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James A. Fanto
Brooklyn Law School, james.fanto@brooklaw.edu

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Subtle Hazards Revisited

THE CORRUPTION OF A FINANCIAL HOLDING COMPANY BY A CORPORATE CLIENT'S INNER CIRCLE*

James A. Fanto†

ABSTRACT

I argue here that the involvement of financial holding companies (FHCs) in the recent corporate scandals shows that the "subtle hazards" of combining commercial and investment banking are not those identified by the United States Supreme Court in *Investment Co. Institute v. Camp*. Rather, the basic subtle hazards risk is that FHC relationship investment bankers become part of a company client's inner circle of management and participate in improper and often illegal transactions that benefit the inner circle at the expense of a company's investors and its other corporate constituencies. Investment bankers draw commercial bankers and the FHCs within the influence of the destructive circle. I contend that evidence from the corporate scandals shows that FHCs incurred this risk and suffered significant harm from it. I then argue that bank regulators need to address the risk by ensuring that a FHC has in place procedures to keep itself and its employees from falling within the influence of the inner circles of its investment banking clients. The Federal Reserve, I propose, should require (and not just recommend) FHCs to have senior transaction and relationship oversight committees with the power necessary to review and veto inappropriate transactions and relationships between the FHC's investment bank or any other nonbank affiliate and their company clients, and it should regularly evaluate the committee's performance as part of its examination of a FHC.

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† Professor of Law, Brooklyn Law School; B.A., University of Notre Dame; J.D., University of Pennsylvania; Ph.D., University of Michigan.

I. INTRODUCTION

In this Article I inquire whether the repeal of the Glass-Steagall Act[1] by the Gramm-Leach-Bliley Act of 1999[2] enhanced the legal and reputation risk[3] facing commercial banking organizations by leading these organizations to become involved in the corporate scandals that appeared at the bursting of the 1990s stock market bubble. Another way of stating this inquiry is to ask whether the full entry of these organizations into investment banking following the repeal resurrected the "subtle hazards" identified by the U.S. Supreme Court in *Investment Co. Institute v. Camp* as the major basis for Glass-Steagall's separation of commercial from investment banking.

The hazards deserve attention because they present a risk (albeit now a small one) that the commercial banks and the banking system could fail catastrophically as they did during the Great Depression. The hazards arise as follows: if investment and commercial banks are part of a single financial organization, commercial banks may occasionally feel compelled to make loans to company clients of their affiliated investment banks or to extend credit to investors to facilitate their purchase of a company client's securities. The hazards of this lending lay in the commercial bankers' felt commitment to support the affiliated investment bank's clients and customers in order to maintain the solvency of the affiliated investment

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[1] Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

[2] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12, 15, 16, 18 U.S.C.).

[3] Bank regulators identify certain risks, which are essentially the potential for events that would seriously hurt a bank, that arise from the banking business. *See, e.g.*, OCC, DETECTING RED FLAGS IN BOARD REPORTS, A GUIDE FOR DIRECTORS 2 (Oct. 2003) (listing such risks as "credit, liquidity, interest rate, price, foreign currency translation, compliance, strategic, reputation, and transaction"), *available at* http://www.occ.treas.gov/rf_book.pdf (last visited Oct. 26, 2004). In the discussion below, I shall focus on a few of these risks, chiefly the compliance or legal risk, which is "the risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards," and reputation risk, which is "the risk to earnings or capital arising from negative public opinion." *See* OCC, BANK SUPERVISION PROCESS, COMPTROLLER'S HANDBOOK 21 (Apr. 1996), *available at* http://www.occ.treas.gov/handbook/banksup.pdf (last visited Oct. 26, 2004). *See also* FEDERAL RESERVE, BANK HOLDING COMPANY SUPERVISION MANUAL §2124.01.6, at 9 (Dec. 1999) ("[*R*]*eputational risk,* which is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.") (italics in original), *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc0604.pdf (last visited Oct. 26, 2004).

bank. They fear that a reversal suffered by the investment bank could affect the commercial bank through financial contagion. That is, if stock markets fell significantly, investors might punish commercial banks for the sins of their investment bank affiliates by withdrawing their money from the banks, thereby causing the banks to fail. Mounting bank failures would cause individuals to lose faith in the banking system, which would lead to more failures. As banks constitute the basic foundation of investment and money flow, such widespread failures would, in turn, end the movement of capital throughout the economy.

The validity of the assumptions underlying *Camp*'s subtle hazards has recently been put to an empirical test of sorts. By most accounts, we experienced a stock market bubble at the end of the 1990s that was burst in part by numerous scandals in companies and in the financial industry.[4] As will be discussed,[5] investment banking affiliates of major banking organizations, like Citigroup and JP Morgan Chase, were clearly involved in many of the scandals. These conglomerates have so far incurred significant penalties,[6] and more may be yet to come. There has been, however, no evidence validating the subtle hazards rationale. Even more significantly, the involvement of investment banks in the recent scandals has not triggered a catastrophic failure of the large complex banking institutions (LCBOs),[7] many of which are regulated as financial holding companies (FHCs).[8] The results of this natural experiment may suggest that the concern over subtle hazards had little basis in fact and led for many years to the inappropriate separation of commercial and investment banking.

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[4] For a discussion of the reasons for the bubble before it burst, see generally ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000).

[5] *See* discussion *infra* Part III.

[6] *See* discussion *infra* Part III.

[7] This is a term of art for banking conglomerates that are engaged in multiple financial services. *See, e.g.*, Lisa M. DeFerrari & David E. Palmer, *Supervision of Large Complex Banking Organizations,* 87 FED. RES. BULL. 47, 47 (Feb. 2001).

[8] The financial holding company is the new banking organization that Gramm-Leach-Bliley created, in essence, to supplement the bank holding company. The major difference between it and the other structure is that the financial holding company and its nonbanking affiliates can engage in a broad range of financial activities, such as insurance and securities activities, rather than be restricted to banking activities and those "closely related" to banking. *See* 12 U.S.C.A. §1843(k)(4)(F) (2004).

I argue, however, that the involvement of banking organizations in the recent corporate scandals has given a new life to *Camp*'s subtle hazards, if reformulated in social psychological terms. In my view, the basic subtle hazards risk is that investment bankers embrace the perspective of a client company's management and become part of management's inner circle, whether in raising capital, advising on a merger, or structuring another financial transaction or product. Like other corporate advisors (outside accountants and lawyers come to mind), these bankers participate in transactions that benefit management's inner circle (of which they are a part) at the expense of outside investors and other corporate constituencies. In this participation, investment bankers draw related commercial bankers and the entire financial organization within the cohesive, but destructive, circle of the corporate client. I contend that the evidence from the corporate scandals shows that FHC investment bankers became members of corporate inner circles and pulled their institutions into the scandals. While FHCs were not the only institutions involved, they may have been particularly prone to the subtle hazards risk because they were competing with traditional investment banks to deliver a complete array of financial services to corporate clients.

I draw several conclusions from the reformulated subtle hazards. In my view, the evidence does not justify a return to Glass-Steagall's separation of commercial from investment banking, which renewed separation, in any event, would be politically impossible and perhaps even economically undesirable if its demise has benefited consumers by enhancing competition in financial services.[9] I contend, however, that this reformulation of the subtle hazards risk should alert bank regulators to be aware of how FHCs became involved in the corporate scandals and to try to prevent a recurrence of this involvement. Bank regulators cannot ignore the ever-present, if remote, legal and reputation risks recognized in *Camp* that consumers will lose confidence in the FHC and its banks because of the FHC's participation in the scandals. Bank regulators need to ensure that a FHC has instituted procedures to keep itself and its employees from falling within the

[9] For the market reaction to the legislation, see generally Faith R. Neale & Pamela P. Peterson, *The Financial Services Industry and the Modernization Legislation* (Sept. 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=447420 (last visited Oct. 26, 2004).

influence of the inner circles of its investment banking clients. A FHC must have a senior level transaction and relationship oversight committee with the power to review and veto inappropriate transactions and relationships between the FHC's investment bank or any other affiliate, on the one hand, and company clients, on the other, and this power should not be regularly overridden by the chief executives of the FHC.

This Article proceeds as follows. In Part II, I examine in more detail the contrast between *Camp*'s presentation of the subtle hazards and my social psychological reformulation of them. In Part III, I review representative evidence of the involvement of investment banks and other affiliates of the FHCs in the corporate scandals, with particular focus on their participation in the Enron and the WorldCom scandals. I discuss in Part IV my proposal for a required transaction and relationship oversight committee for FHCs and observe that it has in fact been mandated in several cases as part of a written agreement entered into between the financial institutions and banking regulators as a result of the formers' involvement in the scandals. The Article concludes in Part V.

II. THE SUBTLE HAZARDS, THEN AND NOW

A. *Subtle Hazards in* Camp

In *Camp*, the U.S. Supreme Court explained that the subtle hazards of affiliating commercial banks with investment banks in the same organization went beyond the risk that there would be little advantage to linking these different kinds of business[10] or that commercial banks would themselves be tempted to invest their assets in the stock market. Rather, the hazards came from financial contagion. In enacting Glass-Steagall, Congress recognized that the ultimate worry of a commercial banking organization is the depositors' loss of confidence in its banks, a sentiment that is at times irrational.[11] Since depositors often do not distinguish between a bank and a non-banking affiliate, the organization is inevitably concerned

[10] I leave aside the consideration of whether *Camp*, a case decided years after the enactment of Glass-Steagall, accurately reflected Congress's justification for the separation of investment and commercial banking. For a discussion of this subject, see Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 323-30 (1990).

[11] *See* Investment Co. Inst. v. Camp, 401 U.S. 617, 631 (1971).

with how the public views each of its affiliates and even its major clients. If problems develop in a securities affiliate or its clients, the bank's executives may feel compelled to shore up the affiliate or clients in order to prevent the contagion from infecting the bank. Banks may, for example, offer their affiliates or clients loans that they would not otherwise have made. Indeed, they might make these unsound loans to these parties even before any problems surface. They would do this to prevent the banks' depositors and other customers from transferring to the banks their concerns or doubts about the affiliate or its clients, even if this transfer were unjustified and thus irrational.[12]

According to the Court, a related subtle hazard is the risk that depositors might punish a banking organization if they viewed it as having improperly fueled a speculative stock market bubble.[13] In other words, the bank's felt obligation to ensure the success of its securities affiliate might compromise its impartiality in offering investment advice to its depositors by inducing it to market securities underwritten by its securities affiliate or lend money to its depositors and other customers to purchase securities dealt in by the affiliate, or even, in the interest of promoting the stock market generally, securities sold by an unrelated broker-dealer.[14] If the securities markets fell, investors would blame the banks for their losses,[15] as they would perceive them to be institutions that benefited from and encouraged securities speculation while failing to protect adequately its depositors, many of whom had little investing experience.

The ultimate subtle hazard recognized by the Court was that the combination of commercial and investment banking

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[12] *See id.* The Court explained this potentially destructive process as follows:

> For example, pressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired. And since public confidence is essential to the solvency of a bank, there might exist a natural temptation to shore up the affiliate through unsound loans or other aid.

Id. (footnote omitted).

[13] *See id.*

[14] *See id.* at 632.

[15] *See id.* The Court stated:

> Congress feared that the promotional needs of investment banking might lead commercial banks to lend their reputation for prudence and restraint to the enterprise of selling particular stocks and securities, and that this could not be done without that reputation being undercut by the risks necessarily incident to the investment banking business.

Id. (footnote omitted).

might significantly change and corrupt the nature of commercial banking. Throughout its discussion, the Court contrasted the aggressive and salesman-oriented mentality of investment bankers with the impartial, prudent, and disinterested fiduciary disposition of commercial bankers.[16] The Court explained that, should the two functions be mixed, ordinary people could no longer look to the banker as a source of disinterested investment advice, for they would always suspect that the banker was influenced by a concern to promote the welfare of affiliated investment bankers in making his or her investment recommendations.[17]

As is now well known, this view of subtle hazards and the justification for Glass-Steagall became the object of considerable economic and financial criticism.[18] Thoroughly discredited, the Glass-Steagall Act met its demise when the Gramm-Leach-Bliley Act put an end to the formal separation between investment and commercial banking.[19] Why, it was

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[16] *See Camp*, 401 U.S. at 630–31. The Court stated:

> The legislative history of the Glass-Steagall Act shows that Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments. This course places new promotional and other pressures on the bank which in turn create new temptations.

Id.; *id.* at 632 ("Senator Glass made it plain that it was 'the fixed purpose of Congress' not to see the facilities of commercial banking diverted into speculative operations by the aggressive and promotional character of the investment banking business.") (footnote omitted).

[17] *See id.* at 633 ("Another potential hazard that very much concerned Congress arose from the plain conflict between the promotional interest of the investment banker and the obligation of the commercial banker to render disinterested investment advice.").

[18] The criticism leveled at Glass-Steagall was aimed at *Camp*'s reading of the Act, as well as Congress's other justifications for the commercial and investment bank separation. For an argument that Glass-Steagall represented nothing more than a protectionist move by investment banks to prevent competition from commercial banks, see RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 219–24 (2003). *See also* ROBERT E. LITAN & JONATHAN RAUCH, AMERICAN FINANCE FOR THE 21st CENTURY 27 (1998). They explain:

> Other factors were at work as well: evidence suggests that the 1933 Glass-Steagall Act was largely a punitive measure aimed at several large banks that had engaged in securities abuses (as many securities firms that were unaffiliated with banks had also done) rather than a device for assuring bank safety.

Id. at 27; FRANKLIN R. EDWARDS, THE NEW FINANCE: REGULATION AND FINANCIAL STABILITY 71 (1996) ("It is now widely accepted that Glass-Steagall restrictions are not necessary to maintain bank soundness or financial stability.") (citations omitted).

[19] The reasons for the repeal of Glass-Steagall are admittedly complex. Under one account, the growth in the capital markets came at the expense of commercial banking, so that banking organizations were forced to enter into investment banking

asked, would a rational banking organization pour good money after bad, jeopardizing its own business and reputation, by shoring up a failing securities affiliate (or the affiliate's corporate clients)? The contagion risk of depositors transferring their mistrust of the securities affiliate to the bank could be addressed by keeping the bank "quarantined" from the securities affiliate, policing transactions between them, and, most importantly, by alerting bank customers and depositors to this separation so they would have no reason to lose confidence in the bank if troubles developed elsewhere in the organization. Moreover, federal insurance for bank deposits would prevent depositors from worrying unduly about the performance of bank affiliates.[20] By the same token, a banking organization would have no long-term incentive to risk its reputation by encouraging its depositors and other customers to make improperly speculative investments. If, as is generally the case, a bank is a "repeat player" in financial markets, it has every reason to perform its securities-related activities, like all its activities, with care and prudence. It is rational for a banking organization to help its customers invest wisely.

Finally, critics of Glass-Steagall posed a powerful existential question: are commercial bankers so different from investment bankers? Like investment bankers, commercial bankers specialize in capital raising, investments, and finance. They, too, make money on the spread between an investment's total return and the return to their clients, or on transaction-based fees. It is true, as a historical matter, that commercial bankers offered a limited range of financial products. But this was not a sign so much of their prudence as it was a result of the legal limitations on banking business. Indeed, as the argument went, confidence in banks should grow when banks and bank holding companies are allowed to engage in a well-diversified range of financial activities that they could offer to their businesses and individual customers.[21]

(for which they were well qualified) in order to survive. They made use of loopholes in Glass-Steagall to engage in investment banking until Gramm-Leach-Bliley completely removed the restrictions. *See generally* JONATHAN R. MACEY ET AL., BANKING LAW AND REGULATION 554–57 (3d ed. 2001).

[20] *See* 12 U.S.C.A. § 1815 (2004); 12 C.F.R. pt. 330 (2004) (for deposit insurance).

[21] *See* Garten, *supra* note 10, at 322–23 (discussing advantages of diversification in bank activities).

B. *Social Psychological Reformulation of Subtle Hazards*

I propose revitalizing the subtle hazards of combining commercial and investment banking identified in *Camp* by grounding the hazards in social psychology. To understand my reformulation, it is first necessary to recognize that *Camp* discusses subtle hazards on the basis of particular assumptions about human behavior. The Court assumes that commercial bankers, and even investment bankers, act rationally while depositors and other bank customers often do not. In the Court's view, although a rational commercial banker might not want to support the troubled securities affiliate or the affiliate's clients, the banker feels compelled to do so in order to prevent depositors from irrationally punishing the bank for this unrelated problem. A similar dilemma faces the commercial banker in deciding whether to make loans to customers to facilitate their purchasing of securities: either rationally to profit from lending and risk the irrational wrath of depositors if and when the securities markets fall, for whatever reason, or to forego the profit from the loan. By separating commercial from investment banking, Glass-Steagall removes commercial bankers from these dilemmas, where either action or inaction by the banker makes perfect sense.

It is not my goal here to discuss the accuracy of the Court's views about depositor behavior in a panic, although I believe there is considerable evidence that individuals do not act rationally in financial panics.[22] Rather, I propose that the subtle hazards of combining commercial and investment banking in one organization lie in the limitedly rational thinking and behavior of investment and commercial bankers, even if it would be difficult to contend that this thinking and behavior are completely irrational. I support this assertion by returning to *Camp*'s emphasis on the promotional, salesmanship aspect of investment banking. I suggest that the risk here, in social psychological terms, is that an investment banker will adopt the perspective of its company client when advising the company on a capital raising, merger or acquisition, or another financial transaction or product instead of maintaining a critical distance from that client. More specifically, an investment banker's client-driven,

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[22] The classic work on this subject is CHARLES P. KINDLEBERGER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (3d ed. 1996).

salesmanship orientation makes the banker particularly susceptible to being swept into the team or inner circle of company management, thus losing his or her distance from the company. As part of such a circle, the banker would focus on facilitating its goals, thus benefiting the group and him or herself, and would forget or ignore his or her responsibilities to the larger organization of which he or she is a part.

Although investment bankers and their clients unquestionably benefit from this team-oriented approach,[23] the social psychological concern arises when an inner circle becomes excessively cohesive and inner-focused. Joining this kind of team may benefit the banker in the short run, but may ultimately hurt the banker, his or her investment bank, and the FHC. Considerable social psychological evidence shows that members of excessively cohesive groups often act for the group's sole benefit despite an explicit mission to do otherwise (e.g., to act on behalf of a larger organization, such as a corporation, of which the group is an important part).[24] A group can transform its members so that they adopt uniform views and become hostile to dissenters and outsiders.[25] The group's continued existence and prosperity become the exclusive goals of its members, who share in this prosperity in varying degrees. Such a group generally forms around a key individual or leader, like a company's chief executive officer, who represents and espouses the group's ideals. Social psychologists who study the formation of these unnaturally cohesive groups explain this behavior in terms of a perversion of the natural

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[23] As an accepted member of a client's management group, the investment banker could understand better, and thus contribute to achieving, the client's business goals. There is considerable research on the benefits of group work and decision-making. *See, e.g.*, Alan S. Blinder & John Morgan, *Are Two Heads Better Than One?: An Experimental Analysis of Group vs. Individual Decisionmaking*, *in* NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER NO. 7909 (Sept. 2000) (presenting experimental data showing that groups outperform individuals), *available at* http://www.nber.org/papers/w7909 (last visited Oct. 17, 2004).

[24] This characteristic of excessively cohesive groups is called "groupthink," as discussed in Irving Janis' classic account. *See* IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 174–77 (2d ed. 1982). *See also* Michael A. Hogg & Sarah C. Hains, *Friendship and Group Identification: A New Look at the Role of Cohesiveness in Groupthink*, 28 EUR. J. SOC. PSYCHOL. 323, 337 (1998).

[25] *See* JANIS, *supra* note 24, at 242–59; Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 499 (1999).

and ordinary search by individuals for social identity and for certainty in unsettling environments.[26]

I contend (as I have argued elsewhere)[27] that evidence available from the corporate scandals in firms like Enron and WorldCom shows that inner circles in those firms exemplified the destructively cohesive groups described by social psychologists. The circles included top executives, board members, and key corporate advisors, such as outside accountants and lawyers. Significantly, investment as well as commercial bankers, including those from FHCs, joined their ranks.

To recapitulate, my reformulated subtle hazards arise as follows: an investment banker of a bank affiliated with a commercial bank in a FHC joins the inner circle of one of his or her corporate clients and participates in or facilitates the destructive and illegal actions of the circle for the benefit of group members, including the banker. This membership in turn insinuates itself into the FHC, sometimes at the highest executive levels, and the FHC ignores established policies in order for the banker to maintain good relations with the inner circle. The FHC's involvement in the scandal ultimately presents significant legal and reputation risks to the FHC. A look at the evidence of the corporate scandals shows that this reformulation of *Camp's* subtle hazards helps explain how commercial banking organizations became involved in them in the first instance.

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[26] In essence, groupthink is simply a natural process taken to extremes: we all obtain much of our identification from groups; it is just that, in groupthink, one's self identification with a group becomes harmful. *See* Michael A. Hogg & Barbara A. Mullin, *Joining Groups to Reduce Uncertainty: Subjective Uncertainty Reduction and Group Identification*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION 248, 254 (Dominic Abrams & Michael A. Hogg eds., 1999). For the role of groups in uncertainty reduction, see id. at 267.

[27] *See* James A. Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 ORE. L. REV. (*forthcoming* 2004). In a comment on this Article, Professor Samuel L. Hayes III observed that investment bankers do not cultivate long-term relationships with corporate clients, nor do the clients want them. The evidence below on Enron suggests that this is not always the case. In any event, a team can still form around a transaction or project and it may be particularly destructive to an organization since it focuses on its benefit from the project, rather than on the project's good for the organization.

III. EVIDENCE OF THE SOCIAL PSYCHOLOGICAL SUBTLE HAZARDS IN THE CORPORATE SCANDALS

Evidence available from the corporate scandals suggests that investment bankers of FHCs became members of corporate inner circles and, as such, actively participated in at least some of the corporate scandals. This participation, along with the acquiescence of others within the institutions, created legal and reputation risk for the institutions. The evidence is still being uncovered, as are the scandals themselves, but there is enough of it to support my point. The following discussion is only exemplary and is limited to FHC involvement in the Enron and the WorldCom scandals.[28]

A. *Enron*

It is well known that the Enron affair involved considerable manipulation of the company's financial results accomplished primarily through the use of special purpose entities (SPEs).[29] The manipulators, not all of whom have been fully identified or prosecuted,[30] transferred assets off Enron's

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[28] By so limiting myself to a few examples, I recognize that I may be accused of falling victim to a well-established psychological heuristic of finding a risk present simply because it is "vivid" or available, rather than because it is established through a systematic empirical study. *See* CASS R. SUNSTEIN, INTRODUCTION TO BEHAVIORAL LAW AND ECONOMICS 1, 5 (Cass. R. Sunstein ed., 2000). I have no defense to this accusation, other than to say that, as discussed below, federal banking regulators have concluded from their review of bank and broker activities that financial institution involvement in the scandals was widespread enough to merit general regulatory action.

[29] For a detailed discussion of this scandal, see William Powers, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation (Feb. 1, 2002), *available at* http://www.enron.com/corp/por/pdfs/PowersReport.pdf (last visited Oct. 26, 2004); First Interim Report of Neal Batson, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2002); Second Interim Report of Neal Batson, Court Appointed Examiner, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (focusing on role of special purpose entities in the fraud); Third Interim Report of Neal Batson, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (discussing the role of financial institutions in aiding Enron's fraud); Final Report of Neal Batson, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (discussing the role of Enron's advisors and financial institutions in aiding Enron's fraud); Report of Harrison J. Goldin, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) (describing, among other things, involvement of financial institutions in Enron's fraud). *See also In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549, 613–37 (S.D. Tex. 2002) (describing in detail the Enron scandal).

[30] One of the major perpetrators, former Enron Chief Financial Officer Andrew Fastow, pleaded guilty to, among other things, securities fraud, and will receive a sentence of ten years in prison. *See* Plea Agreement, United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex. 2004), *available at* http://news.lp.findlaw.com/hdocs/docs/enron/uslfastow11404plea.pdf (last visited Oct. 26, 2004). Enron Chairman and CEO

books to the SPEs and had Enron engage in sham transactions with these vehicles. The demand for considerable financial expertise in executing these complicated transactions led to the involvement of financial professionals, including investment bankers. In many cases, the bankers came from FHC-affiliated investment banks. To be sure, the SPEs and these transactions were structured financings that also involved FHC commercial banks, but, as discussed below, they were generally spearheaded by the investment banking division.

Among other services, a financial institution, through a SPE, loaned money to Enron by disguising the transaction as commodity purchases (these were the "prepay" transactions). This, in turn, generated for the institution interest on the loans, as well as investment banking fees for structuring the SPE and the transaction.[31] Other structured financings included sales of assets to a SPE that was funded by a financial institution.[32] In order to maintain the fiction that the SPE was a separate entity and to show Enron's insiders that the institution was committed to Enron, the institution also generally made a small equity investment in each SPE. The financial institution invariably received a high return on this investment, as did the Enron insiders, like Andrew Fastow, who were the other equity investors. Moreover, because Enron agreed to buy back the equity, the institution's investment was never at risk. These transactions generated false revenues for Enron and removed from its balance sheet assets that might otherwise have declined in value.

Congressional hearings and the special reports of Enron's bankruptcy examiner, Neal Batson, revealed how FHCs played a considerable role in these structured financings.[33] Of the several examples showing this FHC involvement, the best of them involves Citigroup. Enron ranked financial institutions doing business with it in three tiers. Not surprisingly, since Citigroup averaged one transaction a month with Enron for the period of 1997-2001,

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Kenneth Lay and President Jeffrey Skilling have been indicted on securities fraud, and other charges. *See* Superceding Indictment, United States v. Causey, 309 F. Supp. 2d 917 (S.D. Tex. 2004) (Cr. No. H-04-25 (S2)).

[31] For a description of the prepay transactions, see Second Interim Report of Neal Batson, *supra* note 29, at 58–66 & app. E.

[32] *See id.* at 104–12, apps. L & M.

[33] *See supra* note 29. *See also The Role of Financial Institutions in Enron's Collapse: Hearing Before S. Comm. Gov't Affairs, Permanent Subcomm. of Investigations*, 107th Cong., 107-618, VOLS. 1-2 (2002).

reaping $188 million in revenues, Enron designated Citigroup a top-tier bank.[34] The story of Citigroup's involvement with Enron is one in which an entire FHC was gradually corrupted through its investment banking division's close affiliation with Enron's inner circle. This affiliation pulled Citigroup within the influence of that circle, even though it was not in Citigroup's ultimate interest. It is important to be clear here: a FHC such as Citigroup services its clients by delivering a package of financial services such as capital raising, structured financing, and loans. Investment and commercial bankers work together as a team to deliver services to a client.[35] This approach makes it easier for investment bankers to involve those from other bank operations in questionable client activity.

Citigroup's financial sins in the Enron affair are legion. In essence, Citigroup's relationship bankers wholeheartedly accepted the goal of Enron's management of disguising the true financial picture of the company. For example, Citigroup bankers actually proposed to Enron insiders and structured many of the SPE transactions that were designed to allow Enron to give a misleading presentation of its financial situation. In Project Nahanni, the bankers came up with the idea that Enron sell Treasury bonds and report the sale as cash from operating activities from a sale of merchant investments for year-end 1999 (so as to improve year-end cash flows).[36] This initiative makes sense, functionally demonstrating Citigroup's bankers' commitment to Enron's inner circle.

The ready participation of Citigroup investment bankers in Enron's inner circle gradually drew others in the banking organization within the conspiracy. Citigroup's internal accountants, for instance, knew that Enron's accounting treatment with respect to the SPEs was improper.[37] Citigroup engaged in the structured financings even though its Global Capital Group had a policy of avoiding participation in

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[34] These transactions included securities underwritings (21), loans (21), structured financings (14), and M&A (4). As a result of this involvement, Citigroup has an exposure of $2.4 billion to Enron in the firm's bankruptcy. *See* Third Interim Report of Neal Batson, *supra* note 29, at app. D, at 5, 11–21.

[35] *See id.* at app. D, at 8–10 (describing Citigroup's approach to the delivery of client services).

[36] *See id.* at app. D, at 107–15. The ridiculousness of categorizing a sale of U.S. Treasuries as a merchant bank investment is apparent. However, no Citigroup investment banker has so far been indicted regarding Citigroup's participation in the Enron scandal.

[37] *See id.* at 56–57.

transactions with a client that could mislead investors about the financial state of the firm.[38] In fact, Citigroup regularly ignored its credit risk limits for Enron,[39] and it appears to have fired an equity analyst who was critical of Enron and hired one from another bank who was recommended by Enron.[40] Most damning of all, the FHC failed to disclose to public investors, regulators, and bond rating agencies its full knowledge of Enron's liabilities, which lack of disclosure allowed it to lessen its own exposure to Enron by selling Enron securities to other investors.[41] In sum, the Enron-structured financings corrupted many in Citigroup.

Citigroup has not emerged unscathed from its involvement with Enron. Ultimately agreeing to pay a $101 million penalty in its settlement with the SEC over the Enron affair, Citigroup essentially admitted that it had contributed to, and had been a cause of, Enron's violation of Section 10(b) of the Securities Exchange Act of 1934 based upon Enron's misleading presentation of its financial condition.[42] As part of this settlement, Citigroup entered into a written agreement with the Federal Reserve Board whereby it undertook to revise its participation in structured finance by implementing more effective monitoring and disclosure systems with respect to such transactions.[43] Citigroup also faces private, class action securities law suits for its role in the fraud[44] as well as potential subordination of its claims against Enron in bankruptcy court.[45]

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[38] *See id.* at 53–54.

[39] *See* Third Interim Report of Neal Batson, *supra* note 29, at app. D, at 21–24.

[40] *See id.* at app. D, at 30–32.

[41] *See id.* at app. D, at 43–44.

[42] *See In re* Citigroup, Inc., Exchange Act Release No. 34-48230, [2001-2003 Transfer Binder] SEC Accounting R. (CCH) ¶ 6037 (July 28, 2003). The total penalty was in fact $120 million since it also included Citigroup's participation in Dynergy's misleading presentation of its financial condition.

[43] *See* Written Agreement by and between Citigroup Inc. & Federal Reserve Bank of New York, *at* http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030728/attachment.pdf (last visited Oct. 26, 2004).

[44] *See In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549, 642–44 (S.D. Tex. 2002). Citigroup has established reserves of $6.7 billion for its exposure to these suits and other litigation. *See* Press Release, Citigroup, Citigroup Reaches Settlement on WorldCom Class Action Litigation for $1.64 Billion After-Tax (May 10, 2004), http://www.citigroup.com/citigroup/press/2004/data/ 040510a.htm (last visited Oct. 26, 2004).

[45] *See* Third Interim Report of Neal Batson, *supra* note 29, at app. D, at 6–7. *See also* Complaint, *In re* Enron Corp., No. 01-16034, at 56–60 (Bankr. S.D.N.Y. 2003), *available at* http://news.lp.findlaw.com/hdocs/docs/enron/eciti92403advprcd.pdf (Enron's complaint against financial institutions in bankruptcy proceeding) (last visited Sept. 25, 2004).

JP Morgan Chase also participated in the Enron scandal.[46] Like Citigroup, it was a top-tier Enron bank, with a similar transaction history with Enron during the 1996-2000 period when the scandal evolved: its transactions generated $86.3 million in revenues for this financial institution.[47] Indeed, Enron was one of JP Morgan Chase's best clients during this period.[48] As in the case of Citigroup, JP Morgan Chase's investment bankers structured many of the misleading SPE transactions with the participation of others in the banking group, which in turn led to the corruption of the FHC. These bankers were the ones who came up with the structure of the notorious Mahonia transactions, which were designed to give a misleading picture of Enron's financial position. By presenting commodities to be delivered at a future date as "prepays," and thus as cash flow from operating activities, Enron was able to disguise what were in fact unsecured loans from JP Morgan Chase to Enron that should have been recognized as cash flows from financing.[49] The prepays thus increased Enron's operating cash flow and decreased its debt by material amounts.[50] The corruption in JP Morgan Chase from its design of and participation in the prepays was insidious. On the one hand, bank officers properly presented the transactions to the FHC's regulators as loans to Enron, rather than as commodity purchases, and always recognized the substance of the transaction internally.[51] On the other hand, many JP Morgan Chase executives knew that rating agencies and investors did not understand the purpose of these complex financings and yet made no effort to illuminate them.[52]

Like Citigroup, JP Morgan Chase has not emerged unscathed from its Enron involvement. As a result of litigation with insurance companies over surety bonds backstopping Enron's exposure on the prepay contracts (the companies claimed that they did not know that they were backstopping loans), JP Morgan Chase agreed to claim only 50% of the

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[46] *See* Third Interim Report of Neal Batson, *supra* note 29, at app. E, at 5–17.

[47] *See id.* at app. E, at 5–12.

[48] *See id.* at app. E, at 9–12 (discussing Enron's status as a favored "blue" client).

[49] *See id.* at app. E, at 18–57.

[50] *See id.* at app. E, at 21–22.

[51] Third Interim Report of Neal Batson, *supra* note 29, at app. E, at 37–42.

[52] *See id.* at app. E, at 43–53.

surety bond amount.[53] It, too, settled with the SEC (for $135 million) on a complaint alleging that it had aided and abetted Enron's securities fraud,[54] and it entered into a written agreement with the Federal Reserve to improve its monitoring of its structured finance.[55] Also like Citigroup, JP Morgan Chase is facing securities class actions over Enron's demise, suits from lenders that participated in its Enron loan facilities, and equitable subordination of its claims in Enron's bankruptcy.[56]

Unfortunately, the FHCs involved in Enron's fraud do not end with Citigroup and JP Morgan Chase. In the Bammel transaction,[57] Enron and Bank of America formed a SPE that "purchased" natural gas from Enron (the SPE was funded by small equity contributions from each party and a large loan from Bank of America) and then allowed Enron to "use" the gas and pay fees on the use. Enron also agreed to "sell" the gas for the SPE, but bore the risk that the sale proceeds would be less than the SPE's purchase price. This transaction was nothing more than a disguised loan from Bank of America to Enron, which allowed Enron to overstate revenue and cash flow and to disguise its liabilities.[58] Royal Bank of Canada, a foreign bank holding company, engaged in similar transactions with Enron through the structured financing group of its capital markets division, which again resulted in a misleading financial

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[53] For the lawsuit, see JP Morgan Chase Bank v. Liberty Mut. Ins. Co., 233 F. Supp. 2d 550 (S.D.N.Y. 2002).

[54] *See In re* J.P. Morgan Chase, Litigation Release No. 18252 (July 28, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18252.htm (last visited Oct. 26, 2003).

[55] *See* Written Agreement by and among J.P. Morgan Chase & Co., Federal Reserve Bank of New York & N.Y. State Banking Dep't (July 28, 2004), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2003/200307282/attachment.pdf (last visited Oct. 26, 2004).

[56] JP Morgan Chase's exposure to Enron is $1.8 billion in its bankruptcy, which risks being equitably subordinated. *See* Third Interim Report of Neal Batson, *supra* note 29, at app. E, at 2–4; see *also* Complaint, *In re* Enron Corp., *supra* note 45. On the lawsuit from banks that participated in the syndicated facilities supporting the Enron SPEs, see UniCredito Italiano SPA v. J.P. Morgan Chase Bank, 288 F. Supp. 2d 485 (S.D.N.Y. 2003). On the securities law class action, see *In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d 549, 639–42 (S.D. Tex. 2002).

[57] *See* Report of Harrison J. Goldin, *In re* Enron Corp., No. 01-16034 (AJG), 28–58 (Bankr. S.D.N.Y. 2003).

[58] *See id.* at 43–45. Enron was in effect trying to "monetize" gas that could not be extracted, because it had to stay in the natural gas facility or the facility would collapse!

presentation of Enron.[59] The involvement of these and other FHCs in the Enron fraud was so extensive that Enron's bankruptcy examiner could conclude from the evidence that FHCs had aided and abetted, or contributed to, Enron's creation of false accounting statements, as well as breaches of duties by Enron's officers and directors.[60]

Does this participation by the FHCs in the Enron fraud make sense within the perspective of *Camp*'s subtle hazards? For the most part, the answer seems to be no. There is little evidence that, during their dealings with Enron, Citigroup, JP Morgan Chase and the other FHCs tried to maintain the company through loans and other financial help out of a rational fear that its failure could hurt the FHCs' investment banks and eventually, through a loss of depositor confidence, their commercial banks. Nor does it appear that, for the same reason, the FHCs encouraged investors to purchase Enron securities. FHC executives were concerned about the reputation risk that threatened their institution due to their transactions with Enron, but the concern was never acute. Simply put, the FHC executives were not worried that their institution would fail from this activity.[61]

Rather, my reformulation of the subtle hazards—the social psychological attraction of a client's inner circle for investment bankers, who then draw in others in the affiliated FHC—better explains the participation of the FHCs in the Enron scandal. Enron's "deal flow" motivated the bankers and their superiors: it was in their self-interest for their institution to be among Enron's top-tier banks. However, in order to be in this tier, the bankers were required to accede to Enron's demands, which meant structuring financings in accordance with the goals of Enron's inner circle. Accordingly, if Andrew Fastow needed to enhance Enron's cash flow and hide its

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[59] *See id.* at 92–130. It is interesting that the main Royal Bank of Canada bankers involved in the Enron transactions had all come from NatWest of London, where they had previously worked with Enron on similarly misleading transactions. *See id.* at 97–98.

[60] *See* Final Report of Neal Batson, *supra* note 29, at 103. The other banking institutions involved in the Enron scandal include: UBS Warburg AG, *see* Report of Harrison J. Goldin, *supra* note 57, at 173–201; Barclays Bank, Deutsche Bank, and Canadian Imperial Bank of Commerce, *see* Third Interim Report of Neal Batson, *supra* note 29, at 65–81; Royal Bank of Scotland, Credit Suisse First Boston, and Toronto Dominion Bank, *see* Final Report of Neal Batson, *supra* note 29, at 66–81.

[61] As discussed *infra* text accompanying note 94, as a result of the scandals, financial regulators of FHCs are now focusing more on this reputation or franchise risk.

liabilities, or if he wished to increase its revenues for year-end, the bankers had to design the appropriate new product and transaction structure, such as Citigroup's idea to sell treasury bonds as a merchant banking investment or JP Morgan Chase's pre-paid commodities contracts. Although, as discussed above, many executives in the FHCs knew that Enron had misrepresented its financial results through these transactions, they rarely questioned the behavior of their institution. By this point, the FHC's Enron relationship bankers' desire to be part of Enron's team had infiltrated and corrupted the FHC. Enron bankruptcy examiner Neal Batson drives home this point when he describes the criteria used by Enron for designating a FHC a tier one bank.[62] Among other things, Enron looked to the existence of a relationship (as opposed to a transactional) approach towards Enron, an ability to structure complex, mission-critical deals, and an account officer "capable of delivering institution." To be a top-tier Enron bank, in other words, meant that the entire FHC had to become a dependable member of Enron's inner circle despite the reputation risk this membership posed for the institution.

B. *WorldCom and Other Scandals*

The WorldCom scandal involved massive accounting fraud in that the company transformed significant liabilities into capital assets so that its financial results would look better than those of its competitors in the volatile telecommunications industry.[63] The conspirators perpetrated the fraud in order to

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[62] *See* Third Interim Report of Neal Batson, *supra* note 29, at 46 n.121.

[63] This fraud was straightforward and "classic." Expenses reduce income in the year incurred, whereas an expense transformed into a capital asset need only be expensed over the life of that asset. In other words, the WorldCom fraud involved deferring the recognition of expenses, which made WorldCom appear to be in better financial shape than many of its competitors. For detailed descriptions of the WorldCom fraud, see DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (Mar. 31, 2003), *available at* http://news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf (last visited Oct. 26, 2004); First Interim Report of Dick Thornburgh, *In re* WorldCom Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2003); Second Interim Report of Dick Thornburgh, *In re* WorldCom Inc., No. 02-13533 (AJG) 188–90 (Bankr. S.D.N.Y. 2003); Third and Final Report of Dick Thornburgh, *In re* WorldCom Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2003) (discussing in more detail the fraud and potential causes of action against participants); *In re* WorldCom Inc. Sec. Litig., 2003 U.S. Dist. LEXIS 8245 (S.D.N.Y. 2003) (No. 02-Civ-3288). *See also* Richard C. Breeden, Restoring Trust: Report to The Hon. Jed S. Rakoff, the United States District Court for the Southern District of New York on Corporate Governance for the Future of

keep WorldCom's stock price high, allowing the stock to be used as acquisition currency and preventing the exposure of the excessive debt of its CEO, Bernie Ebbers.[64] WorldCom's internal auditors ultimately exposed the scandal,[65] and WorldCom entered into bankruptcy, from which it is only now reemerging as MCI.

The participation of FHCs in this scandal appears to be less widespread than it was in Enron mainly because the WorldCom fraud did not involve the use of SPEs and structured finance, which demand intensive investment banking involvement. Nonetheless, it was significant. To take a prominent example, it is alleged (and, in some cases, undisputed) that Citigroup, through its investment bank, Salomon Smith Barney, turned a blind eye to the WorldCom fraud because of its efforts to capture WorldCom's investment banking business. Between 1997 and 2002, Salomon was the main investment bank for WorldCom and received more than $107 million in investment banking fees from that company.[66] Citigroup essentially garnered much of this business through bribery, allotting shares of "hot" IPOs underwritten by Salomon to WorldCom executives like Ebbers.[67] Significantly, Salomon's infamous telecommunications analyst, Jack Grubman, gave and maintained the investment bank's highest stock rating for WorldCom, even though he had no basis for this rating and may even have been skeptical about

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MCI, Inc. 20–24 (Aug. 2003), *available at* http://news.findlaw.com/hdocs/docs/worldcom/corpgov82603rpt.pdf.

[64] In a situation where truth is stranger than fiction, Ebbers pledged his company stock to financial institutions for loans in the amount of $400 million and used the loan proceeds to make many bad investments. As the value of his stock collateral fell, the banks demanded repayment, which he could not make, so WorldCom itself assumed from the banks the loans to its CEO. *See* Second Interim Report of Dick Thornburgh, *supra* note 63, at 12.

[65] For a discussion of the uncovering of this scandal, see Susan Pulliam & Deborah Solomon, *How Three Unlikely Sleuths Exposed Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1 (describing the story of how internal audit chief Cynthia Cooper and her team unearthed the WorldCom accounting fraud and tracked it through company accounts despite some resistance from executives engaged in the fraud).

[66] *See* Third and Final Report of Dick Thornburgh, *supra* note 63, at 137–40.

[67] This refers to an initial public offering that underwriters expect to rise precipitously above the offer price in the first day (or even hours) of trading. Executives who receive shares of these IPOs risk nothing: the bank advances them money to make the purchase and then sells the shares, with the executive simply pocketing the difference between the purchase and sales price. It is nothing more than a bribe. *See id.* at 140–82.

WorldCom's financial results—all in order to maintain Citigroup's relationship with WorldCom.[68]

While the Citigroup/WorldCom relationship clearly involved corrupt self-interest, it also makes sense in the social psychological terms that I have laid out: the corruption of a FHC through its investment bankers' association with a client's inner circle. There is no question that Salomon investment bankers, most particularly Grubman himself, became part of the WorldCom's inner circle. After all, Grubman attended WorldCom board meetings and gave WorldCom strategic advice, particularly regarding the company's relationship with Wall Street.[69] As in the case of Citigroup and Enron, this inner circle membership of Citigroup bankers was critical for bringing the rest of the FHC within the circle's influence. While the closeness of the Salomon bankers and analysts to WorldCom made sense in the short run, in the long run it seriously harmed the reputation of Citigroup and exposed it to significant legal liability.[70]

Details of FHC involvement in other corporate scandals are yet fully to emerge. Yet there is little question that, in many cases, as in Enron and WorldCom, investment bankers associated with FHCs joined company inner circles and "delivered" their institution to the circles. For example, Freddie Mac, the quasi-public provider of funds for housing mortgage loans, also prepared misleading financial results, often through transactions with SPEs structured by FHCs (including Citigroup and JP Morgan Chase).[71] And, as the scandals related to mutual funds unfold, wherever favored investors were allowed to trade in fund shares in ways that injured ordinary

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[68] *See id.* at 204.

[69] *See* First Interim Report of Dick Thornburgh, *supra* note 63, at 81–104. *See also* Attorney General of the State of New York Bureau of Investment Protection, *In re* Citigroup Global Markets, Inc. (formerly known as Salomon Smith Barney Inc.), Assurance of Discontinuance Pursuant to Executive Law § 63(15), at 51–52 (Apr. 28, 2003), *available at* http://news.findlaw.com/hdocs/docs/ssb/nyagciti42803aod.pdf (last visited Oct. 26, 2004).

[70] Citigroup has paid a $400 million penalty for its misleading analyst activities (including those in the case of WorldCom). *See In re* Citigroup Global Markets, Inc., *supra* note 69, at 58. It has also agreed to pay $2.65 billion ($1.64 billion after tax) to settle private securities law suits against it over its participation in the WorldCom fraud. *See* Citigroup Inc., Form 8-K (May 10, 2004), *available at* http://www.sec.gov/Archives/edgar/data/831001/000104746904016537/0001047469-04-016537-index.htm (last visited Oct. 26, 2004).

[71] *See* OFFICE OF FED. HOUS. ENTER. OVERSIGHT, REPORT OF THE SPECIAL EXAMINATION OF FREDDIE MAC 74–82 (Dec. 2003).

shareholders, banks appear to have been involved in facilitating the improper trading.[72]

IV. THE TRANSACTION AND RELATIONSHIP OVERSIGHT COMMITTEE

It is first important to recognize that FHC investment bankers are not the only ones attracted to dysfunctional inner circles. Evidence from the scandals shows that investment bankers from banks unaffiliated with FHCs, commercial bankers, accountants, and lawyers willingly joined corporate inner circles.[73] The best example may be the former accounting firm, Arthur Anderson. The Arthur Anderson client relationship accountants became part of Enron's team and ignored the restraints of the firm's professional standards committees, which ultimately led to the firm's demise.[74] The same could be said about the law firms involved in the scandals, although their liability has yet to be fully established. Investment bankers may be particularly susceptible to joining an inner circle because, unlike professional service firms, their employees are neither restrained by powerful professional codes of behavior and ethics nor by an ethos of professionalism.[75] As a practical matter, investment bankers are today little more than "hired guns" with weak commitments to their current employer investment bank and more loyalty to their corporate clients, whom they often bring along to any new employer. This client-based loyalty may be particularly acute with bankers affiliated with FHCs because, in order to compete with established investment banks like

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[72] *See, e.g.*, Press release, SEC, SEC Reaches Agreement in Principle to Settle Charges Against Bank of America for Market Timing and Late Trading (March 15, 2004), http://www.sec.gov/news/press/2004-33.htm (last visited Oct. 24, 2004).

[73] *See* Third Report of Neal Batson, *supra* note 29, at 81–85 (discussing role of Merrill Lynch in Enron's fraud); *In re* Enron Corp. Sec., Derivative and ERISA Litig., 235 F. Supp. 2d. 549, 656–86 (S.D. Tex. 2002) (discussing involvement of law firms and accountants in Enron's fraud).

[74] *See In re* Enron Corp. Sec., 235 F. Supp. 2d at 673–85.

[75] It is true that investment bankers are governed by codes of conduct and certification administered by the National Association of Securities Dealers. *See generally* NASD website, *at* http://www.nasdr.com. However, bankers generally do not receive school and professional training of the order of accountants and lawyers. Of course, one should not put too much faith in professional standards, as Arthur Anderson's actions show.

Merrill Lynch and Morgan Stanley, the FHCs have hired teams of bankers away from them.[76]

The inner circle attraction that is central to the reformulated subtle hazards analysis is particularly serious for the FHC. The legal structure of regulation of these complex institutions or LCBOs makes it difficult for regulators to address adequately this problem. Under the law, there is diverse, functional regulation of the different parts of FHCs.[77] The SEC regulates investment banks, insurance regulators oversee the insurance firms, bank regulators govern the commercial bank, and the Federal Reserve the FHC. In other words, with the exception to be discussed in more detail below, a FHC is not responsible to a super-regulator, which would logically be the Federal Reserve.[78] Yet, as I noted in discussing the Enron scandal, this functional regulation contrasts with the manner in which FHCs deliver their services today. They offer, and their clients come to expect, a panoply of different financial services, often through teams of bankers drawn from different parts of the financial institution. It is thus easy for an inner circle's influence to reach throughout a FHC by the client team, composed of investment and commercial bankers, while it is hard for regulators, focused as they are on different parts of the FHC's business, and even for the FHC's top executives, to control the problem before it is too late.[79]

Bank regulators, I contend, must be sensitive to the risk of corruption ensuing from FHC bankers identifying

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[76] In effect, financial institutions, such as Merrill Lynch and Morgan Stanley, are among the largest financial conglomerates and operate some of the largest commercial banks in the country. *See* Large Commercial Banks, Federal Reserve Statistics Release, *at* http://www.federalreserve.gov/releases/lbr/current/default.htm (last visited Oct. 26, 2004) (indicating that, as of June 30, 2004, they rank 64 and 57, respectively, in terms of consolidated assets among commercial banks chartered in the United States). *See also* Statistics on Depository Institutions, Federal Deposit Insurance Corp. (indicating that as of June 30, 2003, Merrill Lynch was 11th in terms of total deposits among FDIC-insured commercial banks and savings institutions), *at* http://www2.fdic.gov/sod/sodSumReport.asp?sInfoAsOf=20032sAreas=2barItem=3 (last visited Oct. 26, 2004). Through various regulatory loopholes, however, they are not regulated as FHCs and thus have less of a regulatory burden than does Citigroup or JP Morgan Chase.

[77] *See* 12 U.S.C.A. § 1844 (2004).

[78] *See* MACEY, *supra* note 19, at 437.

[79] The team approach of FHC towards clients is reflected in the FHC's risk analysis, which is designed to review all the activities of all of its divisions with respect to a particular client. *See* Arthur E. Wilmarth, *How Should We Respond to the Growing Risks of Financial Conglomerates?*, *in* FINANCIAL MODERNIZATION AFTER GRAHAM-LEACH-BLILEY 36–39 (Patricia C. McCoy ed., 2002), *available at* http://papers.ssrn.com/abstract=291859 (last visited Oct. 26, 2004).

themselves too closely with a client's inner circle and must take action to prevent its recurrence. It is important that bank regulators are looking more closely at FHC involvement in structured finance[80] and that, in accordance with the Sarbanes-Oxley Act of 2002, the SEC has enhanced the disclosure of public company off-balance sheet activities and techniques that were used in the scandals.[81] However, this addresses only the most recent manifestation of the inner circle problem. The next wave of scandals involving corporations and FHCs could be based upon a different scheme or abuse. Yet an effective regulatory response is a tall order, especially when the entire focus of FHCs is to deliver the institutions to the clients, when even the chief executives of the FHCs may favor client inner circles,[82] and when investment bankers are often all powerful barons in these financial conglomerates. Moreover, because the risk of a loss of consumer confidence that could arise from the FHC's loss of reputation from a scandal is real, although as yet unapparent in the current scandals, regulators cannot ignore the problem.[83]

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[80] *See* GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-03-511, INVESTMENT BANKS: THE ROLE OF FIRMS AND THEIR ANALYSTS REPORT WITH ENRON AND GLOBAL CROSSING 23 (2003), *available at* http://www.gao.gov/atext/d03511.txt (last visited Oct. 26, 2004); Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28,980 (May 19, 2004).

[81] *See* Sarbanes-Oxley Act of 2002 [hereinafter Sarbanes-Oxley], Pub. L. No. 107-204 § 409, 116 Stat. 745 (codified in scattered sections of titles 11, 15, 18, 28, and 29 of the U.S.C.) (entitled "Real Time Issuer Disclosures" and adding subsection (*l*) to 15 U.S.C.A. § 78m (2004), to disclose accurately off-balance sheet items); *id.* at § 401 (entitled "Disclosure in Periodic Reports" and adding, among other things, a new subsection (j) to 15 U.S.C.A. § 78m (2004), which requires that the SEC promulgate rules mandating annual and quarterly reports to disclose "material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses"); Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, 68 Fed. Reg. 5,982 (Feb. 5, 2003) (final rule) (to be codified at 17 C.F.R. pts. 228, 229, 249); Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, 67 Fed. Reg. 68,054 (proposed Nov. 8, 2002) (to be codified at 17 C.F.R. pts. 228, 229, 249).

[82] The best example of this may well be the closeness of Citigroup's Chairman and former CEO Sandy Weill to many company client CEOs. *See, e.g.*, *In re* Citigroup Global Markets, Inc., *supra* note 69, at 36–45 (discussing Weill's efforts to have analyst Jack Grubman change his rating of AT&T).

[83] Arguably, regulators should be especially concerned about this reputation risk because executives of the largest financial conglomerates believe that regulators will always rescue them, despite the law that is supposed to prevent bank regulators from keeping large banks from failing. *See* Arthur E. Wilmarth, *The Transformation of*

One possible solution is that regulators should require FHCs to implement a firm-wide transaction and relationship oversight committee at the highest level. This committee would then be empowered to review, regulate, and veto—if necessary—transactions, products, and client relationships. The Federal Reserve also has the power to impose on a FHC this kind of committee—a committee that already exists in some FHCs. The Federal Reserve has the authority to prevent unsafe or unsound practices that present a risk to the safety and soundness of banks, and certainly the involvement of FHC bankers in client inner circles counts as a dangerous practice.[84] Moreover, following the passage of Gramm-Leach-Bliley, the Federal Reserve has taken a special supervisory role with respect to LCBOs that involves an understanding of the overall risks of the organization.[85] In this regard, the Federal Reserve demands an evaluation of legal and reputation risks, and the reformulated subtle hazard of the inner circle falls within this category. Indeed, following the corporate scandals and the passage of Sarbanes-Oxley, the Federal Reserve asked FHC examiners to ensure that FHCs had policies and internal control structures in place so that upper management could monitor the diverse activities of the organization.[86]

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the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks, 2002 U. ILL. L. REV. 446–50 (2002) (discussing continued existence of "too big to fail" doctrine among financial regulators).

[84] *See* 12 U.S.C.A. §1844 (2004). Admittedly, that provision and 12 U.S.C.A. § 1848a (2004) imposed limitations on the Federal Reserve's power to examine and regulate subsidiaries of holding companies that were otherwise regulated, but these restrictions are subject to the "unsafe or unsound practice" exception.

[85] *See* DeFerrari & Palmer, *supra* note 7, at 47. *But see* Wilmarth, *supra* note 83, at 454–75 (arguing that this supervision has been ineffective in allowing banking regulators to oversee the entire organization).

[86] *See* FEDERAL RESERVE, *supra* note 3, § 2010.0, *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc0604.pdf (last visited Oct. 26, 2004) (recommending that examiners insist upon written policies of parent company supervision in decentralized holding company structures); *id.* at § 2060.05.1 (discussing internal audit, which is the group, reporting to the audit committee, that ensures that all divisions of the FHC are following the firm's policies and the law); § 2060.4 (dealing with the reporting structure up the chain in the FHC and management information systems); *id. at* § 5010.14 (requiring an examiner to see whether a holding company has in place formal policies to minimize risk). Sarbanes-Oxley enhanced the importance of internal controls in a public firm (which FHCs generally are) by imposing a requirement that chief executives certify that their company has an adequate system of internal controls. *See* Sarbanes-Oxley, *supra* note 81, § 404 ("Management Assessment of Internal Controls"); Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276 (Sept. 9, 2002) (final rule) (to be codified at 17 C.F.R. pts. 228, 229, 232, 240, 249, 270, 274); Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 51,508 (proposed Aug. 8, 2002) (to be codified at 17 C.F.R. pts. 232, 240, 249); Certification of Disclosure

Moreover, in response to the involvement of particular FHCs in the corporate scandals, the Federal Reserve required offending institutions to adopt or to strengthen existing oversight committees. The written agreement[87] between Citigroup and the Federal Reserve regarding the FHC's participation in the Enron transactions required, among other things, that Citigroup develop a "legal and reputational risk management program." This program was intended to identify where transactions pose "heightened legal or reputational risks" to Citigroup, to ensure that these risks are evaluated with respect to transactions, and to ensure that appropriately senior personnel consider the risks.[88] The program also stipulated that there be a "higher level review of the overall customer relationship between the counterparty and Citigroup and its subsidiaries independent of the business line" in situations of heightened risk,[89] which could serve to prevent bankers from pulling the institution into the designs of the inner circle. Even more specifically, the Canadian Imperial Bank of Commerce (CIBC) and the Federal Reserve (as well as the Canadian banking regulator) entered into a written agreement to address CIBC's participation in the Enron scandal.[90] As part of the agreement, CIBC was required to establish a Financial Transaction Oversight Committee (FTOC), composed of senior representatives of the FHC's departments, including legal and accounting, that had to pre-approve all structured finance activities and any other transaction in which a member of the committee felt that the

in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 41,877 (June 20, 2002) (to be codifed at 17 C.F.R. pts. 232, 240, 249) (offering a proposed rule before passage of Sarbanes-Oxley because investors were losing confidence that executives are paying attention to company disclosure). *See also* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, 274) (final rule under which executives of a public company must report on and certify internal control systems in their company).

[87] A written agreement is a quasi-formal action that bank regulators take, with the consent of the regulated party, to address a problem with the latter. *See* MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 300 (2d ed. 2003).

[88] Written Agreement by and between Citigroup Inc. & Federal Reserve Bank of New York, *supra* note 43, at 3–4.

[89] *See id.* at 5. J.P. Morgan Chase entered into a similar agreement with the Federal Reserve Bank of New York and the New York State Banking Authority. *See* Written Agreement by and among J.P. Morgan Chase & Co., *supra* note 55, at 4–5.

[90] *See* Agreement by and among Canadian Imperial Bank of Commerce, The Superintendent of Financial Institutions & Federal Reserve Bank of New York (Dec. 22, 2003), *at* http://www.osfi-bsif.gc.ca/eng/newscentre/newsrelease/pdf/agreement_e.pdf (last visited Oct. 26, 2004).

Committee's approval was necessary or that an employee had referred to the Committee. In deciding whether to approve a transaction, the Committee had to evaluate, among other things, the reputation risk that it posed to CIBC.[91]

Most significantly, the new Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities (the Statement) recommends policies that have the effect of preventing FHCs and other financial institutions from participating in transactions generated by company inner circles (through "captured" investment bankers).[92] As the Statement explains, because structured finance is not a commoditized product and instead is tailored to fit a company's specific needs, it is particularly susceptible to being used by an inner circle to further its interests at the expense of the company. Additionally, being complex, structured financing involves the participation of different professionals.[93] From the social psychological perspective adopted here, this means that a company's inner circle may well enlist multiple parties in these transactions that advance its, not the company's, goals. The Statement recognizes that a financial institution's participation in, and structuring of, these transactions may lead it to incur the kinds of legal risks seen in the case of Citigroup with Enron and, more significantly, the risk that the financial institution's existence may be threatened if its reputation is tarnished.[94] In a psychologically astute manner, the Statement recommends that there be established

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[91] *See id.* at app., at 2–5. In addition, CIBC employees are encouraged to report problematic transactions to the FTOC, and CIBC has to develop a web site that, among other things, provides a means for communications by employees to the FTOC.

[92] *See* Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28,980 (May 19, 2004). In the past, banking agencies have proposed guidelines for financial institutions with respect to particular transactions that posed legal and other risks to them. *See, e.g.*, OCC Examining Circular on Leveraged Buyouts and Other Forms of Leveraged Transactions, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 87,529 (Dec. 14, 1988) (proposing guidelines on a bank's involvement with highly-leveraged transactions). I owe this observation to Brandon Becker.

[93] *See* Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28,980, 28,985 (May 19, 2004).

[94] *See id.* at 28,981. As recent events have highlighted, financial institutions may face substantial legal risk to the extent they participate in complex structured finance transactions that are used by customers to circumvent regulatory or financial reporting requirements, evade tax liabilities, or further other illegal or improper behavior by the customer. Involvement in such transactions also may damage an institution's reputation and franchise value. Reputational risk poses a major threat to financial institutions because the nature of their business requires maintaining the confidence of customers, creditors, and the general marketplace.

procedures for approving and monitoring these transactions, particularly to involve financial institution members other than the relationship bankers and employees in the same line of business as the questionable transaction.[95] Furthermore, the Statement strongly recommends that financial institutions adopt the senior transaction oversight committee structure,[96] or at least require transaction oversight by senior executives, reasoning that this committee will have the institutional power and the distance from transactions to be able to decide whether the financial institution should even engage in them.[97] While the Statement is powerful, it would have added authority if it were based explicitly on a social psychological foundation.

How effective can this transaction and relationship oversight committee be and what can be done to enhance its effectiveness? Will the committee be able to identify and veto transactions that raise issues of reputation and legal risk, especially when FHCs are competing so vigorously to win and keep corporate clients? The committee may never see problematic transactions until it is too late, may be too weak to oppose them (because it is not composed of significant executives), or may be too co-opted to police the transactions (because its members are "team inclined" and representative of

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[95] *See id.* at 28,986.

[96] *See id.* In part, the Statement reads as follows:

> In order to manage the risks associated with complex structured finance transactions, some institutions have established a senior management committee that is designed to ensure that all of the relevant control functions within the financial institution, including independent risk management, accounting policy, legal, and financial control, are involved in the oversight of complex structured finance transactions. The goal of such a senior-level risk control committee is to ensure that those complex structured finance activities that may expose the financial institution to higher levels of financial, legal and reputational risk are comprehensively and consistently managed and controlled on a company-wide basis. This senior management committee regularly reviews trends in new products and complex structured transaction activity, including overall risk exposures from such transactions, and typically provides final approval of the most complicated or controversial complex structured finance transactions. The agencies believe that such a senior-level committee can serve as an important part of an effective control infrastructure for complex structured finance activities.

Id. (footnote omitted). *See also id.* at 28,987 ("Policies should clearly define the types of circumstances where the approval of transactions or patterns of transactions should be elevated to higher levels of financial institution management for reasons specific to legal or reputational risk.").

[97] The Statement also provides a non-exclusive list of the kinds of transactions that should be subject to scrutiny by whatever review process the financial institution adopts. Many of these were used by Enron insiders with the help of financial institutions. *See* Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. at 28,988 (May 19, 2004).

the interested FHC divisions and client relationships). In addition, a FHC's complexity makes it difficult for bank examiners to determine whether the committee is functionally independent or merely window dressing.

There is little reason to be overly optimistic about the oversight committee's ability successfully to prevent a recurrence of the reformulated subtle hazards. But I see no choice other than to experiment with it as a way of countering the inner circle attraction that is likely to continue to affect and corrupt FHCs. The oversight committee would have the best chance of success if it reported to knowledgeable outsiders, such as the FHC board members, who may be better positioned to resist the excessive client-driven orientation of the financial institution. After all, it will be difficult to make the committee fully effective, even with bank examinations, without resisting this orientation. The obvious answer is to have the committee regularly report to the board's audit committee, composed as it is of independent directors and assigned the task of supervising the internal audit function of the FHC.[98] Indeed, the Statement proposes board oversight over a financial institution's involvement in structured finance,[99] and it would do better by recommending direct supervision by the audit committee. I recognize that this recommendation may just move the problem out a step since the effectiveness of audit committee oversight presumes that this committee is composed of active, critical board members who are themselves immune to the team mentality—the kind of people who, frankly, do not appear today to populate boards or even to be independent directors.[100]

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[98] On the audit committee generally, see Section 301 of Sarbanes-Oxley (entitled "Public Company Audit Committees"), adding a new subsection (m) to 15 U.S.C.A. § 78f (2004). This provision directs national securities exchanges and associations to prohibit listing a security of a company that does not have an audit committee in accordance with the standards set forth by the Act. The SEC implemented Section 301 by its rule-making, which in turn affects stock exchange rules. *See* Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (final rule) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274); Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 2,638 (proposed Jan. 17, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 274). It is possible that the oversight committee could report to another board committee, such as a Risk Management Committee, with particular competence in the transaction review area. *See* OCC, COMPTROLLER'S HANDBOOK, DUTIES AND RESPONSIBILITIES OF DIRECTORS 13 (Jan. 1998) (referring to possible committees of a bank's board), *available at* http://www.occ.treas.gov/handbook/directors1.pdf (last visited Oct. 26, 2004).

[99] *See* Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. at 28,985–86 (May 19, 2004).

[100] *See generally* Fanto, *supra* note 27.

The Federal Reserve could also increase the transaction oversight committee's likelihood of success by insisting that its members include senior executives, as well as legal and other compliance officers, and that the committee have a charter that is widely distributed throughout the firm.[101] The charter would not only put FHC employees on notice about the dangers of client inner circles, but it would also give the oversight committee rules of behavior that would enable them to resist the attraction of these circles when bankers advocate specific transactions.[102] Moreover, bank examiners would be directed to regularly review the oversight committee's minutes and performance as part of the current special review of LCBOs for legal and reputation risks and look for situations suggesting that a committee has been too passive (e.g., where it has not vetoed any transactions or client relationships).

V. CONCLUSION

Increasingly, it seems like a distant age when banks were only banks, rather than integral components of today's FHCs. *Camp*'s subtle hazards appear similarly archaic based as they were upon the efforts of commercial bankers to support affiliated investment banks and their corporate clients because of their fear of depositors' irrational action, efforts which might nevertheless threaten banks' solvency.

I have argued that FHC involvement in the recent corporate scandals provides empirical support for a reformulation of the subtle hazards risks. Investment bankers' involvement with dysfunctional inner circles of corporate clients can pull the bankers, the investment bank, commercial bankers—indeed the entire FHC—into the corruption of the circle. This risk is exacerbated by the current "deliver the institution" and team approach of FHCs in providing their services to corporate clients. This risk could lead to the same result feared by the Court in *Camp*: because of its involvement

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[101] Again, as noted above, the Interagency Statement recommends the involvement of senior officials and legal personnel in the review of structured financing, *see* Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. at 28,986–87, and it, too, calls for establishing policies regarding transactions that are circulated throughout the financial institution, *see id.*

[102] *See generally* JAMES G. MARCH, A PRIMER ON DECISION MAKING: HOW DECISIONS HAPPEN 60–61 (1994) (discussing the importance of rules in decision-making within organizations).

with a particular inner circle, a FHC could suffer significant legal and, most importantly, reputational harm, with potentially disastrous institutional consequences. I have supported my argument for the reformulated subtle hazards by reference to evidence about the significant involvement of FHCs in the corporate scandals of Enron and WorldCom.

My proposal to deal with the reformulated subtle hazards is to implement a transactions and relationship oversight committee whose main mission will be to prevent the FHC from falling under the influence of a client inner circle. Without being too optimistic about the effectiveness of this committee, I argue that regulators have little choice but to implement it, as they already have in some FHCs involved in the scandals. As has been suggested in the Interagency Statement regarding structured finance, regulators must try to entrust the committee with powers that will enhance its effectiveness: by requiring it to be composed of senior executives and legal and compliance officers, by having it report to the board audit committee, by formalizing and publicizing its procedures, and by rigorously reviewing its performance as part of the examination of legal and reputation risks within the special examination accorded to LCBOs. Without this reform, it is almost certain that FHCs run the risk of again becoming instruments of their corporate clients' inner circles.