purportedly based on the impact an indictment would have on the accounting industry and the ineffectiveness of prosecuting the company for the acts of individuals.[90] The U.S. Attorney for the Southern District of New York denied that the decision not to indict KPMG does not reflect the idea that some firms are too big to fail.[91] Instead, he postulates that punishing directors has a greater deterrent effect.[92] Again, it appears that the government is focused on determining how best to deter future fraudulent acts. The decision not to prosecute KPMG may send another message to other large companies, that the company is immune to criminal prosecution due to its size.

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[82] Jonathan D. Glater, *Tax Shelters and KPMG: Sorting Out Legal Issues*, N.Y. TIMES, Oct. 7, 2005, at C1.

[83] Browning, *supra* note 75.

[84] *Id.*

[85] *Id.*

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] Stephanie Kirchgaessner, *The Confessions of a Corporate Crime-Fighter Combating Corruption: The Man Who Jailed Bennie Ebbers Hopes to Deter More of the 'Morally Challenged'*, FINANCIAL TIMES UK, Sept. 6, 2005, *available at* 2005 WL 13976736.

[90] *Id.*

[91] *Id.*

[92] *Id.*

F. Conclusion

Refco is a new reminder that corporate scandals are not a problem of the past, although corporate crime has been extensively addressed through both regulation and punishment in the wake of other major scandals. Courts are still focused on the hopeful deterrent effect of longer criminal sentences, larger settlements and increasing personal liability of directors for official actions. Ultimately, the developments in corporate scandals in the year 2005 evidence the ongoing hope of the courts to prevent corporate crime in the face of its obvious continuation.

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