

**DEVELOPMENTS IN BANKING AND FINANCIAL LAW:
2007-2008**

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I. The Federal Reserve's Multi-faceted Response to the Credit Crisis

The Federal Reserve's response to the current credit crunch signals operational and ideological changes in policymaking. The Federal Reserve has four duties: (1) conducting monetary policy; (2) regulating banking to ensure "safety and soundness" and protect consumer credit rights; (3) stabilizing the financial markets; and (4) providing financial services, such as operating the payments system.¹ Until recently, the agency had adhered to traditional monetary policy tools and "safety and soundness" regulation, while it had placed less weight on consumer credit protection.² The 2007 credit crisis, however, prompted the Federal Reserve to unveil unprecedented monetary policy tools and to emphasize consumer credit protection initiatives. Through this combined approach, the Federal Reserve seeks not only to alleviate the apparent symptoms but also to address the underlying causes of the credit crunch so that investors may redeposit their trust in the financial markets.

A. Background on the Source and Scope of the Credit Crunch

Economists define a bank "credit crunch" as a significant decline in the supply of bank loans.³ Interactions between adverse macroeconomic forces and speculative transactions in the subprime mortgage market led to the 2007 bank credit crunch.⁴ Starting in

¹ THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 1 (9th ed. 2005), http://www.federalreserve.gov/pf/pdf/pf_1.pdf.

² See *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Fin. Servs.*, 109th Cong. 1 (2005) (statement of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.). <http://financialservices.house.gov/media/pdf/072005ag.pdf>; see also Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 *BROOK. J. INT'L L.* 411, 427 (2003).

³ See Ben S. Bernanke et al., *The Credit Crunch*, 1991 (no. 2) *Brookings Papers on Economic Activity*, 205, 207 (1991) (defining "bank credit crunch" as "a significant leftward shift in supply curve for bank loans, holding constant both the safe real interest rate and the quality of potential borrowers").

⁴ *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 2 (2008) (statement of Ben S. Bernanke,

2006, after several years of excessive growth, the domestic housing market began to contract.⁵ As home prices fell, many homeowners with poor credit histories found themselves unexpectedly stuck with subprime mortgages, which they had borrowed on the assumption that rising home prices and income would enable them to afford those loans.⁶ On the other side, speculative homeowners could no longer “flip” their homes as planned (i.e., buying and quickly reselling for a profit).⁷ Furthermore, those with subprime adjustable-rate mortgages (“ARMs”) could no longer refinance and thus, faced reset interest rates much higher than the attractive introductory rates that they could afford.⁸ The combination of falling home prices and excessively risky mortgages led to high default and foreclosure rates in 2007.⁹

At the same time, banks were originating loans, bundling them, and selling shares in those bundles as mortgage-backed securities to investors all over the world.¹⁰ Banks used this securitization process to engage in off-the-balance-sheet lending, which allowed them to avoid regulatory capital requirements.¹¹ The subprime failure rendered lenders wildly uncertain of the true risk levels of subprime-backed securities and other derivative instruments.¹² Consequently, the value of such securities collapsed.¹³

Chairman, Bd. of Governors of the Fed. Reserve Sys.), http://www.house.gov/apps/list/hearing/financialsvcs_dem/022708_mpr_house.pdf.

⁵ *Id.*

⁶ Ruth Simon, Rising Rates to Worsen Subprime Mess—Interest Payments Set to Grow on \$362 Billion in Mortgages in 2008, *WALL ST. J.*, Nov. 24, 2007, at A1.

⁷ *Id.*

⁸ *Id.*

⁹ Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Fostering Sustainable Homeownership, Speech At the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm> (stating that at the end of 2007, more than 20% of the roughly 3.6 million outstanding subprime ARMs “were seriously delinquent . . . about four times higher than it was in mid-2005” and that “more than one-half of the foreclosure starts in 2007 were . . . subprime”).

¹⁰ David Wessel, Crisis Tests Fed Chairman’s Toolbox, *WALL ST. J.*, Aug. 23, 2007, at A2.

¹¹ *Id.* (“Banks still make lots of loans and mortgages, but they don’t hold them on their books . . .”).

¹² *Id.*

Although the subprime mortgage market was largely a U.S. phenomenon, it generated global panic through the widespread use of securitization.¹⁴ The collapse of subprime-backed securities forced banks to absorb large losses and to anticipate further fallout.¹⁵ To protect their balance sheets, banks became highly risk-averse, offering to each other and to firms and households less credit on stricter terms.¹⁶ The heightened risk aversion spread from money markets “to almost every corner of the credit markets.”¹⁷ The ensuing credit crisis has restrained economic growth, stirred recession fears, and aggravated global financial turmoil.¹⁸

B. Easing Illiquidity with Unprecedented Monetary Policy Tools

The Federal Reserve responded to the subprime crisis and the credit crunch by introducing unprecedented monetary policy tools to increase short-term capital flow. The Federal Reserve has recognized that it must actively pursue both monetary policy and consumer credit protection in order to stabilize investor expectations and restore public trust in the financial markets.

1. Background on Traditional Monetary Policy Tools

¹³ John H. Makin, *Recession 2008?*, WALL ST. J., Sep. 8, 2007, at A13.

¹⁴ Natasha Brereton, *Global Economy: Governments Are Urged to Make Lenders Bear Some Risk on Securitized Loans*, WALL ST. J., Nov. 13, 2007, at A16.

¹⁵ *The Near-Term Outlook for the U.S. Economy: Hearing Before the H. Comm. on the Budget*, 110th Cong. 2 (2008) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), http://www.house.gov/budget_democrats/hearings/Bernanke%20Testimony.pdf; Simon, *supra* note 6 (reporting that interest rates are expected to reset on \$362 billion worth of subprime ARMs in 2008).

¹⁶ Chairman Bernanke’s Testimony on Economic Outlook, *supra* note 15.

¹⁷ Kate Kelly et al., *Fed Races to Rescue Bear Stearns in Bid to Steady Financial System—Storied Firm Sees Stock Plunge 47%*; J.P. Morgan Steps In, WALL ST. J., Mar. 15, 2008, at A1.

¹⁸ Chairman Bernanke’s Testimony on Economic Outlook, *supra* note 15.; *see also* Carrick Mollenkamp & Mark Whitehouse, *Banks Fear a Deepening of Turmoil*, WALL ST. J., Mar. 17, 2008, at A1.

The Federal Reserve Act of 1913 expressly mandates that the Federal Reserve's monetary policy "shall maintain long run growth of the monetary and credit aggregates . . . so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."¹⁹ To meet this mandate, the Federal Reserve's Federal Open Market Committee ("FOMC") sets and announces a target federal funds rate that it believes will "promote financial conditions consistent with achieving maximum employment, stable prices, and moderate long-term interest rates."²⁰ For example, the FOMC can lower its target rate to induce banks to make more credit available to borrowers if doing so will promote the mandate.²¹ The actual federal funds rate is the market interest rate at which banks make overnight loans to each other from their reserve accounts at their respective Federal Reserve Banks.²² To keep the actual federal funds rate close to the target rate, the Federal Reserve has traditionally used three monetary policy tools: (1) conducting open market operations; (2) imposing reserve requirements; and (3) extending credit through its discount window facility.²³ For example, the Federal Reserve can cause the actual federal funds rate to fall by doing any or all of the following: purchasing U.S. Treasury securities on the open market from banks, lowering reserve requirements for banks, or lowering the discount rate (i.e., the rate of borrowing directly from the Federal Reserve as the lender of last resort).²⁴ However, the discount window, until recently, has been "tainted" and largely avoided because using it has been viewed historically to

¹⁹ Federal Reserve Act of 1913 § 2A, 12 U.S.C. § 225a (2000).

²⁰ THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS, *supra* note 1, at 16.

²¹ *Id.* Lowering the target rate causes the actual federal funds rate and other short-term market interest rates to fall. Short-term rates tend to fall quicker than bank deposit rates. Thus, bank deposits temporarily become more attractive, inducing people to deposit more money, ultimately making more credit available to borrowers.

²² Bd. of Governors of the Fed. Reserve Sys. Frequently Asked Questions Monetary Policy, <http://federalreserve.gov/generalinfo/faq/faqmpo.htm#3> (last visited Mar. 6, 2008) ("[T]he [actual federal funds] rate may vary from depository institution to depository institution and from day to day. The target federal funds rate is set by the Federal Open Market Committee (FOMC).").

²³ THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS, *supra* note 1, at 35.

²⁴ *Id.*

signal that the borrower was in financial distress.²⁵ In sum, these three traditional monetary policy tools have allowed the Federal Reserve to control the market federal funds rate in order to achieve its statute-mandated goals.

2. New Tools to Provide Liquidity and Stability

In the wake of the subprime failure, traditional monetary policy tools by themselves proved insufficient to assuage acute credit strains.²⁶ Thus, the Federal Reserve made additional moves to improve credit liquidity and promote financial market stability.

a. Innovative Liquidity Tools

To enhance liquidity in short-term funding markets, the Federal Reserve introduced several new initiatives: stigma-free discount window, Term Auction Facility, Primary Dealer Credit Facility, and Term Securities Lending Facility.²⁷

i. Advertising a Stigma-free Discount Window

In mid-August 2007, the Federal Reserve negotiated with the four largest U.S. banks for them to borrow from the discount window.²⁸ The Federal Reserve reduced the spread between the

²⁵ Greg Ip, Discount Rate is Also on the Fed's Table, WALL ST. J., Sep. 18, 2007, at A2.

²⁶ See Wessel, *supra* note 10 ("Mr. Bernanke and his monetary mechanics are stuck using 1913-era tools designed for a bank-centric financial system to repair a 2007-era market-centric financial system.").

²⁷ Bd. of Governors of the Fed. Reserve Sys. The Discount Rate, <http://www.federalreserve.gov/monetarypolicy/discontrate.htm> (last visited Mar. 31, 2008); Bd. of Governors of the Fed. Reserve Sys. Term Auction Facility, <http://www.federalreserve.gov/monetarypolicy/taf.htm> (last visited Mar. 31, 2008); Bd. of Governors of the Fed. Reserve Sys. Primary Dealer Credit Facility, <http://www.federalreserve.gov/monetarypolicy/pdcf.htm> (last visited Mar. 31, 2008); Bd. of Governors of the Fed. Reserve Sys. Term Securities Lending Facility, <http://www.federalreserve.gov/monetarypolicy/tslf.htm> (last visited Mar. 31, 2008).

²⁸ Robin Sidel et al., Banks Step Up to Fed's Window—Four Biggest U.S. Lenders Borrow \$2 Billion in Bid to Lift Market Confidence, WALL ST. J., Aug. 23, 2007, at A3.

discount rate and the target federal funds rate from 100 basis points to 50 basis points and extended the duration of the loans from one day to thirty days, making discount-window borrowing less expensive and more flexible than before.²⁹ A few days later, in a non-traditional conference call with bank executives, the Federal Reserve persuaded Citigroup Inc., Bank of America Corp., JPMorgan Chase & Co. and Wachovia Corp. to borrow a total of \$2 billion from the discount window.³⁰ The banks also made an extraordinary gesture by publicly announcing their discount window transactions.³¹ In return, the Federal Reserve narrowly and temporarily permitted the investment-banking units of those banks to use their discount-window funds to purchase certain securities.³² The Federal Reserve sought to erase the traditional stigma of borrowing from the discount window so that banks could feel comfortable about borrowing and lending the money to creditworthy borrowers facing financing difficulties.³³

Markets, however, responded with mixed results because investors had difficulty changing their negative perceptions of discount-window use.³⁴ By mid-March 2008, the Federal Reserve reduced its target federal funds rate to 2.25% (compared with 5.25% in August 2007) and the discount rate to 2.5% (compared with 6.25% in July 2007), thus reducing the gap between the two rates to 25 basis points.³⁵ Some economists criticized the timing and focus of the rate

²⁹ See Press Release, Bd. of Governors of the Fed. Reserve Sys., Approval of the Discount Rate Requests (Aug. 17, 2007), <http://www.federalreserve.gov/newsevents/press/monetary/20070817c.htm>.

³⁰ Sidel, *supra* note 28 (“Citigroup Inc., Bank of America Corp., J.P. Morgan Chase & Co. and Wachovia Corp.—the nation’s largest banks as measured by total assets—said they each borrowed \$500 million from the so-called discount window.”).

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.* (suggesting that “some investors worried that the decision of several big banks to use the discount window might be a sign that one of them, or another major bank, was in trouble”; reporting that J.P. Morgan Chase shares experienced a small decline while Citigroup, Bank of America, and Wachovia shares “finished slightly higher”).

³⁵ Press Release, Bd. of Governors of the Fed. Reserve Sys., FOMC Statement and Board Approval of Discount Rate Requests of the Federal Reserve Banks of Boston, New York, and San Francisco (Mar. 18, 2008), <http://www.federalreserve.gov/newsevents/press/monetary/20080318a.htm>.

cuts as being “too little too late . . . and . . . lax on supervision and regulation.”³⁶ Other economists suggested that although cutting the target rate may encourage lending among banks, it may not be enough to overcome the great degree of risk-aversion among some lenders and borrowers.³⁷ Furthermore, many economists estimated that the effects of the rate cuts may take six to twelve months to fully unfold.³⁸ Thus, an accurate evaluation of the Federal Reserve’s rate cuts will require more time.

ii. Term Auction Facility

The Federal Reserve introduced the Term Auction Facility (“TAF”) as another channel of liquidity. Launched in mid-December 2007, the TAF is a temporary program by which the Federal Reserve auctions term funds to depository institutions.³⁹ These term funds are direct advances from the Federal Reserve, having 28-day maturity and fixed interest rate determined by a centralized, single-price auction.⁴⁰ The TAF can provide credit to more depository institutions based on more types of collateral than open market operations can.⁴¹ Banks may also view participation in TAF auctions more favorably than borrowing at the discount window, which is still met with reluctance, as explained *supra*.⁴²

To encourage broad utilization of the TAF, the Federal Reserve established relatively simple rules. Any depository institution is eligible to participate if it is financially sound and eligible to borrow at the discount window.⁴³ Use of TAF funds is

³⁶ Phil Izzo, Economists Raise the Odds of a Recession to 49%: Bernanke’s Ratings Slip, Despite Effort to Reignite Growth, WALL ST. J., Feb. 7, 2008, at A4 (quoting Allen Sinai, an economist for Decision Economics).

³⁷ Justin Lahart, Credit Crunch: With Central Bank on the Move, Some Answers on What It Means, WALL ST. J., Jan. 24, 2008, at A13.

³⁸ *Id.* (“That means that the Fed’s actions won’t stop a recession if a downturn is getting under way. But the rate cuts should help reduce the length and depth of any downturn.”).

³⁹ Bd. of Governors of the Fed. Reserve Sys. Term Auction Facility Questions and Answers, <http://www.federalreserve.gov/monetarypolicy/taffaq.htm> (last visited Mar. 6, 2008).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Sudeep Reddy, Fed Auction’s Biggest Interest Comes From Wall Street Area, WALL ST. J., Dec. 28, 2007, at A2.

⁴³ TAF Q&As, *supra* note 39.

unrestricted, but the loans must be fully collateralized by any of the broad range of collateral that is accepted in other Federal Reserve lending programs.⁴⁴

The auction process itself is also straightforward. The Federal Reserve announces the total amount of funds it plans to allocate (e.g., \$30 billion).⁴⁵ An eligible depository institution may submit its bid (i.e., offer to borrow a specified amount at a specified interest rate).⁴⁶ After the bidding period closes, the Federal Reserve allocates the funds using a “single-price auction format”: it orders the bids according to the offered interest rate (from highest to lowest) and fills the loan amount of the bidder offering the highest interest rate; then, it fills the next highest bid, proceeding down the list, until it entirely allocates the total offering amount or fills the last bidder’s amount, whichever occurs first.⁴⁷ All accepted bidders will pay the lowest accepted interest rate (i.e., the “stop-out rate”).⁴⁸ Furthermore, submission of a bid constitutes a commitment so that a winning participant must accept its award.⁴⁹

From December 2007 through March 2008, the Federal Reserve completed eight auctions, awarding a total of \$260 billion.⁵⁰ It plans to conduct biweekly TAF auctions at least well into the second half of 2008.⁵¹ Ben S. Bernanke, Chairman of the Federal Reserve, testified that “TAF is [intended] to reduce the incentive for banks to hoard cash and increase their willingness to provide credit to households and firms.”⁵² The TAF seems to have had some

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.* For example, suppose the Federal Reserve announces it will auction a total of \$30 billion. If A, B, and C bid \$20 billion each and offer interest rates of 3%, 4%, and 5%, respectively, then the preference ordering is C, B, A. C gets its full \$20 billion; there is only \$10 billion left, so B gets only \$10 billion even though it requested \$20 billion; A does not win any award. The stop-out rate is B’s 4%. C and B will each repay their 28-day loans at 4%.

⁴⁹ *Id.*

⁵⁰ TAF, *supra* note 27 (announcing the auction results).

⁵¹ Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Announces Two Initiatives to Address Heightened Liquidity Pressures in Term Funding Markets (Mar. 7, 2008), <http://www.federalreserve.gov/newsevents/press/monetary/20080307a.htm>.

⁵² Chairman Bernanke’s Testimony on the Economic Outlook, *supra* note 15.

positive effects, evidenced by sharply declining rates on three-month loans since December 2007.⁵³ In sum, the TAF operates as an additional liquidity source, intended to improve credit circulation.

iii. Primary Dealer Credit Facility

Another new lending facility is the Primary Dealer Credit Facility (“PDCF”), effective March 16, 2008, which provides primary dealers with overnight loans.⁵⁴ The interest rate is the same as the primary credit rate of the discount window at the Federal Reserve Bank of New York (“FRBNY”).⁵⁵ Permissible collateral for these loans includes “all collateral eligible for pledge in open market operations, plus investment grade corporate securities, municipal securities, mortgage-backed securities, and asset-backed securities.”⁵⁶ Only primary dealers of the FRBNY may borrow (via their clearing banks) from the PDCF.⁵⁷ Clearing banks act as intermediaries, verifying the sufficiency of a dealer’s collateral and crediting the FRBNY’s loan to the dealer’s account.⁵⁸ The amount of a loan may not exceed the amount of “margin-adjusted eligible collateral” that the dealer pledges.⁵⁹ Goldman Sachs, Morgan Stanley, and Lehman Brothers Holdings borrowed from the PDCF in its first week of operation.⁶⁰

iv. Term Securities Lending Facility

Finally, the Term Securities Lending Facility (“TSLF”), effective March 20, 2008, is a 28-day facility by which the FRBNY auctions general Treasury collateral (e.g., T-bills, notes, bonds, and inflation-indexed securities) to its primary dealers in exchange for other program-eligible collateral (e.g., certain mortgage-backed

⁵³ Lahart, *supra* note 37.

⁵⁴ Fed. Reserve Bank of N.Y., Primary Dealer Credit Facility Program Terms & Conditions, http://www.newyorkfed.org/markets/pdcf_terms.html (last visited Mar. 31, 2008).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*; Serena Ng & Susanne Craig, Stepping Up to the Fed’s Window, WALL ST. J., Mar. 20, 2008, at C1.

⁶⁰ Emily Barrett, Short-Term Treasury Yields Touch 50-Year Lows, WALL ST. J., Mar. 21, 2008, at C2.

securities).⁶¹ Only primary dealers may bid in the weekly single-priced auction and may borrow up to 20% of the par value of the offered collateral.⁶² The TSLF does not impact reserve levels, unlike the TAF and PDCF.⁶³ The Federal Reserve planned to offer \$75 billion in the first TSLF auction held in late March 2008 and ultimately, it seeks to lend up to \$200 billion of Treasury securities.⁶⁴ Some industry experts, however, doubt that such policy measures will fix the credit contraction.⁶⁵ Instead, they remained concerned about the underlying problem of thin capital cushions and more volatile and riskier balance sheets of non-bank financial institutions.⁶⁶

The new lending facilities provided temporary relief to strained credit markets.⁶⁷ Prior to the openings of the programs, dealers demanded excessively high amounts of Treasury securities (“Treasurys”) such that Treasurys prices soared and yields fell to 50-year lows (bond price and yield move in opposite directions).⁶⁸ Dealers wanted to hold Treasurys so badly that they arranged repurchase agreements (“repos”) at negative interest rates.⁶⁹ After the

⁶¹ Fed. Reserve Bank of N.Y., Term Securities Lending Facility: Frequently Asked Questions, http://www.newyorkfed.org/markets/tslf_faq.html (last visited Apr. 2, 2008).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ Press Release, Fed. Reserve Bank of N.Y., New York Fed Announces Modifications to Terms & Conditions of Term Securities Lending Facility (Mar. 20, 2007), <http://www.newyorkfed.org/newsevents/news/markets/2008/rp080320.html>.

⁶⁵ David Roche, Recession is Inevitable, WALL ST. J., Mar. 14, 2008, at A19.

⁶⁶ *Id.*

⁶⁷ Min Zeng, Tepid Auction A Positive Sign?—Treasurys Swap May Ease Worries Over Credit Crunch, WALL ST. J., Mar. 28, 2008, at C2.

⁶⁸ *Id.*; Barrett, *supra* note 60.

⁶⁹ Barrett, *supra* note 60 (“[D]ealers were in such desperate need of Treasurys, they were starting to bid negative repo rates just to get their hands on paper.”); see Michael J. Fleming & Kenneth D. Garbade, *Repurchase Agreements with Negative Interest Rates*, 10 (no. 5) CURRENT ISSUES in ECON. & FIN. 1, 1–2 (2004), http://www.newyorkfed.org/research/current_issues/ci10-5.pdf (explaining that a repo “is a sale of securities coupled with an agreement to repurchase the same securities on a later date and is broadly similar to a collateralized loan” and that “a lender may be willing to pay interest if the securities offered as collateral on a loan allow it to meet a delivery obligation”).

Federal Reserve announced the results of its first Treasuries auction, prices in the Treasuries market fell and yields rose.⁷⁰ However, demand for the auctioned funds was substantially lower than expected, indicating that something more than a lack of cash was causing the credit crunch.⁷¹ In sum, the new facilities provided more than enough additional funds, but they did not address the deeper problem afflicting market participants—that of fear.⁷²

b. Unprecedented Bailout of an Investment Bank, Bear Stearns

Despite the Federal Reserve's efforts to increase liquidity through its new lending facilities, fear continued to dominate the markets and produced an inconceivable casualty when Bear Stearns Cos. ("Bear"), the fifth largest investment bank, abruptly teetered on the brink of bankruptcy in March 2008.⁷³ More than a week before Bear's near collapse, U.S. fixed-income traders, who received information that European banks had stopped trading with Bear, began to withdraw their own cash from Bear lest their money be lost in a potential bankruptcy.⁷⁴ Throughout the week, Bear's counterparties accelerated a "run" on Bear: securities firms began to demand cash in lieu of collateral while hedge fund clients withdrew cash from their accounts at Bear.⁷⁵ Alan Schwartz, CEO of Bear, contacted James Dimon, CEO of JPMorgan Chase & Co. ("JPMorgan"), the second largest U.S. bank in stock-market value, to request emergency financing.⁷⁶ JPMorgan in turn contacted the Federal Reserve about the situation.⁷⁷

The Federal Reserve faced a difficult choice between two problematic alternatives: bail out Bear or let it collapse.⁷⁸ Bailing out

⁷⁰ Zeng, *supra* note 67.

⁷¹ *Id.*

⁷² Deborah Lynn Blumberg, Fed Auction Can't Help Investors' Confidence, WALL ST. J., Mar. 24, 2008, at C9 ("But while market participants expect [the Fed's first Treasury swap auction] to help alleviate some of the immediate strains . . . the Fed's efforts won't help resolve the underlying problem: a lack of confidence among market participants.").

⁷³ Kelly et al., *supra* note 17.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

Bear would arguably set a precedent that encourages moral hazard (i.e., the bailout would encourage other firms to engage in similarly risky behavior).⁷⁹ Furthermore, a bailout would damage market transparency by denying the public an important opportunity to learn about the internal problems that caused Bear's failure and to demand increased accountability of corporate insiders.⁸⁰ However, the Federal Reserve was even more worried that Bear's collapse could irreparably jeopardize the entire financial system.⁸¹ As an 85-year-old financial institution that had survived the Depression, Bear had maintained a reputation for astute risk management, but its large mortgage business and comparatively less diverse portfolio damaged its recent image in the wake of the subprime-mortgage crisis.⁸² If a giant like Bear fell without a cushion underneath, the markets might become paralyzed.⁸³ Given the severity of the credit crisis, the complicated interdependencies among financial institutions, and Bear's strong reputation in the financial community, the Federal Reserve and the Department of Treasury decided that they would risk fueling moral hazard rather than expose the entire financial system to unknown and far riskier consequences.⁸⁴ Thus, after it had determined that Bear was unable to obtain financing on its own, the Federal Reserve made a difficult decision to rescue Bear. In an unprecedented move, the Federal Reserve offered to lend at the discount window to Bear Stearns through JPMorgan.⁸⁵

Choosing JPMorgan as the intermediary lender was logical. As a commercial bank, JPMorgan was already subject to regulation by the Federal Reserve and had access to the discount window.⁸⁶ As Bear's clearing agent, JPMorgan was also familiar with Bear's

⁷⁹ *Id.*

⁸⁰ Nicole Gelinas, *The Bear Precedent*, WALL ST. J., Mar. 19, 2008, at A17 (arguing that "[a] spectacular bankruptcy would shine a bright light on this mess" by requiring Bear's counterparties and creditors to publicly explain their positions and Bear's lawyers to meticulously review internal documents, thus, "making the full autopsy public").

⁸¹ Kelly et al., *supra* note 17.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* (suggesting that if Bear were to suddenly collapse and default on extensive "repo" loans, such loans would become less available to other securities dealers, and "the pledged securities behind those loans [w]ould be dumped in a fire sale, deepening the plunge in securities prices").

⁸⁵ *Id.*

⁸⁶ *Id.*

collateral.⁸⁷ The Federal Reserve, Bear, and JPMorgan reached a deal during the final weeks of March 2008. Bear, which had been worth \$20 billion in January 2007, initially agreed that JPMorgan would buy it in a fire-sale at \$2 per share (about \$236 million total); but JPMorgan later raised the bid to \$10 per share (about \$1.2 billion total) after Bear's shareholders and employees expressed overwhelming outrage at the initial offer.⁸⁸ JPMorgan immediately acquired 39.5% control of Bear by buying 95 million new Bear shares at the deal price.⁸⁹ In return, the Federal Reserve lent Bear \$29 billion at the discount rate and took as collateral a portfolio of Bear's risky assets valued at \$30 billion.⁹⁰ JPMorgan agreed to absorb the first \$1 billion of any losses to the portfolio.⁹¹ The Federal Reserve agreed to guarantee the remaining \$29 billion and will receive any realized gains from the portfolio.⁹² The Federal Reserve hired BlackRock Financial Management, Inc. to manage the portfolio "to minimize disruption to financial markets and maximize recovery value."⁹³

In order to lend to Bear at the discount window, the Federal Reserve had to exercise its authority under a rarely-used 1932 amendment, Federal Reserve Act § 13-3:

⁸⁷ *Id.*

⁸⁸ Robin Sidel & Kate Kelly, J.P. Morgan Quintuples Bid to Seal Bear Deal, WALL. ST. J., Mar. 25, 2008, at A1; Robin Sidel et al., J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis—Ailing Firm Sold For Just \$2 a Share In U.S.-Backed Deal, WALL. ST. J., Mar. 17, 2008, at A1 ("Bear Stearns . . . was worth \$20 billion in January 2007.").

⁸⁹ Sidel & Kelly, *supra* note 88.

⁹⁰ Press Release, Fed. Reserve Bank of N.Y., Statement on Financing Arrangement of JPMorgan Chase's Acquisition of Bear Stearns (Mar. 24, 2008),

<http://www.ny.frb.org/newsevents/news/markets/2008/rp080324.html>. The New York Fed formed a limited liability company to take control of the portfolio; Greg Ip & Greg Hitt, Credit Crisis: Market Bounces: Mortgage Securities Back Fed Loan to Bear Stearns, WALL ST. J., Apr. 2, 2008, at C2 (reporting that the assets consist primarily of "mortgage-backed securities and related hedge investments").

⁹¹ Press Release, *supra* note 90.

⁹² *Id.*; Sidel & Kelly, *supra* note 88 ("The Fed . . . originally had stepped in to fund \$30 billion of potential Bear Stearns losses.").

⁹³ Press Release, *supra* note 90.

In unusual and exigent circumstances, the Federal Reserve Board . . . by the affirmative vote of not less than five members, may authorize any Federal reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange . . . Provided, [t]hat . . . the Federal reserve bank shall [first] obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.⁹⁴

In other words, the Federal Reserve may lend to non-banks at the discount window only in extraordinary circumstances (the last time it used this clause was during the Depression).⁹⁵ Furthermore, with two board seats vacant and one board member out of the country, the Federal Reserve had to invoke another special provision that allowed the four available board members to approve the loan.⁹⁶ Making the discount window available to an investment bank was a controversial move, but the market seemed to respond somewhat positively to the final deal. The Dow Jones Industrial Average rose 1.5% to its highest close in March.⁹⁷ However, the deal's real success might have been more limited than it appeared since positive home-sales data provided a concurrent reason for the market-wide rally.⁹⁸

In sum, a combination of novel monetary policy tools and lending strategies helped increase credit liquidity, but with fairly limited results. If the Federal Reserve wants to improve long-run public confidence in the economy, it must uproot the underlying fear in the markets by strengthening consumer credit protection.

⁹⁴ Federal Reserve Act of 1913 § 13-3, 12 U.S.C. § 343 (2008).

⁹⁵ Greg Ip, *Bear on the Brink: Desperate Fed Dusts Off Remedy From the Depression to Save Bear—Opening the Discount Window For a Nonbank Requires Special Votes at Central Bank*, WALL ST. J., Mar. 15, 2008, at A9.

⁹⁶ Federal Reserve Act of 1913 § 11(r)(2), 12 U.S.C. § 248(r)(2) (2008); Kelly et al., *supra* note 17.

⁹⁷ Peter A. McKay, *Dow Jumps 187.32 as Clouds Lift a Bit—Investors Take Cheer in Home-Sales Data, Higher Offer for Bear*, WALL ST. J., Mar. 25, 2008, at C1.

⁹⁸ *Id.*

**c. *Reducing Consumer Vulnerability with
Regulatory Leadership and Collaboration***

Consumer vulnerability in the subprime market continues to be both a major cause and effect of the strain on the financial markets.⁹⁹ Such vulnerability existed where lenders lured unsophisticated homeowners into high-rate and/or poorly documented subprime ARMs without disclosing the full risks of those transactions.¹⁰⁰ At the heart of the problem was the fact that most subprime lending institutions were not subject to federal banking regulation.¹⁰¹ Opportunistic borrowers, who were willing to misrepresent their income and assets and/or their intention to occupy the properties, sought to borrow more than their circumstances allowed, and thus aggravated the situation.¹⁰² In response, the Federal Reserve recently intensified its consumer protection efforts in the mortgage industry.¹⁰³

The Federal Reserve has at least two reasons to emphasize consumer credit protection. First, better consumer protection in financial transactions bolsters the quality of the capital markets, which is essential for economic stability. In his July 2007 congressional testimony, Chairman Bernanke stated, “In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions.”¹⁰⁴ In contrast,

⁹⁹ *The State of the United States Economy and Financial Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 2 (2008) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve), http://banking.senate.gov/_files/BernankeSenateBanking_21408.pdf.

¹⁰⁰ *Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 1 (2007) (statement of Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys.), http://www.house.gov/apps/list/hearing/financialsvcs_dem/htkroszner_-_fed120607.pdf.

¹⁰¹ *Id.* (“For instance, in 2006, over 45 percent of high-cost first mortgages were originated by independent mortgage companies.”).

¹⁰² Ruth Simon & Michael Corkery, *Speculators May Have Accelerated Housing Downturn—Rising Number of Defaults Also Could Complicate Effort to Help Homeowners*, WALL ST. J., Feb. 6, 2008, at B8.

¹⁰³ Governor Kroszner’s Testimony on Accelerating Loan Modifications, *supra* note 100.

¹⁰⁴ *Monetary Policy and the State of the Economy: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 1 (Jul. 2007) (statement of Ben S.

in his February 2007 congressional testimony, he mentioned nothing about consumer protection.¹⁰⁵ The change in the Federal Reserve's rhetoric indicated a substantive policy change. Second, better consumer protection may render monetary policymaking easier by reducing the magnitude of the credit crunch and thus, facilitating clearer interpretations of economic indicators.¹⁰⁶ In sum, the Federal Reserve has recognized that effective monetary policy depends on robust capital markets, which ultimately require effective consumer protection and education.¹⁰⁷

The Federal Reserve is leading consumer protection efforts in three areas: (1) coordinated enforcement of consumer protection laws; (2) loss mitigation efforts; and (3) consumer protection regulations.¹⁰⁸ First, in light of the diversification of the mortgage industry, the Federal Reserve's enforcement coordination with other regulators, especially state bank regulators, is increasingly important.¹⁰⁹ In July 2007, the Federal Reserve, the Office of Thrift Supervision ("OTS"), the Federal Trade Commission ("FTC"), and state agencies represented by the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") launched an innovative pilot project to evaluate the consumer-compliance procedures of selected non-depository lenders with significant subprime mortgage operations.¹¹⁰ The agencies selected a sample of such entities throughout

Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbernanke071807.pdf.

¹⁰⁵ *The State of the Economy, the State of the Labor Market, and the Conduct of Monetary Policy: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 1 (Feb. 2007) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.), http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbernanke021507.pdf.

¹⁰⁶ Bernanke et al., *supra* note 3, at 206.

¹⁰⁷ Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., Speech At the Am. Securitization Forum 2008 Conf.: Protecting Homeowners and Sustaining Home Ownership (Feb. 4, 2008), *available at* <http://www.federalreserve.gov/newsevents/speech/kroszner20080204a.htm>.

¹⁰⁸ Governor Kroszner's Testimony on Accelerating Loan Modifications, *supra* note 100.

¹⁰⁹ *Id.*

¹¹⁰ Joint Press Release, Bd. of Governors of the Fed. Reserve Sys. et al., Federal and State Agencies Announce Pilot Project to Improve Supervision

several jurisdictions and conducted reviews, shared information, and collaborated to develop methods to improve the effectiveness of such reviews.¹¹¹ The reviews, which began in the final quarter of 2007, examined underwriting standards, risk-management strategies, and compliance with consumer protection laws and regulations.¹¹² This coordinated approach provides the advantages of consistency and breadth.¹¹³ As of the end of March 2008, the agencies have not yet issued reports on the reviews.

In September 2007, the Federal Reserve also issued a joint statement with other financial regulatory agencies regarding appropriate loss mitigation strategies.¹¹⁴ Servicers (i.e., both federally regulated institutions and state-supervised entities that service mortgage loans) are encouraged to identify high-risk borrowers (e.g., those with impending interest rate resets), to contact them and assess their ability to repay their loans, to determine whether default is “reasonably foreseeable,” and to consider strategies for helping them avoid losing their homes.¹¹⁵ Servicers should use loss mitigation techniques that allow the borrower to meet his obligations “in a sustained manner over the long term” and should refer borrowers to qualified homeownership counseling services.¹¹⁶ By working directly with consumer and community affairs groups and by formally encouraging lenders to cooperate in

of Subprime Mortgage Lenders (Jul. 17, 2007), <http://www.federalreserve.gov/newsevents/press/bcreg/20070717a.htm>.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ See Joint Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages 1, Fed. Deposit Ins. Corp. et al. (Sep. 4, 2007), <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf>.

¹¹⁵ *Id.* at 1 (defining “servicers” to include both federally regulated institutions and state-supervised entities that service mortgage loans); *Id.* at 1, n.2 (explaining that a default is “reasonably foreseeable” when a lender has contacted the borrower, assessed his ability to pay, and has a reasonable basis to conclude that he will be unable to continue to make the mortgage payments in the foreseeable future).

¹¹⁶ *Id.* (providing examples of loss mitigation: loan modifications, deferral of payments, extension of loan maturities, conversion of adjustable-rate into fixed-rate or fully indexed, fully amortizing adjustable-rate mortgages, capitalization of delinquent amounts, or any combination; providing examples of homeownership counseling services: those administered by the Federal Housing Administration).

loss mitigation, the Federal Reserve seeks to preserve homeownership and avoid foreclosures.¹¹⁷

External pressure also helped accelerate the Federal Reserve's consumer protection efforts. Congressman Barney Frank, Chairman of the House Financial Services Committee, had threatened that if the Federal Reserve did not increase its consumer protection efforts by fall 2007, he would propose legislation to transfer that authority to other regulators.¹¹⁸ In December 2007, the Federal Reserve responded by proposing and asking for public comment on changes to Regulation Z, which implements the Home Ownership and Equity Protection Act ("HOEPA") and the Truth in Lending Act ("TILA").¹¹⁹ HOEPA introduced new disclosure requirements and limitations on specified high-rate mortgages and also granted the Federal Reserve power to prohibit certain practices relating to mortgage transactions.¹²⁰ TILA required a uniform disclosure system, protected borrowers against misleading credit practices, and "impose[d] limits on home equity lines of credit and certain closed-end home mortgages," among other things.¹²¹ The purpose of the TILA was "to ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably."¹²²

The recent proposals to amend Regulation Z focused on three objectives: (1) to prevent unfairness, deception, and abuse in lending practices; (2) to improve mortgage advertising; and (3) to give consumers early disclosures about the risks in their loan transactions.¹²³ Creditors would have to consider more fully a

¹¹⁷ Governor Kroszner's Testimony on Accelerating Loan Modifications, *supra* note 100.

¹¹⁸ Damian Paletta & Benton Ives-Halperin, Project Set To Monitor Lenders, WALL ST. J., Jul. 18, 2007, at A4.

¹¹⁹ Governor Kroszner's Testimony on Accelerating Loan Modifications, *supra* note 100; *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys., Request for Comment on Changes to Regulation Z to Protect Consumers from Unfair or Deceptive Home Mortgage Lending and Advertising Practices (Dec. 18, 2007), <http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm> (highlighting key protections).

¹²⁰ *Id.* at 2.

¹²¹ *Id.* at 4.

¹²² *Id.*

¹²³ Truth in Lending; Proposed Rule, 73 Fed. Reg. 1672, 1673 (proposed Jan. 9, 2008) (to be codified at 12 C.F.R. pt. 226).

borrower's ability to repay from non-collateral sources,¹²⁴ increase transparency in loan advertising,¹²⁵ and provide consumers with earlier transaction-specific disclosures to facilitate their mortgage shopping opportunities.¹²⁶ The proposal expressly prohibits certain types of bad faith conduct such as encouraging misstated appraisals in connection with a mortgage loan, "pyramiding" late fees, creating an impression that the mortgage broker or lender is the consumer's fiduciary, and selectively providing attractive information in a foreign language while providing mandatory disclosures only in English.¹²⁷ In 2008, the Federal Reserve will conduct one-on-one interviews with consumers to test the current TILA mortgage disclosures as well as its new Regulation Z proposals in order to identify further improvements in rulemaking.¹²⁸

C. Policy Projections

a. Looking into 2008

The Federal Reserve has a challenging agenda for 2008. Dampening of public expectations may continue to contribute to a weak economic forecast.¹²⁹ To implement effective monetary policy, the Federal Reserve must secure the public's confidence in the integrity and stability of the markets. In light of the subprime crisis, the Federal Reserve must actively collaborate with other government supervisory agencies and industry participants to protect and educate consumers about the risks of their credit transactions, particularly in connection with homeownership. Robust markets require sound transactions, which are possible only if consumers are well-informed about the costs and benefits of their particular transactions.

The Federal Reserve has taken on a more active and multi-dimensional role in protecting consumers in financial transactions.

¹²⁴ *Id.*

¹²⁵ *Id.* (proposing to require loan ads to contain "accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features").

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ See Kelly Evans & Joellen Perry, Recession Fears Intensify: Service-Sector Index Hits Six-Year Low; Further Rate Cuts Seen as Dow Drops 2.9%, WALL ST. J., Feb. 6, 2008, at A1.

As the primary rule-writing authority for many consumer protection laws, the Federal Reserve is adopting two fundamental approaches to consumer protection: one focuses on disclosure, and the other involves curbing “abusive and unfair practices.”¹³⁰ The Federal Reserve acknowledges the need for increased collaboration with other federal and state agencies in order to keep pace with the breadth and depth of the financial services markets. As Federal Reserve Governor Randall S. Kroszner observed, “The increased fragmentation of the mortgage process . . . [has] resulted in the oversight of mortgage lending extending beyond the federal banking agencies, and this underscores the importance of collaborating with the state banking agencies and other organizations.”¹³¹

b. Looking beyond 2008

The subprime failure and resulting credit crunch have shed light on a host of systemic problems such as distorted incentives, mismatched coordination, insufficient accountability, opaqueness, and unchecked greed. Investors, consumers, financial intermediaries, and government regulators all experienced a rude awakening as to the extensive vulnerabilities in the capital markets. Federal regulators have considered the possibility of broadly reforming the substance and structure of U.S. financial regulation.

The U.S. Treasury Department recently proposed to expand the Federal Reserve’s financial regulatory powers, but the proposal would also reduce the Federal Reserve’s bank supervision powers. On March 31, 2008, the Treasury Department released its *Blueprint for a Modernized Financial Regulatory Structure* (“*Blueprint*”), which recommended a comprehensive reform of the U.S. financial regulatory structure, including changes to the Federal Reserve’s powers and responsibilities.¹³² According to the *Blueprint*, the Federal Reserve would continue the central bank functions of

¹³⁰ Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., Markets, Financial Institutions, and Consumers: The Roles of the Federal Reserve, Speech At the Nat’l Bankers Ass’n 80th Ann. Convention, Durham, N.C. (Oct. 11, 2007), available at <http://www.federalreserve.gov/newsevents/speech/kroszner20071011a.htm>.

¹³¹ *Id.*

¹³² Press Release, U.S. Dept. of the Treasury, Treasury Releases Blueprint for Stronger Regulatory Structure (Mar. 31, 2008), <http://www.ustreas.gov/press/releases/hp896.htm>.

implementing monetary policy and providing liquidity. It would maintain the exclusive responsibility of drafting “regulations for national mortgage lending laws.”¹³³ The Federal Reserve would also become the regulator of market stability.¹³⁴ It would have broad regulatory powers over three types of federally chartered institutions: federal insurance institutions (“FIIs”), federal insured depository institutions (“FIDIs”), and federal financial services providers (“FFSPs”).¹³⁵ Under the proposed objectives-based system, however, the Federal Reserve would have to share regulatory authority with two new agencies, the Prudential Financial Regulatory Agency (“PFRA”) and the Conduct of Business Regulatory Agency (“CBRA”).¹³⁶ Furthermore, the *Blueprint* proposes to consolidate bank regulation in the Office of the Comptroller of the Currency (“OCC”), causing Federal Reserve officials to worry that they might lose bank-supervision powers, which have been useful tools of crisis management.¹³⁷ Initial reactions to the *Blueprint* were skeptical, and it is likely to encounter strong resistance from the industry and in Congress.¹³⁸

For now, the Federal Reserve must focus on adeptly using its existing statutory authority to steady the morale of market participants. Looking forward, the Federal Reserve must continue to synchronize its monetary policy and consumer credit protection efforts in order to convince investors that capital allocation via financial markets is efficient and sustainable.

Y. Nancy Ni¹³⁹

¹³³ U.S. DEPT. OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FIN. REG. STRUCTURE 7 (2008), <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

¹³⁴ *Id.* at 15.

¹³⁵ *Id.* at 14-15.

¹³⁶ *Id.* at 14-16 (describing the proposed new roles that the Federal Reserve would have).

¹³⁷ *Id.* at 8; Greg Ip, Fed’s ‘Supercop’ Role May Give It Headaches, WALL ST. J., Mar. 31, 2008, at A1.

¹³⁸ Kara Scannell, Treasury’s Blueprint—The Details: Handicapping the High Points—Some of the Big Ideas Behind the Overhaul and Their Probable Fate, WALL ST. J., Mar. 31, 2008, at A16.

¹³⁹ Student, Boston University School of Law (J.D. 2009).

II. Unwinding the Deals that Fell Victim to the Credit Crunch

The 2007 financial crisis marked the end of an era of seemingly limitless credit and relatively lenient lending practices by the banking industry. The upheaval of the lending industry has resulted in a decrease in capital and liquidity. In the years leading up to the subprime crisis, investment banks had financed massive deals and then unloaded the debt to secondary markets. But given the increasing number of defaulting borrowers, the willingness of the banking industry to take on further debt has waned. With the subprime mortgage crisis keeping buyers out of the debt market, banks are facing the prospect of shouldering any credit that they lend to fund mergers and acquisitions. As a result, investment banks and financial institutions are seeking to renegotiate the deals they originally committed to last spring. Major deals have either fallen through and been scrapped completely or the original pricing has changed as a result of difficulty obtaining financing. Renegotiations have also led to executive shuffles, refinancing agreements, and litigation. The “credit crunch” led to approximately \$754 billion in acquisition offers being withdrawn in 2007, the highest value of pulled bids since 2000.¹

This article will survey five major deals that were drastically changed or foregone as a result of the uncertainty and turmoil in the credit markets. The discussion will consider the respective terms of the original deals as well as their revisions. It will also dissect the reasons behind the failure or restructuring of each deal, and will provide analysis on how future deals and the market for such deals may be affected in the long run.

A. Beginning the Crisis: Home Depot

One of the first major deals affected as a result of the credit crunch was Home Depot’s planned sale of its HD Supply unit. In June, 2007, Home Depot announced the sale of HD Supply, its wholesale distribution business, to Bain Capital, the Carlyle Group, and Clayton, Dubilier & Rice, for \$10.33 billion.² While the initial

¹ Dana Cimilluca, *2007: Top Year for Pulled Deals*, WALL ST. J., Nov. 2, 2007, at C3.

² Dennis K. Berman and Henny Sender, *Home Depot Talks on Unit Get Hostile—Equity Groups Work to Set Deal; Banks Challenge Terms*, WALL ST. J., Aug. 24, 2007, at A10.

terms of the agreement appeared profitable to Home Depot, the credit crunch, as well as the decline in the home improvements market provided the buyers group with incentives to demand renegotiations or threaten to walk away from the deal.³ In the summer of 2007 it appeared that a collapse of the Home Depot deal was imminent. First, the buyers' group threatened to back away from the purchase, claiming that the decline in the housing market was a material adverse change that altered the terms of the deal.⁴ Home Depot, which was in need of the proceeds from the sale of HD Supply to finance a planned stock buyback, subsequently reduced the purchase price to \$8.5 billion.⁵ Even with this concession, the buyers group remained hesitant and the three banks involved in the deal's financing, Lehman Brothers, JPMorgan Chase and Merrill Lynch, demanded their own concessions.⁶ Home Depot agreed to maintain 12.5% of HD Supply and agreed to provide \$1 billion in debt financing in the form of a senior secured loan to obtain the banks' approval of the deal.⁷ Though the buyout agreement had a \$309 million break-up fee, the buyers group did not appear exceedingly concerned that it would be forced to pay this amount for threatening to renege on the deal.⁸

Several key Wall Street executives were instrumental in salvaging the buyout during its final negotiations, including JPMorgan's Chief Executive Officers James Dimon and Steve Black, as well as senior banker James B. Lee.⁹ Lehman Brothers CEO Richard Fuld was also deeply involved in these late summer discussions.¹⁰ Additionally, Home Depot's chief executive, Frank Blake, and CFO, Carol Tomé, traveled to New York to discuss the

³ *Id.*

⁴ Andrew Ross Sorkin and Michael J. de la Merced, *Home Depot Sells Unit, With Price Cut*, N.Y. TIMES, Aug. 29, 2007, at C9.

⁵ Andrew Ross Sorkin and Michael J. de la Merced, *Redone Deal Not Thought Contagious*, N.Y. TIMES, Aug. 28, 2007, at C1.

⁶ Andrew Ross Sorkin and Michael J. de la Merced, *Home Depot Unit Sees Price Plunge in Tight Market*, N.Y. TIMES, Aug. 27, 2007, at A1.

⁷ Sorkin, *supra* note 4.

⁸ Sorkin, *supra* note 5.

⁹ Henny Sender, Dennis K. Berman, and Robin Sidel, *Home Depot Hit as Credit Crunch Squeezes Deals*, FINANCIAL NEWS ONLINE US, Aug. 27, 2007, available at <http://www.financialnews-us.com/index.cfm?page=ushome&contentid=2448626120&uid=4908-8802-672617-900649>.

¹⁰ *Id.*

formalities of the sale.¹¹ The closing date was initially targeted for August 17, 2007, but the buyers' and financing banks' new demands extended the closing by two weeks.¹² Finally, the \$8.5 billion deal closed in late August, 2007.¹³

Home Depot appears to have steadied after the HD Supply sale, but there have been some shifts in the corporation since the deal's conclusion. In June, 2007, Home Depot announced its plan to use the sale proceeds from the HD Supply deal to finance its repurchase of 550 million shares of Home Depot stock.¹⁴ Even after the HD Supply deal closed on less favorable terms than initially agreed upon, Home Depot executives confirmed that the stock buyback would proceed as planned.¹⁵ The buyback is estimated at approximately \$22.5 billion, with \$7.9 billion coming from the HD Supply sale.¹⁶ The entire buyback was to be completed in 2007, yet Home Depot executives recently announced that they are stalling the second phase of the planned share repurchase until the credit markets improve.¹⁷

Also in the news for Home Depot, the company announced that its chief operating officer, Joseph DeAngelo, was resigning.¹⁸ Joseph DeAngelo oversaw the wholesale distribution business and, though stepping down from his role as COO, will still work with HD Supply.¹⁹ While Home Depot appears minimally affected by HD Supply sale's reduced price, the deal's renegotiation triggered concerns that other pending takeovers would fall victim to the credit crunch.²⁰ As the *Wall Street Journal* quoted one trader saying, "If

¹¹ *Id.*

¹² 2nd Update: *Home Depot to Get \$8.5B for 87.5% of HD Supply*, DOW JONES NEWS SERVICE, Aug. 28, 2007.

¹³ *Id.*

¹⁴ Ann Zimmerman, *Home Depot's Deal Renovation Won't Derail Big Stock Buyback*, WALL ST. J., Aug. 29, 2007, at C3.

¹⁵ *Id.*

¹⁶ 2nd Update: *Home Depot to Get \$8.5B for 87.5% of HD Supply*, *supra* note 12.

¹⁷ Mary Ellen Lloyd, *Home Depot Gives Gloomy Outlook*, WALL ST. J., Feb. 27, 2008, at B5.

¹⁸ The Associated Press, *Home Depot Inc.: Chief Operating Officer Leaves After Unit's Sale*, WALL ST. J., Sept. 1, 2007, at A4.

¹⁹ *Id.*

²⁰ Peter A. McKay and Robin Sidel, *Stocks Decline on Concern That Takeovers Will Fall Off*, WALL ST. J., Aug. 28, 2007, at C1.

they can [renegotiate] this one, they can do it to some others. It's a slippery slope."²¹

B. Material Adverse Circumstances Clause: Harman International Industries, Inc.

One of the first major deals to collapse as a result of the lack of available capital was the \$8 billion takeover bid for Harman International Industries Inc. ("Harman"), an audio equipment manager. The deal was led by Kohlberg, Kravis Roberts & Co. ("KKR") and Goldman Sachs Group, Inc. In late 2006, Harman was in the process of replacing its company leadership,²² and KKR then offered Harman \$8 billion for the company, a price substantially higher than its market value.²³ Even as the credit crunch loomed, KKR released a statement in June 2007 that it was poised to carry out the Harman purchase.²⁴ In September 2007, however, KKR announced it no longer sought to move forward on the deal, alleging that it found unacceptable financial conditions within the company.²⁵ KKR and Goldman argued that these conditions amounted to a material adverse change, thus allowing the cancellation of the deal.²⁶ The Harman stock plunged 24% after news of KKR and Goldman backing out of the buyout.²⁷ As in the Home Depot deal, several major banks were closely watching the acquisition: Credit Suisse Group, Goldman Sachs, Lehman Brothers, and Bank of America, had collectively agreed to provide over \$5 billion in debt financing to the buyout.²⁸

Litigation over the failed Harman deal appeared inevitable, as there was an express clause in the agreement that the buyers could not back out for events "generally affecting the consumer or

²¹ *Id.*

²² Carol J. Loomis, *An Old Hand in a Strange New World*, FORTUNE, Jan. 24, 2008, available at http://money.cnn.com/2008/01/21/news/companies/harmon_kardon.fortune/index.htm.

²³ *Id.*

²⁴ *Id.*

²⁵ Dana Cimilluca and Dennis K. Berman, *KKR, Goldman Cancel \$8 Billion Harman Deal—Stereo Firm's Prospects Are Said to be Worse; Legal Battle May Erupt*, WALL ST. J., Sept. 22, 2007, at A3.

²⁶ *Id.*

²⁷ *Id.*

²⁸ Dana Cimilluca, *Winners, Losers In Harman Fiasco—Blackstone, Schwarzman Get New Sword to Wield*, WALL ST. J., Sept. 24, 2007, at C6.

professional audio, automotive audio, information, entertainment or infotainment industries, or the economy or the financial, credit or securities markets.”²⁹ Though KKR was attempting to utilize the MAC clause in the agreement, these conditions are incredibly difficult to prove and litigation would have likely favored awarding Harman the contract’s \$225 million breakup fee.³⁰ In October 2007, Harman and KKR avoided litigation by reaching a compromise with KKR agreeing to purchase a \$400 million stake in the company.³¹ While the final agreement was not as profitable to Harman as the buyout would have been, the \$400 million still represents a substantial KKR investment in the company.³²

Overall, the Harman deal demonstrates the willingness of buyers in this struggling credit market to utilize the MAC clause, a clause which had previously been untested, even in deals concluded in the aftermath of the September 11th terrorist attacks.³³ Even though this deal was completed without litigation or a complete back-out on the part of the purchaser, deal participants will certainly pay more attention to and negotiate harder over the terms of the MAC clause in the future.

C. Rise of Termination Fees: United Rentals, Inc.

One of the first of the post-credit crunch buyout failures to reach the courts was Cerberus Capital Management LP’s proposed purchase of United Rentals Inc., a construction equipment rental company. In July 2007, Cerberus and United agreed to a \$4.1 billion buyout to be closed in November.³⁴ According to United Rentals, the buyout also included another \$2 billion in assumed debt, making the entire deal worth approximately \$7 billion.³⁵ Even though the deal

²⁹ Dennis K. Berman and Dana Cimilluca, *Harman’s Suitors Sour on Buyout—Will New Discovery Prompt KKR, Goldman to Pull Out of \$8 Billion Agreement?*, WALL ST. J., Sept. 21, 2007, at A3.

³⁰ Loomis, *supra* note 22.

³¹ Dennis K. Berman, *Harman Takeover Canceled, Fight Avoided*, WALL ST. J., Oct. 22, 2007, at A2.

³² *Id.*

³³ *Id.*

³⁴ Dana Cimilluca, *Cerberus Seeks to Exit United Rental Deal—Latest Casualty of Credit Crunch May Land in Court*, WALL ST. J., Nov. 15, 2007, at A5.

³⁵ The Associated Press, *Cerberus Backs Out of Agreement to Buy United Rentals*, N.Y. TIMES, Nov. 15, 2007, at C6.

was agreed to after concerns about the credit market arose, Cerberus attempted to renegotiate the terms as early as August 2007.³⁶ In November 2007, Cerberus informed United Rentals that it was not prepared to go forward with the purchase, and United Rentals brought suit.³⁷ Cerberus chief executive Stephen Feinberg testified that the downturn of the markets led the firm's banks to shy away from funding the deal.³⁸ Prior to backing out, Cerberus and its banks had been utilizing high-yield notes to finance the buyout and the deterioration of the high-yield financing market may have also contributed to the termination of the agreement.³⁹

Unlike other collapsed buyouts, Cerberus did not attempt to utilize the MAC clause in the contract and instead offered to pay the agreement's \$100 million termination fee.⁴⁰ In its suit, United Rentals alleged that Cerberus could not terminate the deal without declaring a material adverse change.⁴¹ The Delaware court ruled in Cerberus' favor that it could walk away from the deal by paying the \$100 million.⁴² The court found that the Cerberus attorneys had negotiated the termination fee with the intent that paying it would get Cerberus out of its buyout commitment, so Cerberus did not need to demonstrate a material adverse change.⁴³ The collapse of the United Rentals deal brought about a new concern for both buyers and sellers, as the Delaware court appeared to have based its decision on the communication between the two parties during the agreement's negotiation.⁴⁴ As the credit crunch makes firms appear willing to back out of their buyout commitments, the lesson learned from the United Rentals litigation is to be wary of ambiguous drafting and to pay more attention to the meaning and implications of the MAC clause during negotiations.⁴⁵

³⁶ Cimilluca, *supra* note 34.

³⁷ Matthew Karnitschnig, *Court Lets Cerberus Cancel United Rentals Deal*, WALL ST. J., Dec. 22, 2007, at A4.

³⁸ *Id.*

³⁹ Cimilluca, *supra* note 34.

⁴⁰ Michael J. de la Merced, *Equity Firm is Sued Over Withdrawal from Deal*, N.Y. TIMES, Nov. 20, 2007, at C5.

⁴¹ *Id.*

⁴² Michael J. de la Merced, *United Rentals Loses Bid to Make Suitor Complete Buyout*, N.Y. TIMES, Dec. 22, 2007, at C4.

⁴³ *Id.*

⁴⁴ Michael J. de la Merced, *United Rentals Will Not Appeal Ruling*, N.Y. TIMES, Dec. 25, 2007, at C3.

⁴⁵ Merced, *supra* note 42.

D. Refinancing: Sallie Mae

The largest casualty of the credit crunch to date was the proposed \$25 billion takeover of Sallie Mae. In April 2007, J.C. Flowers & Co, Freidman, Fleischer & Lowe, JPMorgan Chase Bank, and Bank of America proposed a \$25.3 billion buyout offer of the student loan company.⁴⁶ The deal looked profitable when it was negotiated, but it took a turn after the summer credit crunch and Congress's passing of the College Cost Reduction and Access Act, which cut subsidies to student lenders and reduced Sallie Mae's profit margin.⁴⁷ Further, investors JPMorgan and Bank of America were eager to rid themselves of their preexisting buyout commitments as the nation's credit crunch worsened.⁴⁸ In September, 2007, J.C. Flowers invoked the MAC clause in the buyout plan to renegotiate the deal.⁴⁹ In October 2007, J.C. Flowers attempted to negotiate a twenty percent reduction in the buyout price, reducing its bid to fifty dollars per share.⁵⁰ Sallie Mae refused to accept this lower purchase price and walked away from the deal in December.⁵¹

The upheaval surrounding the collapsed Sallie Mae buyout led to changes in Sallie Mae's leadership. On January 7, 2008, Sallie Mae appointed Anthony P. Terracciano to succeed Albert L. Lord as Chairman, though Mr. Lord remains chief executive.⁵² Mr. Terracciano has experience in both selling troubled companies and finding them capital.⁵³ The *Wall Street Journal* suggested that the new chairman offered a contrast to Lord's brash demeanor that might

⁴⁶ Jim McTague, *Will Sallie be Left at the Altar?*, BARRON'S, Sept. 3, 2007, at 41.

⁴⁷ *Id.*

⁴⁸ *See Id.*

⁴⁹ Dennis K. Berman, *Buyout Group Balks at Sallie Mae—J.C. Flowers Wants to Cut Bid Amid Tighter Credit; Lender's Chief Fights Back*, WALL ST. J., Sept. 27, 2007, at A3.

⁵⁰ Paula Schaap, *Sallie Mae Buyers Try for Lower Price*, FINANCIAL NEWS ONLINE US, Oct. 3, 2007, available at <http://www.financialnews-us.com/index.cfm?page=ushome&contentid=2348872447&uid=4108-3002-452616-294208>.

⁵¹ Berman, *supra* note 49.

⁵² Peter Eavis, *SLM Asks: Brother, Can You Spare \$30 Billion, Cheaply?*, WALL ST. J., Jan. 10, 2008, at C1.

⁵³ Jed Horowitz, *Sallie Mae Names Turnaround Expert as Chairman*, WALL ST. J., Jan. 8, 2008, at A2.

increase Sallie Mae's credit rating and investor confidence.⁵⁴ In late January 2008, Sallie Mae and J.C. Flowers struck a deal ending the pending litigation between the parties and JPMorgan, Bank of America, Barclays PLC, and Deutsche Bank AG are providing a \$30 billion credit line to Sallie Mae, effectively allowing J.C. Flowers to walk away from the \$900 million breakup fee.⁵⁵ Though the \$900 million breakup fee would have been a substantial gain for Sallie Mae, the company's spokesman, Tom Joyce, dubbed the loan commitments a "vote of confidence" in the company.⁵⁶ According to Chairman Anthony Terracciano, the company remains open to the possibility of being acquired.⁵⁷ The Harman and Sallie Mae settlements both suggest that buyers groups wishing to back out of buyouts but eager to avoid excessive litigation costs will present creative refinancing and investment offers to their once targeted prospects.

E. Ongoing Dispute: Alliance Data Systems

Blackstone Group agreed to buy Alliance Data Systems (ADS), a credit card processing company, in May 2007. In late January 2008, Blackstone Group stated that it was unable to complete its \$6.4 billion buyout of ADS, citing objections from federal banking regulators.⁵⁸ The comptroller's office allegedly had strict capital and liquidity requirements that it expected Blackstone to guarantee, and the Comptroller's approval was required because the World Financial Network National Bank handles Alliance Data's credit card services, which thus subjects Blackstone to national banking laws.⁵⁹ Blackstone alleged that the requirements imposed by the Office of the Comptroller of the Currency were "unprecedented and unacceptable."⁶⁰ ADS brought suit in the Delaware Chancery

⁵⁴ *Id.*

⁵⁵ Andrew Dowell, *Sallie Scores Funding as it Ends Deal Fight*, WALL ST. J., Jan. 29, 2008, at C5.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Dana Cimilluca, *Maybe ADS Stands for Another Deal Saga—Blackstone Balks at Pact as Regulator Weighs In: "Price is Not the Issue"*, WALL ST. J., Jan. 29, 2008, at C3.

⁵⁹ Michael J. de la Merced, *New Barrier to Buyout of Alliance Data*, INT'L HERALD TRIB., Jan. 30, 2008 at 14.

⁶⁰ *Id.*

Court to enforce the deal or the \$170 million breakup fee.⁶¹ In the aftermath of Blackstone's attempts to walk out on the deal, ADS shares plummeted thirty-five percent to \$42.48 per share, a far cry from the \$81.75 per share value agreed to in the buyout.⁶²

In February 2008, ADS dropped its lawsuit against Blackstone citing that the companies are attempting to work out a settlement.⁶³ ADS shares rose to \$55.02 per share after this announcement.⁶⁴ However, ADS is free to bring another lawsuit if the companies fail to reach an agreement.⁶⁵ Carl Icahn, a billionaire shareholder in ADS, announced in a regulatory filing that he reserves the right to discuss the proposed takeover with ADS management.⁶⁶ The *Wall Street Journal* speculates that Mr. Icahn will become an active negotiator in the Blackstone/ADS deal and that he will work with ADS' investment bankers, Bank of America Securities and Lehman Brothers.⁶⁷ Additionally, in late March, 2008, the OCC clarified a contentious point in the bargain.⁶⁸ The OCC is now allowing ADS to offer \$400 million of collateral should the credit-card bank fall into financial difficulty, thus requiring Blackstone to step in only if ADS is unable to secure the \$400 million.⁶⁹ Blackstone had previously argued that the OCC refused to limit its liability;⁷⁰ Therefore, this new cap on exposure might move the deal towards completion.⁷¹

F. Future Deals and Analysis

One of the biggest buyouts scheduled to close in 2008 is the \$19 billion acquisition of Clear Channel Communications by

⁶¹ Michael J. de la Merced, *Alliance Data Drops Suit to Force Deal*, N.Y. TIMES, Feb. 9, 2008, at C3.

⁶² Cimilluca, *supra* note 58.

⁶³ Andrew Edwards, *Alliance Data Drops Suit as Blackstone Deal Revives*, WALL ST. J., Feb. 9, 2008, at B5.

⁶⁴ *Id.*

⁶⁵ Merced, *supra* note 61.

⁶⁶ Heidi Moore, *Blackstone-ADS: Icahn's Intervention—Billionaire Jumps Into a Wobbly Proposed Deal*, WALL ST. J., Feb. 13, 2008, at C3.

⁶⁷ *Id.*

⁶⁸ Heidi Moore, *Alliance Data: Less Sticky—A Regulator Eases Blackstone's Path; Other Issues Loom*, WALL ST. J., Mar. 21, 2008, at C3.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

Thomas H. Lee Partners and Bain Capital.⁷² If the buyers back out of the deal, there is a \$600 million breakup fee in the agreement.⁷³ The Clear Channel acquisition is already in jeopardy as a result of an inability to obtain financing.⁷⁴ At the end of March 2008, Clear Channel sued the group of banks and securities firms funding the buyout, a group that includes Citigroup, Morgan Stanley, Credit Suisse Group, The Royal Bank of Scotland, Deutsche Bank AG, and Wachovia.⁷⁵ Clear Channel alleged breach of contract, fraud, and that the banks “improperly interfere[ed]” with the merger agreement.⁷⁶ The direction of the Clear Channel deal and its resulting litigation will likely be watched by all of Wall Street. Clear Channel is yet another example of how the events of the past six months leave little security in purchase values set and deals formed in early 2007.⁷⁷ Before the credit crunch, company leaders were able to obtain maximum values for their companies.⁷⁸ It was also considered a truism that investment banks and other financial institutions would be unwilling to bear the reputational consequences of backing out of buyout deals.⁷⁹ However, things have changed, and it is likely that, in the upcoming months, corporations may have to accept reduced deal values if they wish to proceed with such buyouts.⁸⁰ As seen in the Home Depot, Harman, and Sallie Mae deals, companies are increasingly vulnerable because of the lack of available financing, and, coupled with the investment banks’ willingness now to back out of deals, some companies may be willing to accept altered deal terms in order to forego lengthy litigation, and to gain from an expedited jolt of financing.⁸¹

⁷² Karen Donovan, *As Some Buyouts Falter, New Tactics Aim to Lock in Deals*, N.Y. TIMES, Jan. 4, 2008, at C6.

⁷³ *Id.*

⁷⁴ Michael J. de la Merced and Andrew Ross Sorkin, *Clear Channel and Balking Suitor Talk*, N.Y. TIMES, Feb. 23, 2008, at C8.

⁷⁵ Matthew Karnitschnig and Peter Lattman, *Buyout Firms Sue Lenders Over Busted Deal for Clear Channel*, WALL ST. J., Mar. 27, 2008, at C1.

⁷⁶ *Id.*

⁷⁷ Thomas Heath, *Private Equity’s Loss of Leverage: Credit Crunch Puts the Brakes on Buyout Blitz, Forces Firms to Change Directions*, WASH. POST, Jan. 2, 2008, at D8.

⁷⁸ Donovan, *supra* note 72.

⁷⁹ *Id.*

⁸⁰ Heath, *supra* note 77.

⁸¹ *See Id.*; Donovan, *supra* note 72. *See also* Berman, *supra* note 31; Dowell, *supra* note 55; Sorkin, *supra* note 4.

A striking change from this credit crunch appears to be the willingness of deal participants to go back on their agreed-upon buyouts obligations. As firms grasp at material adverse change clauses in their purchase agreements, it is likely that there will be a judicial ruling in the foreseeable future clarifying these previously unaddressed clauses.⁸² Even if firms appear unlikely to prevail on the MAC challenges, it is speculated that the threat of this litigation is enough to get the selling company to renegotiate.⁸³ The reputational consequences of firms backing away from these agreements have yet to be tested. Nevertheless, it is suggested that seller companies implement stricter contractual provisions given the newly established precedent for breaking multi-million and billion dollar deals.⁸⁴ Though buyout contracts already appear to be fairly airtight, one should expect the contract language to intensify and leave even less maneuverability.⁸⁵ Sellers are going to seek stronger financing guarantees and higher breakup fees.⁸⁶ These breakup fees are likely to become massive, especially since the United Rentals decision appears to give firms the go-ahead to abandon deals so long as they can pay the termination fees.⁸⁷ On the buyers' side, it is likely that firms will begin approaching deals with more cash and less debt in order to avoid pressure from lenders to renegotiate the deals' terms.⁸⁸ Buyers and sellers are now coming to the bargaining table not only trying to negotiate the best deal, but also trying to plan for potential cancellation in the most favorable manner.

Jessica Lynn Costa⁸⁹

⁸² See Donovan, *supra* note 72; Loomis, *supra* note 22. See also Claire Smith, *Bidders Consider Get-Out Clauses to Offer Lower Price*, FINANCIAL NEWS ONLINE US, Sept. 27, 2007, available at <http://www.financialnews-us.com/index.cfm?page=ushome&contentid=2448806520&uid=3308-9902-722723-455306>.

⁸³ Andrew Ross Sorkin, *If Buyout Firms Are So Smart, Why Are They So Wrong?*, N.Y. TIMES, Nov. 18, 2007, §3, at 8.

⁸⁴ Dennis K. Berman, *The Game: Reputation is Everything, Until it Costs—Deal Makers to Breakers as Street Hits Straits; Adopt Hoo-Hoo Model?*, WALL ST. J., Oct. 23, 2007, at C1.

⁸⁵ Merced, *supra* note 42.

⁸⁶ See Sorkin, *supra* note 83.

⁸⁷ *Id.* See also Merced, *supra* note 42.

⁸⁸ Heath, *supra* note 77.

⁸⁹ Student, Boston University School of Law (J.D. 2009).

III. Ratings Agency Accountability

Market commentators disagree on the precise level of blame the credit rating agencies deserve for the subprime mortgage crisis. Almost all the commentators agree, however, that the credit rating agencies played a significant role in creating this crisis.¹ By giving undeservedly high credit ratings (“AAA”) to many structured products with underlying subprime mortgages, these rating agencies undoubtedly increased investor confidence and helped generate demand for these subprime-backed securities.² The subsequent high default rates on these subprime loans, however, suggest that these credit ratings were faulty.

Soon after the scope of the subprime crises became apparent, government agencies and regulators began questioning the rating agencies’ role in facilitating the securitization and selling of subprime mortgages. SEC examiners, state attorneys general,³ and an interagency committee, (the President’s Working Group on Financial Markets) led by Treasury Secretary Henry Paulson are currently investigating the extent of the credit rating agencies’ responsibility in contributing to the subprime crisis.⁴ Though the results of these investigations have not yet been completed, analysts, lawmakers, and others will be watching closely.

This paper will first put forth several theories of what the credit rating agencies’ role was in contributing to the subprime crisis. It will then describe the agencies’ reactions and responses to this crisis. The article will continue to explain the current regulatory framework, to which the credit rating agencies are subject, and the various avenues of potential regulation being proposed to prevent a similar crisis in the future.

¹ Ben Heath, *For Rating Agencies, Now 'the Trust is Gone'*, The Advocate, Dec 28, 2007.

² Paul Krugman, Op-Ed., *Just Say AAA*, N.Y. TIMES, July 2, 2007, at A19.

³ Julie Creswell, Vikas Bajaj, *S&P and Moody's Try to Shore Up Credibility*, INT’L HERALD TRIBUNE, Feb 9, 2008, at 13.

⁴ Stephen Labaton, *Debt-Rating Agencies Are Under Scrutiny by S.E.C.*, N.Y. TIMES, Sept. 27, 2007, at C4.

A. *The Role of Rating Agencies in the Subprime Mortgage Crisis*

Market commentators have put forth several theories as to how the credit ratings provided by the major reporting agencies like Moody's Investor Services and Standard's & Poor's, were inaccurate in assessing the true risk of the rated assets. Common to all these theories is the discovery that various pressures existed in the market that created in the credit rating agencies "an inherent tendency for optimism."⁵ These pressures also caused the rating agencies to be especially tardy in downgrading their ratings.⁶

One prominent theory is that credit rating agencies have a conflict of interest due to their compensation structure.⁷ Typically, the owner of a security being rated, not the investors that purchase these securities, will pay the credit rating agency that provides the rating.⁸ Therefore, the agencies' impartiality is possibly strained—if they give the security a low rating, they are likely to lose the business of that client. This conflict is particularly problematic with regard to structured products.⁹ When rating traditional corporate bonds, there is less fear that each issuer has any substantial influence over the rating agency, because these issuers number in the thousands, and each individual issuer is less material to the rating agencies' revenue.¹⁰ Structured products, however, work very differently in several respects. There are only a few investment banks that assemble and structure the bulk of products that the credit rating agencies rate.¹¹ Losing the business of these investment banks would result in large revenue losses for the rating agency, especially considering that structured finance business accounts for most of the agencies' total revenue.¹² It is, therefore, no surprise that the

⁵ *The Role and Impact of Credit-Rating Agencies on the Subprime Credit Market Hearing before the S. Banking, Housing And Urban Affairs Committee, 110th Cong. (Sept. 26, 2007) [hereinafter *Hearing*] (Statement of John Coffee).*

⁶ *Id.*

⁷ *Overhaul in S&P's Procedures*, INT'L HERALD TRIBUNE, Feb. 8, 2008, at 11.

⁸ *Id.*

⁹ *Hearing*, *supra* note 5 (statement of John Coffee).

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

evidence shows that ratings on structured products are more likely to be inflated than the ratings on corporate debt.¹³

Others claim that the rating agencies are not to blame. Rather, the fault lies primarily with the loan originators and mortgage brokers who generated the defaulting subprime loans.¹⁴ Typically, a mortgage broker receives the loan recipient's financial and credit information and passes it on to the loan originators, who provide the actual mortgage.¹⁵ The loan originator works with an investment bank to securitize the mortgage, usually pooled together with other such mortgages and an array of other financial products to lower the risk that a single mortgage will default. The investment banks send these completed products, together with the respective mortgage information, to the credit rating agencies.¹⁶ The credit rating agencies then rate the security based on this information.¹⁷ However, the credit rating agencies are not equipped to verify the veracity of the mortgage information, which is the job of the loan originators and mortgage brokers.¹⁸ Rather, the task of the credit rating agency is to build models that, based on such information, can accurately predict the default rates of the structured products.¹⁹

Others in the financial sector, in addition to the agencies themselves,²⁰ have adopted the argument that credit rating agencies are not principally to blame for faulty ratings. Congressman Barney Frank, for example, stated that the credit rating agencies had no idea that there were so many bad loans underlying the securities they were rating.²¹ This suggests that it is possible that the credit rating

¹³ *Id.*

¹⁴ Editorial, *The Moody's Blues*, WALL ST. J., Feb. 15, 2008, at A15.

¹⁵ Lynnley Browning, *The Subprime Loan Machine*, N.Y. TIMES, March 23, 2007.

¹⁶ Hearing, *supra* note 5 (statement of Ms. Tillman, Executive Vice President, Standard & Poor's Credit Market Services).

¹⁷ *Id.*

¹⁸ Jenny Anderson & Vikas Bajaj, *Reviewer of Subprime Loans Agrees to Aid Inquiry of Banks*, N.Y. TIMES, Jan. 27, 2008, at A1.

¹⁹ *Id.*

²⁰ Vickie Tillman, *Don't Blame the Rating Agencies*, WALL ST. J., Aug. 31, 2007, at A9 (Vickie Tillman is executive vice president of Credit Market Services for Standard & Poor's).

²¹ Congressman Barney Frank, Chairman, House Financial Services Committee, Address at Boston University School of Law (Feb. 11, 2008) (stating that the credit rating agencies were simply "drinking the kool-aid") (transcript available in Morin Center for Banking and Financial Law).

agencies were not falsifying statistics or blindly rating securities due to any actual conflicts of interest. However, even under this more optimistic interpretation of events, the credit rating agencies' response was delayed. They waited until July 2007 to lower the ratings on many mortgage-backed securities, long after the market for subprime loans collapsed, and tremendous default risk became clear.²²

Complicating things further is that historically, credit rating agencies have been notorious for their tardy downgrades of non-performing debt.²³ The reason is that credit rating agencies risk offending their clients, the powerful investment banks, and the institutional investors.²⁴ Moreover, downgrading a debt security typically causes its market value to fall. When issuers are at the brink of default, this decline in price may actually end up facilitating the default, causing even more damage to the issuer and investors as a whole.²⁵ Thus, the market circumstances incentivize delaying the downgrading of securities.

The highly concentrated nature of the credit rating industry also may inhibit accurate ratings.²⁶ Only a handful of credit rating agencies provide the majority of the market ratings.²⁷ One reason for this concentration is that the SEC has, in the past, discouraged new entrants.²⁸ Also, it is difficult for a new entrant to build a good reputation on which investors are willing to rely.²⁹ The Credit Rating Agency Reform Act of 2006, discussed below, should change this by encouraging new entrants and making the industry more competitive.³⁰

²² Jesse Westbrook and David Scheer, *SEC May Propose New Rules for Credit-Rating Companies*, BLOOMBERG, Feb. 8, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWdgRpYzug8k&refer=home>.

²³ Hearing, *supra* note 5 (statement of John Coffee).

²⁴ *Id.*

²⁵ *Id.*

²⁶ Hearing, *supra* note 5 (statement of John Coffee).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

B. Credit Rating Agency Reaction to the Subprime Crisis

The credit rating agencies have reacted in a variety of ways, from blaming the loan originators to proposing major changes in their rating methodology. The agencies claim that they were deceived by the parties responsible for compiling the loans that made up the structured products,³¹ including the loan originators and broker-dealers who solicited the information.³² However, despite not being willing to internalize all the blame for the subprime collapse, the credit rating agencies have announced their intention to overhaul aspects of their credit ratings procedures. Standard & Poor's (S&P) announced it would hire an ombudsman to help deal with conflict of interest concerns and will demand disclosure of collateral in structured products.³³ Also, it plans to be more informed about the processes the loan originators use to determine the accuracy of their data.³⁴ In terms of its predictive models, S&P announced it would begin to highlight additional factors not traditionally covered, such as liquidity, volatility, correlation and recovery.³⁵ Deven Sharma, President of S&P, said that these steps would "enhance independence, strengthen the ratings process and increase transparency."³⁶

Moody's similarly announced plans to change elements of its rating system. Moody's is considering a new rating system that uses numbers instead of the traditional letters and would also add "sf" to signal a rating of structured products.³⁷ Moody's also proposed new measures that would allow investors to choose the underlying assumptions and data with which to calculate the resulting value of the structured product.³⁸ Investors will be able to compare these values with those recommended by Moody's.³⁹ With these measures,

³¹ Heath and Howley, *supra* note 1.

³² *Id.*

³³ *Overhaul in S&P's Procedures, supra* note 7.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ Mark Pittman, *Moody's Considers Substituting Numbers for Ratings*, BLOOMBERG, Feb. 4, 2008 available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aanhAYt9dT88&refer=home>.

³⁸ Saskia Scholtes, *Markets & Investing: Moody Offers New Tools to Value CDOs*, FINANCIAL TIMES ONLINE, Nov. 16, 2007.

³⁹ *Id.*

Moody's aims to help investors price securities in different possible scenarios, which illustrates the wide a range of values structured-finance securities can have.⁴⁰

Fitch also indicated its willingness to overhaul its rating procedures for complex structured products.⁴¹ In February of 2008, it issued a statement saying that it was weighing its options for how to rate corporate collateralized debt obligations (CDOs).⁴² Fitch stated that the goal of any change would be to add "an important level of transparency" to the ratings of these complex products.⁴³

Despite the agencies themselves attempting to be proactive in fostering changes in their procedures, not all have reacted positively to such announcements. New York Attorney General Andrew Cuomo called the efforts mere "public relations window dressing" and not indicative of systemic reform.⁴⁴ Others claim that the rating agencies' true motivation is to avoid governmental oversight and regulation.⁴⁵ Most market commentators doubt that these attempts will be completely successful in preventing all future federal regulation.⁴⁶ Nonetheless, there will be new changes in the ratings process and it will become apparent in the coming years whether these changes will represent any apparent improvements for investors.

C. Current Rating Agency Regulation

Under the current legal scheme, credit rating agencies are regulated by the SEC only if they desire to qualify as a Nationally

⁴⁰ *Id.*

⁴¹ Saskia Scholtes, *Ratings Agencies Move to Restore Credibility*, FINANCIAL TIMES, Feb. 7, 2008, available at <http://www.ft.com/indepth/ratingsagencies> (follow "Rating agencies move to restore credibility" hyperlink).

⁴² *Deal and Deal Makers: Fitch is Studying CDO-Rating Change*, WALL ST J., Feb. 6, 2008, at C2.

⁴³ *Id.*

⁴⁴ Andrew Cuomo, Statement, New York State Attorney General Website, http://www.oag.state.ny.us/press/2008/feb/feb08a_08.html (last visited Mar. 9, 2008).

⁴⁵ Dakin Campbell and Andrew Ackerman, *Raters Look to Curb Conflicts of Interest S&P, Moody's Eye Ways to Boost Confidence*, The Bond Buyer, Feb. 8, 2008 at 1 (quoting an unnamed source as saying the actions taken are needed "to keep the regulators and Congress off their back.").

⁴⁶ *Overhaul in S&P's Procedures*, *supra* note 7.

Recognized Statistical Rating Organization (NRSRO). Alternatively, they can choose to adopt the optional Code of Conduct issued by the International Organization of Securities Commissions (IOSCO).

a. SEC Regulation of NRSROs

NRSROs are credit rating agencies, on which the SEC permits other financial institutions to rely for various regulatory purposes.⁴⁷ For example, SEC rule 15c3-1 requires brokers and dealers to have a certain amount of capital.⁴⁸ Securities that have an ‘investment grade’ rating from an NRSRO can count toward this capital requirement.⁴⁹

Before 2006, the SEC had little direct regulatory authority over credit rating agencies.⁵⁰ The commission staff would identify a credit rating agency as an NRSRO through a “no action letter.”⁵¹ The letter stated that the commission would not recommend enforcement action against broker dealers that relied on that credit rating agency’s rating for purposes of complying with the SES’s net capital rules.⁵² Because the SEC’s main concern was for new “fly-by-night” rating agencies, its staff would designate as an NRSRO only well established agencies, upon which investors ordinarily relied.⁵³ Incidentally, this made the rating market highly concentrated, as new entrants, who had not yet had the chance to acquire broad market reliance on their ratings, were consistently denied NRSRO status.⁵⁴

This approach had two major criticisms. First, the no action letter approach lacked transparency, as it was a discretionary commission staff decision, and it led to the above mentioned anti competitive results.⁵⁵ Second, the credit rating agencies are essential to the financial markets, and their lack of supervision can have

⁴⁷ Securities and Exchange Commission, *Definition of Nationally Recognized Statistical Rating Organization*, 17 C.F.R. pt. 240, (2005).

⁴⁸ 17 C.F.R. § 240.15c3-1 (2007).

⁴⁹ *Id.*

⁵⁰ Hearing supra note 5 (statement of SEC Commissioner Christopher Cox).

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* (statement of John Coffee)

⁵⁵ Securities and Exchange Commission, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, 17 C.F.R. Pts 240 and 249b, at 7 (2007) [hereinafter *NRSRO Regulation*].

significant adverse effects, as evinced by the Enron and WorldCom scandals.⁵⁶ In 2006, Congress responded to these concerns by passing the Credit Rating Agency Reform Act.⁵⁷ The Act gave the SEC new authority to directly regulate credit rating agencies and to set up clear procedures for qualifying as an NRSRO.⁵⁸ Specifically, the 2006 Act (1) “defines the term NRSRO; (2) provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to NRSROs, and; (3) directs the Commission to issue final implementing rules.”⁵⁹ It is important to note, however, that the Act does not authorize the SEC to regulate the substance of the ratings or the methodologies the credit rating agencies use to determine their ratings.⁶⁰ Rather, the SEC’s responsibility is to promote competition, manage potential conflicts of interest, and ensure accurate disclosure.⁶¹

Pursuant to the 2006 Act, the SEC has issued a draft of new rules called the Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations (2007). These rules are aimed at improving the quality of credit ratings and include the following:⁶²

- Rule 17g-1—Requiring a credit rating agency seeking to register as an NRSRO to register with the SEC and, if approved, provide updated information and an annual certification on Form NRSRO;⁶³
- Rule 17g-2—Requiring an NRSRO to make and retain certain business records;
- Rule 17g-3—Requiring NRSROs to annually furnish the SEC with certain financial reports, including audited financial statements;
- Rule 17g-4—Requiring NRSROs to adopt policies and procedures governing the use of material nonpublic information obtained in connection with credit rating;

⁵⁶ *Id.* at 8.

⁵⁷ Pub.L. No. 109-291, §3850, Stat. 1327, 1327 (2006).

⁵⁸ *Id.* at 1332.

⁵⁹ NRSRO Regulation, *supra* note 55, at 152.

⁶⁰ *See* Hearing, *supra* note 5 (statement of Chairman Cox)

⁶¹ *Id.*

⁶² Rachel McTague, *SEC Unanimously Adopts Rules To Implement Credit Rating Agency Law*, BNA BANKING DAILY, May 24, 2007.

⁶³ NRSRO Regulation, *supra* note 55, at 11 (applies through rule 17g-6).

- Rule 17g-5—Requiring NRSROs to disclose and manage their conflicts of interest. Such conflicts include being paid by issuers of the securities, which the NRSROs are rating; and
- Rule 17g-6—Prohibiting an NRSRO from engaging in unfair, coercive, or abusive practices.

These rules, although not released in response to the subprime mortgage crisis, will have a significant impact on the credit rating industry.

b. IOSCO Optional Requirements

The International Organization of Securities Commissions (IOSCO) brings together the regulators of the world's securities and futures markets. In 2004, IOSCO issued a Code of Conduct, addressing the credit rating agencies potential conflicts of interest.⁶⁴ The Code recommends that the agencies publish their ratings methodologies, their methods of addressing conflicts of interest, and their nondisclosure policies regarding material nonpublic information.⁶⁵ Most of the major credit rating agencies have adopted this Code.⁶⁶

D. Potential Future Regulation

Government officials and regulators have had mixed reactions to the credit rating agency issue. Several Attorneys General have launched investigations and lawsuits against credit rating agencies. Already mentioned is Andrew Cuomo's investigation into whether the rating agencies requested or had information that revealed the risk in the underlying mortgages that were backing many of the securitized assets scattered throughout the market.⁶⁷ His office has not yet filed any lawsuits but promised to actively pursue its

⁶⁴ Code of Conduct Fundamental for Credit Rating Agencies, International Organization of Securities Commissions (Dec. 2004), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf>.

⁶⁵ *Id.* at 4.

⁶⁶ Media Release, *IOSCO Reports Good Progress in Adoption of Code of Conduct*, (Feb. 14, 2007), *available at* <http://www.iosco.org/news/pdf/IOSCONEWS100.pdf>.

⁶⁷ Creswell and Bajaj, *supra* note 3.

investigation.⁶⁸ Similarly, Attorney General Richard Blumenthal of Connecticut issued subpoenas to S&P, Moody's and Fitch as part of an antitrust investigation, and his office is examining whether the credit ratings on subprime mortgage backed securities were honest and accurate.⁶⁹

At the federal level, Charles Schumer, New York Senator and Chairman of the Congress Joint Economic Committee promised that his committee will hold hearings on the credit rating agencies this year.⁷⁰ He has also suggested changing the rating agencies' compensation structure so that the agencies are paid by subscribing investors using the ratings, rather than by the entities whose securities are being rated.⁷¹ Some commentators, however, advise against this for two reasons.⁷² First, under a subscription-based compensation structure the agencies rarely break even.⁷³ Second, such a structure would allow subscribers to pass along this rating information to their "free riding" friends and associates, thus threatening the agencies' customer base and revenues.⁷⁴

In September 2007, the Senate Banking Committee held a hearing on the role of the credit rating agencies in the subprime crisis.⁷⁵ SEC Commissioner Christopher Cox, representatives of S&P and Moody's, and leading securities regulation scholars attended the hearing.⁷⁶ Commissioner Cox stressed to the committee that the SEC is not authorized to "second guess the quality of the [agencies'] ratings."⁷⁷ He also stated that the SEC has not yet formed a complete view of the rating agencies' role in the crisis, and thus it was too

⁶⁸ Aaron Lucchetti, *Rating the Rating Overhaul: New York State Official Calls Voluntary Moves 'Window Dressing'*, WALL ST. J., Feb. 8, 2008 at C2.

⁶⁹ Paul Menchaca, *Rating Agencies Remain Targets of Blame*, ASSET SECURITIZATION REPORT, Nov.12, 2007.

⁷⁰ *Senior Lawmaker Vows Mortgage Broker Crackdown*, Reuters (Feb. 6, 2008) available at <http://www.reuters.com/article/Regulation08/idUSN0629444420080206>.

⁷¹ Labaton, *supra* note 4 (quoting Sen. Schumer as saying "[w]e need to find ways to prevent this crisis from happening again.").

⁷² Hearing, *supra* note 5 (statement of John Coffee).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* (listing the following attendees: SEC Chairman Christopher Cox, Professor John Coffee, Professor Lawrence White, Michael Kanef of Moody's Financial Services, & Vickie Tillman of Standard & Poor's).

⁷⁷ Hearing, *supra* note 5 (statement of Christopher Cox).

early to ask Congress for additional SEC authority to regulate the substance of the ratings.⁷⁸

Columbia University Law Professor John Coffee also testified at the Senate hearing.⁷⁹ He began by describing the structure of the ratings industry as pressuring the agencies into producing overly optimistic ratings.⁸⁰ He then proposed that the government counter this by placing pressure on the rating agencies to be honest and accurate.⁸¹ He first recommended that the SEC calculate the five-year default rates on different classes of financial products for each rating agency and publically disclose this data on one centralized website.⁸² This would make the rating agencies' track record accessible to all investors, thus allowing investors to compare the initial rating with the eventual performance of the security.⁸³ This would also allow investors to assess the reliability of a particular agency's rating of a security. Theoretically, this proposal would increase the agencies' diligence and ensure the accuracy of their ratings, as they would strive to maintain their good reputation (perhaps the rating agencies most valuable asset).⁸⁴

In February 2008, Commissioner Cox stated that part of the Commission's agenda for 2008 is to draft new rules pursuant to the Credit Rating Agency Reform Act.⁸⁵ These rules will include new disclosure procedures for the rating agencies.⁸⁶ Chief among these disclosure measures would be, as John Coffee suggested, a requirement that agencies publicize their past ratings so that investors can compare the ratings to the securities' actual performance.⁸⁷ Cox believes that this increased information will "highlight successful past performances and punish rating agencies for poor and unreliable information."⁸⁸

At the September 26 hearings, John Coffee also recommended that NRSROs should lose their NRSRO status if they do not maintain

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ JOHN C. COFFEE JR., *GATEKEEPERS* 285 (Oxford University Press 2007).

⁸⁵ Ron Orol, *Cox Discusses 2008 agenda*, DAILY DEAL, Feb. 11, 2008.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

a certain level of accuracy.⁸⁹ The reason is that if an NRSRO rating simply provided the market with (credit) information regarding a security then inaccurate information would cause the NRSRO to lose clients.⁹⁰ However, under the current structure, an NRSRO rating provides more than just information on a security. Because many regulated institutional investors are only allowed to purchase investment-grade securities, the NRSROs are also giving these investors “governmentally-delegated” permission to buy these rated securities.⁹¹ Consequently, even if their ratings are inaccurate, their services will still be in demand because it allows the issuer to sell its securities to regulated investors.⁹² To remedy this problem, Coffee suggests revoking an agency’s NRSRO status if its ratings are inaccurate.

Under John Coffee’s recommendation, the SEC would need to define a maximum default rate for each letter grade rating and would then measure the rating agencies’ compliance with this standard.⁹³ If an agency’s default rate exceeds that limit, it would lose its NRSRO standing for that security. However, during the hearing, Commissioner Cox expressed doubt whether the SEC had the authority to revoke NRSRO status for inaccurate ratings.⁹⁴

At the same hearing, a few senators contemplated enacting mandatory waiting periods for those working at a credit rating agency before they work for a client, be it an issuer or an investment bank.⁹⁵ This would provide less incentive for producing overly optimistic ratings, since doing so would not be rewarded with a lucrative job offer with the client.⁹⁶ Michael Kanef, managing director at Moody’s, expressed willingness to comply with such

⁸⁹ Hearing, *supra* note 5 (statement of John Coffee) (calling this proposal the “best response” to the problem of insufficient market penalization of inaccurate rating performance).

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* (calling this a “[market] power no other [financial services lynchpin] possesses.”).

⁹³ *Id.*

⁹⁴ *Id.* Hearing, *supra* note 5 (statement of Christopher Cox) (responding to a question by Senator Shelby: “[I]f you’re asking me whether we would use our authority [to revoke NRSRO status] given the current statute, I think it would be very difficult”).

⁹⁵ Associated Press, *Credit Rating Agencies Defend Track Record*, Sept. 26, 2007, available at <http://www.msnbc.msn.com/id/20992048/>.

⁹⁶ *Id.*

waiting periods, while Vickie Tillman, representing S&P, was more reluctant.⁹⁷

A final regulatory response is an effort, led by the IOSCO, and of international regulators, including the SEC, in considering modifications on their Code of Conduct for credit rating agencies.⁹⁸ These new recommendations would tighten and improve the ratings of structured products.⁹⁹ Specifically, it would require disclosure of the assumptions underlying ratings for structured products and prohibit the rating agencies from giving advice on how to structure products the agency also rates.¹⁰⁰ Because the IOSCO has no authority to enforce any of these rules, these rules can only be effective if the rating agencies choose to adopt them.

E. Conclusion

At this stage of the subprime crisis, it is clear that at least some regulatory response to the subprime mortgage crisis will focus on the credit rating agencies. Currently, most commentators are blaming the loan originators and mortgage brokers, and these seem most likely to bear the brunt of the regulatory response. However, the credit rating agencies clearly erred in providing defaulting products with AAA ratings. In its new draft of rules (pursuant to the 2006 Act), the SEC will likely institutionalize reputational damage by requiring agencies to make their track records public. Additionally, the SEC may pass rules requiring the rating agencies to adopt policies and procedures for managing any potential conflicts of interests. These changes should move the credit rating agencies closer to providing accurate and reliable ratings.

Mendy Piekarski¹⁰¹

⁹⁷ Hearing, *supra* note 5 (in response to Senator Reid's question).

⁹⁸ Media Release, *IOSCO Addresses Subprime Crisis*, (Feb. 6, 2008), available at <http://www.iosco.org/news/pdf/IOSCONEWS113.pdf>.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Student, Boston University School of Law (J.D. 2009).

IV. Valuing Opaque Assets in an Illiquid Market

Financial sector participants rely on a dynamic securities market, bolstered by facilitative data analysis, available asset information, and active buyers and sellers to set market prices. Entities such as investment banks value their own portfolios based on these prices. If a market mechanism falters, uncertainty in asset value causes a market freeze-up. This scenario is occurring in the US economy, as large investment banks are holding onto asset-backed collateralized debt obligations (“ABS CDOs”). These assets possess opaque price information and a small trading market, thus leading to reduced liquidity and valuation accuracy. When nationwide home prices dropped and the market saw higher than predicted default rates on subprime mortgages, the assets and investment instruments backed by these mortgages fell in value. Investment banks, otherwise financially sound, felt the effects of this drop on their own asset portfolios. The current “credit crisis” both stems in part from and contributes to this liquidity freeze. This article examines the causes, effects and possible legal ramifications of difficult-to-valuate asset portfolios for investment banks and the U.S. financial markets.

A. Definitions

Investment banks create and sell asset-backed securities (“ABSs”)¹ as a means of raising capital. These instruments give investors a claim to cash flows derived from the bundled rated assets that back the security. The backing assets can take any form, including bundled assets secured by residential mortgages (mortgage-backed securities, or MBS).² Once these assets are bundled together into sellable forms, banks often use instruments called collateralized debt obligations (CDOs) to separate out the securities by tranches and to pool together tranches with similar risk characteristics.³ Rating agencies label the individual tranches by risk,

¹ 17 C.F.R. § 229.1101(c)(1) (2007).

² The assets backing the securities are distinct from the securities held by investment banks. The issues of valuation and liquidity discussed throughout are refer to the securities on bank balance sheets which are backed by mortgages and other assets.

³Randall S. Kroszner, Governor, Fed. Reserve Bank, Remarks to the 2007 Credit Markets Symposium at the Charlotte Branch of the Federal Reserve

and the securities pay out revenues correlating to the risk and payoff preference of each investor.⁴

In addition to using CDOs to raise capital, investment banks also invest in mortgage-backed assets. These banks use structured investment vehicles (SIVs)⁵ to hold these mortgage-backed assets off their balance sheets, and use them to generate capital by issuing commercial paper.⁶ Banks use SIVs as investment tools to speculate that the long term rates of return on the investments will perform above the rates it pays to its creditors in the short term.

B. Causes of the Asset Valuation Problem

a. Securitization

The root causes of the asset valuation problem are simple in theory but formidable when aggregated. The valuation issue concerns a wide array of securities back by a myriad of assets, and securitization by investment banks only exacerbates the problem. In many cases investment banks use mortgages to back the ABS CDOs it creates, and the inherent value of the CDOs depends largely on the value of the underlying mortgages. Turning to the current market crisis, the housing market remained robust from 2001 to 2007, and prices stayed constant or increased through that time.⁷ The downturn came, however, when home prices began to decline in the third

Bank of Richmond, Charlotte, N.C. (Mar. 22, 2007), *available at* 2007 WL 1303869.

⁴ Alan Greenspan, Chairman, Fed. Reserve Bank, Risk Transfer and Financial Stability, Remarks to Federal Reserve Bank of Chicago, 41st conference on Bank Structures, Chicago, Ill. (May 5, 2005), *available at* 2005 WL 1078446 (F.R.B.).

⁵ Risk-Based Capital Guidelines, 69 Fed. Reg 44908, 44909, n. 1 (June 28, 2004) (defining SIVs as “entities that earn a spread by issuing commercial paper and medium-term notes and using the proceeds to purchase highly-rated debt securities”).

⁶ *Id.*

⁷ See S & P/Case-Shiller Home Price Indices, Nov. 27, 2007, *available at* http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html [hereinafter *Home Price Indices*].

quarter of 2007,⁸ lowering the value of the secured mortgages forming a part of the MBSs.⁹

The market effects indicate that investment bankers did not prepare for the fall in housing prices during the securitization process or evaluation of the MBSs,¹⁰ and the market decline substantially affected those holding on to the assets.¹¹ Also responsible for this valuation error are the major credit rating agencies who incorrectly rated groups of the underlying mortgages during the securitization process, giving them very high ratings when their risk profile should have dictated otherwise.¹² As a consequence, the housing market downturn has forced many investment banks and other entities to cease any trading of assets with unstable prices.¹³ These asset owners likely feel more comfortable holding onto the assets while the market settles, rather than sell them at artificially low prices during fire drill sales. In hindsight, one can debate whether the optimism exemplified in the pricing and selling of these instruments stemmed from a good-faith believe in the continuing growth of the housing market or whether there was some failure of due diligence by investment bankers and analysts. The upshot is clear: these assets declined in value throughout 2007 and continue to do so.

Factoring heavily into the asset-valuation problem too is the fact that the securitization processes made these securitized assets difficult to understand, analyze, or value. Before securitization, investment bankers selected and grouped the underlying mortgages based on estimates of the risk of default and the desire to group

⁸ *Id.*

⁹ See "Slower Asset Growth Is Centered in Real Estate," FED. DEPOSIT INS. CORP., FDIC QUARTERLY BANKING PROFILE 3-4 (1st Quarter, 2007).

¹⁰ See Greg Ip, Mark Whitehouse and Aaron Lucchetti, *U.S. Mortgage Crisis Rivals S & L Meltdown*, WALL ST. J., Dec. 10, 2007, at A1 (examining market effects in both the financial and consumer market sectors).

¹¹ See Steve Schifferes, *Carnage on Wall Street as Good Loans Go Bad*, BBC NEWS, Nov. 13, 2007, <http://news.bbc.co.uk/1/hi/business/7086909.stm>.

¹² Stephen Labaton, *S.E.C. Inquiry Looks for Conflicts in Credit Rating* N.Y. TIMES, Sept. 27, 2007.

¹³ Jody Shenn, *CDO Market Is Almost Frozen*, JP Morgan, Merrill Say, BLOOMBERG NEWS, Feb. 5, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aCk0Qr1f2Eew>.

similar sources of revenue together to suit investor preferences.¹⁴ Valuation processes would normally give discriminating investors a supposedly accurate estimate of future cash flows based on risk profile.¹⁵ However, currently, securitizing the assets (many of them subprime mortgages), and placing them in world capital markets, adds to the intricate nature of the instruments and thus makes it more difficult to properly value them. Inaccurate credit ratings and overly complicated risk evaluation models have created instability in these securities' prices, which has stymied potential post-issuance transactions and cast an illiquid shadow over the entire ABS market as a result.¹⁶

With so many independent variables affecting them, asset-valuation has become suspect. Investment banks invested in the CDOs they originally created (through SIVs); but other buyers have proceeded with caution because they could not themselves accurately determine a fair value for the assets.¹⁷ In addition to uncertainty in valuation, subsequent events (the housing market downturn, high default rates and general economic slowdown) have chilled the growth of a liquid market for the securities.¹⁸ A large and active

¹⁴ See Ben Bernanke, Chairman, Fed. Reserve Bank, Financial Markets, the Economic Outlook, and Monetary Policy, remarks given at the Women in Housing and Finance and Exchequer Joint Luncheon, Washington, D.C. (Jan. 10, 2008), available at www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm [hereinafter *Bernanke speech*] (stating that the process of grouping and securitizing mortgages involved divisions of "portions, or tranches, of varying seniority and credit quality . . . which could be matched to the needs of ultimate investors.").

¹⁵ *Id.*

¹⁶ *Id.* (discussing investors who "rel[ie]d heavily on the evaluations of these products by credit-rating agencies" and the effects of inaccurate ratings on investor behavior).

¹⁷ *Id.* (explaining the various reasons investors were reluctant to hold onto ABSs issued by banks, forcing the banks to use SIVs that issued commercial paper to hold the assets); see also Manmohan Singh and Mustafa Saiyid, *IMF Survey: Credit Market Turmoil Makes Valuation Key*, International Monetary Fund (Jan. 15, 2008), available at <http://imf.org/external/pubs/ft/survey/so/2008/res0115a.htm> [hereinafter *IMF Survey*] ("[The complexity of the cash flow seniority scheme] according to deal-specific rules made it difficult and time-consuming for many investors to model these securities independently.").

¹⁸ See Center for Audit Quality, "Measurements for Fair Value in Illiquid (or Less Liquid) Markets," at 1 (included in Center for Audit Quality, *CAQ Issues White Papers on Illiquidity in the Markets* (CAQ Alert #2007-51)

trading market no longer exists for these state-of-the-art ABS CDOs, and the assets have remained in place as their value is now suspect and they are viewed as more risky investments. On an individual company basis, the fact that a small number of major financial players hold a large amount of these assets on their balance sheets means that they are feeling the sting even more as the liquidity crisis continues.¹⁹ Furthermore, the major banks holding onto these assets in some instances are not properly diversified, which effectively increases the magnitude of the liquidity disturbance on their cash flow and operations.²⁰

b. Defaulting Mortgages

At the consumer level, mortgage payments increased substantially for some borrowers holding adjustable-rate mortgages, or ARMs.²¹ ARMs often use a low “teaser rate” for an introductory period, which then increases to a rate set to some external indicator plus a “margin.”²² Consequently, some borrowers could not afford

(Oct. 3, 2007)) [hereinafter *CAQ Alert*] (“As a result of the uncertainty in the market place arising from current conditions, investors and lenders have largely retreated from investments in assets backed by subprime mortgages, creating a co-called ‘liquidity crisis.’”).

¹⁹ See Carrick Mollenkamp and David Reilly, *Why Citi Struggles to Tally Losses*, WALL ST. J., Nov. 5, 2007, at C1.

²⁰ For an example of such a scenario playing out in the hedge fund context and the ramifications for Wall Street, see *infra* notes 48 to 50 and accompanying text.

²¹ See Dr. Faten Sobry and Dr. Thomas Schopfloch (Practising Law Institute), *The Subprime Meltdown: A Primer*, 1633 PLI/Corp 89, 98-99 (June 21, 2007) [hereinafter *2007 PLI Primer*]. This situation is exacerbated if the value of the securing asset (the house) drops.

²² Declining home value and rising payments can combine such that a borrower owes more on a mortgage than the value of the home itself. This situation is commonly called being “upside-down” and can lead to a set of perverse incentives for borrowers. Most apparent would be the incentive to default on the payments and lose only the value of the home in foreclosure while keeping the current and future income that would otherwise be devoted to mortgage payments. Anecdotal evidence exists, but no complete statistical data exists as of this time regarding the number of borrowers who face or have faced this choice due to the recent market downturn. For a basic discussion of the issue, see Bob Irvy, *Subprime Borrowers to Lose Homes at Record Pace as Rates Rise*, BLOOMBERG NEWS (Sept. 19, 2007), available at

these higher mortgage obligations after their interest rates re-set to a higher rate.²³ As homeowners have been defaulting at higher levels, lenders are feeling the sting of loan default and are consequently reining in their lending policies in order to limit risk exposure.²⁴ Consumers currently find it difficult to acquire loans to maintain current debt obligations and to bolster short-term spending and debt-servicing needs, thereby increasing default rates.²⁵

Borrowers in the financial markets also face lenders' reticence. Some hedge funds and SIVs find themselves without the capital to make planned market investments due to scarce available credit.²⁶ With a capital structure that relies on commercial paper issuances, SIVs in particular need inexpensive credit to profit from the spread between short- and long-term CDOs. SIV fund managers find themselves unable to cover positions if one "side" of the spread fails due to a failure of the asset (the mortgage) backing the security, and no other channels of liquidity exist.²⁷ Investment banks and others therefore have not been able to finance the purchase of CDOs, and the paucity of arms-length transactions has prevented an accurate "market price" for the assets from materializing.²⁸ Liquidity problems due to market failure represent a classic "positive feedback loop" from which all roads lead to asset valuation difficulties.

<http://www.bloomberg.com/apps/news?pid=20601103&sid=akOEPec30TR4&refer=us>.

²³ See 2007 PLI Primer, *supra* note 21, at 99-100.

²⁴ Sudeep Reddy, *Lenders to Home Buyers to Tighten Further*, WALL ST. J., Nov. 7, 2007, at A2.

²⁵ See CAQ Alert, *supra* note 18, at 1 ("Lenders that are still making loans have significantly tightened their underwriting standards, making it more difficult for existing borrowers to refinance.").

²⁶ See generally *The Effects of the Credit Crunch on SIVs and Hedge Funds*, WHITE AND CASE LLP NEWS: TALKING. . . , (Dec. 18, 2007) available at https://www.whitecase.com/talking_12182007/.

²⁷ See statement by Stephen Phillips, Partner, White and Case LLP, *id.* (observing that for SIVs, "the short-term asset-backed commercial paper market effectively seized up, cutting off their incoming cash flow supply, and secondly, many were forced to sell assets to maintain their leverage within pre-set levels when the net asset value of the portfolios declined.") This forced sale of assets would likely be more difficult in an illiquid market.

²⁸ Shenn, *supra* note 13

c. Lack of Dependable Pricing Models

The lack of a dependable pricing model most materially affects the liquidity and pricing of assets. Asset owners use three different methods of valuation based upon the nature of the asset being examined: mark-to-market, mark-to-matrix, and mark-to-model. A mark-to-market scheme requires a large market for “actively traded, identical assets” and the ability to acquire pricing information quickly.²⁹ Mark-to-matrix schemes use pricing information created by analyzing similar assets in large markets to price “less actively traded assets,” including some ABSs.³⁰ Mark-to-model valuation reduces to the best estimation of value by the holder based on its own analytical methodology.³¹ This model applies to non-liquid assets such as certain tranches of CDOs.³² The mark-to-model method has been referred to derogatively as “mark to myth,”³³ because it provides the least definitive measure of value for market transactions. This is not to say that the value derived is always wrong or the result of fraud. The problem lies in the inability to have independent auditing of the valuation method, coupled with the high degree of managerial discretion imputed to the selection of the models used.³⁴ To a lesser extent, the “mark-to-matrix” method faces similar valuation difficulties. The use of the marking to model leads to distrust by potential buyers in the value assigned to assets which impedes market transactions.

d. Effects on the Market

The summer of 2007 saw the burden that these complex and difficult-to-mark assets placed on investment banks materialize. In response to investor concerns that balance sheets were not accurately portraying the value of companies, the Financial Accounting

²⁹ IMF Survey, *supra* note 17

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ Susan Pulliam, Randall Smith and Michael Siconolfi, *U.S. Investors Face an Age of Murky Pricing*, WALL ST. J., Oct. 12, 2007, at A1 (quoting Warren Buffet).

³⁴ See Jim Chanos, *Short-Lived Lessons—From an Enron Short*, WALL ST. J., May 30, 2006, at A14 (discussing the role mark-to-model valuation had in the corporate looting of Enron by its management).

Standards Board (FASB) established three separate “levels” of assets for valuation purposes based on the liquidity of markets in which they trade.³⁵ MBS CDOs fall under Level 3 through the use of “mark- to-model” valuation procedures.³⁶ Level 3 status indicates three things: (1) the price inputs are unobservable; (2) management assumptions drive the valuation process; and (3) no liquid market exists with which to value the asset.³⁷ Banks now must state in their financial reports that certain assets cannot be priced on a broad, fluid market and no other reliable pricing method exists.³⁸

In compliance with FASB regulations, asset owners began shifting assets from Level 2 to Level 3 in their financial reports and SEC filings, indicating a lack of information and a liquid market in which to trade and value.³⁹ Some analysts see this as a less

³⁵ FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards 157, p. 25-30 (Fin. Accounting Standards Bd., Sept. 2006), *available at* <http://fasb.org/pdf/fas157.pdf>. This FASB statement establishes three tiers of assets for accounting purposes and SEC reporting. Level 1 assets use pricing inputs that are “quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.” Level 2 assets use “inputs other than quoted prices included in Level 1 that are observable for the asset. . . , either directly or indirectly through corroboration with observed market data. . . .”

³⁶ See David Reilly, *Marking Down Wall Street*, WALL. ST. J., Sept. 14, 2007, at C1 (discussing the potential effects the new accounting rules would have on major investment back balance sheets due to the large number of “mark to model” assets they carried at the time).

³⁷ See FAIR VALUE MEASUREMENTS, *supra* note 35.

³⁸ *Id.* Some banks use unfamiliar and possibly inaccurate indexes such as ABX to track CDO values with mixed results. ABX is an index used to measure the cost of insuring subprime mortgage bond through credit default swaps, presumably giving some indication of the value of the bond as an asset. See generally *Who's Profiting from the Subprime Bust*, BUSINESS WEEK ONLINE, Mar. 8, 2007, *available at* 2007 WLNR 4382010. USB recently started recognizing ABX's values as an indicator of value after previously stating that its use was limited and its accuracy was suspect. See Serena Ng, Carrick Mollenkamp, and Scott Patterson, *A Subprime Gauge, in Many Ways?*, WALL. ST. J., Dec. 12, 2007, at C1.

³⁹ See Morgan Stanley, Annual Report (Form 10-K), at 123-24 (2008) (“The Company reclassified certain Corporate and other debt and Net derivative contracts from Level 2 to Level 3 because certain significant inputs for the fair value measurement became unobservable. These reclassifications included transfers in the fourth quarter primarily related to the continued market and liquidity deterioration in the mortgage markets. The most

troublesome way to accomplish an asset write-down that indicates the same thing: the owner incorrectly estimated of the assets' values, and investors should be cognizant of a weaker asset portfolio.⁴⁰ Investment banks have colored their rhetoric to market analysts and investors by speaking of future opportunities and lessons learned from the past year. Specifically, fourth quarter earnings reports from 2007 acknowledge the disappointment in the need for write-downs of assets but look toward 2008 as having less risk exposure.⁴¹

Asset valuation issues affected balance sheets and investor returns substantially. In addition to moving assets from Level 2 to Level 3, investment banks recognized large asset write-downs,⁴² which received a huge amount of publicity in the financial media.⁴³ Citigroup took a \$17.4 billion write-down in the final quarter of

material transfers into Level 3 were in commercial whole loans, residuals from residential securitizations, and interest-only commercial mortgage and agency bonds as well as commercial and residential credit default swaps.”). *See also* John Glover, *Banks Face \$100 Billion of Write-downs on Level 3 Rule*, BLOOMBERG NEWS, Nov. 7, 2007, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=ap42s_XrP58Q&refer=home (predicting \$100 billion in revaluation under FASB new rules to level 3 status and conflating this process with an asset write-down).

⁴⁰ *See* Glover, *id.*

⁴¹ *See* Citibank Report, *supra* note 44 (quoting Vikram Pandit, Chief Executive Officer: “Our financial results this quarter are clearly unacceptable. . . . [However,] [w]e have a unique franchise that is well positioned in growing markets with tremendous capabilities to serve clients around the world.”).

⁴² An asset write-down follows recognition that the asset's value is impaired in some manner. In financial accounting terms, a write-down, or reduction, of an asset's value on the balance sheet must be matched by a decrease in liabilities or owner's equity. The mechanics of the accounting procedure includes the recognition of an expense on the firm's income statement in the amount of the write-down. This reduces retained earnings on the balance sheet that follows the income statement period. As retained earnings are a species of “owner's equity,” the balance sheet stays in balance with the firm's (and therefore investors') value being reduced. *See* PETER EASTON, JOHN WILD, ROBERT HALSEY, AND MARY LEA MACNALLY, *FINANCIAL ACCOUNTING FOR MBAS*, § 6:31-33 (Cambridge Business Publishers 3rd ed. 2008).

⁴³ For a sampling of recent media coverage, see Mollenkamp and Reilly, *supra* note 19; Pulliam et al., *supra* note 33; Reilly, *supra* note 36.

2007⁴⁴ and adjusted the asset portfolios of itself and its seven SIVs, taking on some \$49 billion in assets onto its own books.⁴⁵ Merrill Lynch and Morgan Stanley posted record write-downs of \$11.5 billion⁴⁶ and \$9.4 billion⁴⁷, respectively. In August of 2007, Bear Stearns announced the closing of two hedge funds trading heavily in mortgaged-backed CDOs, which sent pangs through the market.⁴⁸ The first quarter of 2008 saw the stakes rise significantly as Bear Stearns collapsed from a solvent investment bank to fire-sale fodder. Wall Street's fifth largest investment bank experienced a classic "run" on its cash reserves due to fears of its inability to back the obligations attached to its ABS CDOs and fears that it was heading towards bankruptcy.⁴⁹ The Federal Reserve, acting to prevent a precipitous domino effect causing bank failures elsewhere, financed a short-term loan to the bank which eventually became the funding for a purchase of Bear Stearns by J.P. Morgan Chase & Co.⁵⁰

C. *The Future*

Several regulatory and legal issues will need attention in the coming months. The role of the federal government and the Federal

⁴⁴ CITIGROUP, 2007 FOURTH QUARTER AND YEAR-END REPORT (Jan. 15, 2008) [hereinafter *Citigroup Report*].

⁴⁵ Robin Sidel, David Reilly and David Enrich, *Citigroup Alters Course, Bails Out Affiliated Funds*, WALL. ST. J., Dec. 14, 2007, at A1.

⁴⁶ MERRILL LYNCH, 2007 SUMMARY ANNURAL REPORT, (Jan. 17, 2008) [hereinafter *Merrill Report*].

⁴⁷ MORGAN STANLEY, 2007 FOURTH QUARTER AND YEAR-END REPORT (Dec. 19, 2007) [hereinafter *Morgan Report*].

⁴⁸ Kate Kelly, Liam Plevin & James R. Hagerty, *Bear Stearns Hit Again By Investors Fleeing Mortgage Sector*, WALL. ST. J., Aug. 1, 2007 at. A1; see also Press Release, Bear Stearns, "Bear Stearns Provides Update on BSAM Structured Credit Strategies Funds," June 26, 2007, available at http://www.bearstearns.com/sitewide/our_firm/press_releases/content.htm?d=06_26_2007.

⁴⁹ See Greg Ip, *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis*, WALL. ST. J., Mar. 17 2008, at A1.

⁵⁰ The Federal Reserve's loans to J.P. Morgan were in fact secured "solely by difficult-to-value assets inherited from Bear Stearns." *Id.* The low price given for Bear Stearns (initially \$2 a share) can be contributed to the inability to value the securing assets which were being purchased in the deal. The deal also injected liquidity into the asset market due even if at low value levels. *Id.*

Reserve Bank has yet to be fully outlined beyond the Fed's facilitation of open market transactions and regulation of interest rates.⁵¹ The SEC's role is equally being defined as it serves an investigatory function by delving into the processes used by investment banks to value their assets. In recent developments, UBS faces investigation for firing a hedge fund manager for reducing the value of assets in opposition to its own estimates,⁵² and Merrill Lynch faces a similar SEC investigation.⁵³ The FBI and the U.S. District Attorney in New York opened investigations against Merrill Lynch and UBS in connection with the same allegations the SEC is pursuing.⁵⁴

Courts also may be forced to deal with fallout from the process leading up to, and the execution of, the securitization and investment of these CDOs.⁵⁵ Whether any of these lawsuits will stem directly from the asset valuation problem remains to be seen. Plaintiffs have already claimed that the underwriters and ratings agencies committed fraud in the formation of difficult-to-value assets.⁵⁶ Other claims have been brought against the various actors

⁵¹ See Bernanke speech, *supra* note 14 (discussing the monetary policies maneuvers taken by the Federal Reserve, including lowering the discount rate, but also warning that “. . . in light of recent changes in the outlook for and the risks to growth, additional policy easing may well be necessary” to encourage the growth of liquid markets). If banks can borrow money cheaply from the Federal Reserve through the discount window, any “credit crunch” may be mitigated and access to ready funds would not serve as a barrier to asset liquidity.

⁵² See Kara Scannell, Anita Raghavan and Amir Efrati, *The Subprime Cleanup Intensifies*, WALL ST. J. Feb 2, 2008 at B1 (citing authorities as “investigating whether USB AG misled investors by booking inflated prices of mortgage bonds it held despite knowledge that the valuations had dropped”); Pulliam et al., *supra* note 33.

⁵³ Amir Efrati, Susan Pulliam, Kara Scannell and Craig Karmin, *Prosecutors Widen Probe Into Subprime*, WALL ST. J., Feb. 8, 2008, at C1 (discussing that among the regulators' goals is to find determine if the Merrill Lynch “booked inflated prices of mortgage bonds it held despite knowledge that the valuations had dropped”).

⁵⁴ Evan Perez and Kara Scannell, *FBI Launches Subprime Probe*, WALL ST. J. Jan 30th 2008 (discussing Merrill Lynch); see also Scannell et al., *supra* note 52 (discussing USB).

⁵⁵ See 2007 PLI Primer, *supra* note 55, at 92.

⁵⁶ *In re First Alliance Mortg. Co.*, 471 F.3d 977 (9th Cir. 2006)

up and down the asset-formation chain.⁵⁷ However, the lack of an accurate valuation measure, through market mechanics or other means, may not in itself suffice for claims of fraud or breach. Had the investment banks colluded with or coerced the rating agencies to intentionally make the instruments difficult to comprehend and rated the instruments above their actual risk profile, a completely different list of regulatory and legal issues comes to the surface. However, proving this is a difficult task indeed, and plaintiffs likely face an uphill battle in prevailing on fraud claims.

D. Conclusion

Prior to the subprime crisis and credit crunch, U.S. capital markets seem to have taken accurate asset pricing and liquidity for granted. The two concepts, though, are intertwined, for the failure of one begets the failure of the other. The happenings in the In ABS CDOS has made it apparent that accurate asset-pricing and liquidity are of paramount importance to sound investment environment and a stable market. The subprime crisis has precipitated a world of worry about proper asset-valuation, and one of the biggest problems the market has faced has been the apathy of banks and asset-holders simply not knowing exactly they owned. The growing uncertainty in the market caused banks to exercise caution in lending money, and they subsequently sat on their hard-to-value, hard-to-sell assets, waiting for some indication of value to materialize. In the meantime, the market freeze-up that has accompanied the subprime crisis will continue to provide challenges for financial institutions, regulators, and economists, as they all search for ways to provide more certainty and transparency to asset-valuation in the future.

William Collins⁵⁸

⁵⁷ See generally 2007 PLI Primer, *supra* note 55 (discussing the services and possible legal fault various entity types had in the Abs formation process).

⁵⁸ Student, Boston University School of Law (J.D. 2009).

V. *The Credit Crunch: Causes and Impact*

The effects of the subprime mortgage collapse have not been confined to the housing sector, and have instead been felt throughout the global economy. Because many subprime mortgages were securitized and sold many times over, the risk of foreclosure associated with these mortgages likewise was distributed widely throughout the market.¹ All debt instruments that contain subprime loans are now viewed with great suspicion, which is problematic because financial institutions, as well as corporations, often offer these debt instruments as collateral to obtain credit.² Currently, banks and other investors are reluctant to accept as collateral any asset that contains subprime mortgages since the futures of many of these mortgages are in jeopardy.³ This skepticism is warranted, since many of the subprime mortgages contain adjustable rates, and each upward adjustment to the interest rate has the potential to produce a flood of defaults. The result is a reduction in the availability of credit.⁴ The consequence is that there is less available credit for financing purposes.

Money center banks and large financial institutions have experienced an additional set of problems related to the subprime mortgage fallout. These institutions hold a large number of subprime mortgages on their balance sheets, but the secondary market for these assets has largely vanished.⁵ As the value of subprime mortgages declined, banks started to report large losses, and their share prices dropped to reflect these developments.⁶ Additionally, as capital eroded, banks naturally had to be cautious with their lending activity.⁷ According to Federal Reserve Chairman Ben Bernanke: "The combination of larger balance sheets and unexpected losses prompted banks to become protective of their liquidity and balance sheet capacity and thus to become less willing to provide funding to

¹ Ben Bernanke, Chairman, Board of Governors of Federal Reserve, Address at the Women in Housing and Finance and Exchequer Club Joint Luncheon (Jan. 10, 2008), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm>.

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

other market participants, including other banks.”⁸ Banks have also raised credit standards for firms and households that are seeking loans.⁹ This may be due in part to the decreased creditworthiness of borrowers as the economy slows down.

Furthermore, companies have experienced difficulty obtaining credit through commercial paper, a common alternative to bank loans.¹⁰ Commercial paper provides a great deal of short-term credit for companies, which allows them more flexibility in meeting their financial needs. However, since these short-term loans are often secured by mortgage assets, the risks in the current housing market make investors reluctant to purchase these offerings.¹¹ Statistics show that there was a 25% reduction in the amount of commercial paper issued between August 8, 2007 and October 18, 2007.¹² The reduction in this vital source of credit will almost certainly cause many businesses to delay or eliminate plans for growth.

Naturally, every downturn in the housing market exacerbates the problems that stem from subprime mortgages being bundled with other assets. Growth of the global economy has therefore become connected to the rate at which recent subprime mortgages have been in default. In particular, the reduced availability of credit has the potential to prevent good business opportunities from going forward. This paper will examine the present state of the credit crunch, what the U.S. Government and Federal Reserve are doing in response, and the outlook for the near future.

A. Current State of the Credit Crunch: Where Will the Money Come From?

A major economic concern that regulators must deal with is how creditworthy borrowers—both corporate and consumer—will continue to obtain funds for productive activities. Answering this question requires an examination of the current state of the credit market, and how firms are dealing with the credit crunch.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Neil Unmack, *Rhinebridge Commercial Paper SIV May Not Repay Debt*, BLOOMBERG.COM, Oct. 18, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aEacPeg9pmlg&refer=home>.

A Federal Reserve survey of senior loan officers in January 2008, confirms that banks are tightening lending standards for a broad range of loan types.¹³ Banks are pulling back on real estate loans in particular, as a greater percentage of loan officers reported raising standards for these loans now compared with the tightening standards witnessed in the savings and loan crisis of the early 1990's.¹⁴ However, cutting against this survey data are reports that the total value of commercial, consumer, and real estate loans is currently at an all time high and on an upward trajectory.¹⁵ If this data accurately represents the loan market, it is not easy to reconcile how bank officers can be reporting tighter credit standards while granting more loans than ever before. One explanation would be that although banks have tightened credit standards, the availability of credit is still reasonable and increased consumer demand has sustained high levels of loan activity. Another possible explanation is that the inability of companies to raise credit from the sale of commercial paper has forced them to rely more heavily on banks, despite higher interest rates. The later explanation would still be consistent with a general reduction in the availability of credit.

For companies that cannot obtain loans or sell commercial paper, the options for raising funds are less attractive. Certain companies may decide to withhold dividends to keep more cash on hand, effectively borrowing from its shareholders.¹⁶ Alternatively, companies can sell off assets to raise money, and may be forced to do so even though they would choose not to if credit was more readily available.¹⁷ Former Federal Reserve chairman Alan Greenspan recently remarked that high cash reserves have greatly reduced the negative impact of the credit crunch on businesses.¹⁸ This, however,

¹³ Board of Governors of the Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices, (Jan. 2008), *available at* <http://federalreserve.gov/boarddocs/SnLoanSurvey/200801/default.htm>.

¹⁴ *Id.*

¹⁵ Board of Governors of the Federal Reserve, Commercial and Industrial Loans of Weekly Reporting Large Commercial Banks, (2008), *available at* <http://research.stlouisfed.org/fred2/series/CIBOARD>.

¹⁶ Ben Steverman, *Thornburg Braces for Tough Times Ahead*, BUSINESSWEEK, Oct. 17, 2007, *available at* http://www.businessweek.com/investor/content/oct2007/pi20071017_695086.htm?campaign_id=yahoo.

¹⁷ Bernanke, *supra* note 1.

¹⁸ John Porretto, *Economy 'on the Edge' of Recession, Greenspan Says*, USA TODAY, Feb. 13, 2008, *available at*

is only a temporary solution and problems will emerge if the credit crunch outlasts businesses' cash reserves.

Some companies are finding success obtaining credit through less mainstream markets. For example, the European medium-term note (MTN) market has been more active during the credit crunch.¹⁹ This market matches individual investors with corporations for the purchase of bonds at specifically tailored exposure levels.²⁰ The structure of the debt can vary wildly, as almost any currency can be used, and the terms can range from 6 months to 50 years.²¹ However, the MTN market does not fulfill the credit needs of all industries. Since the investors themselves seek out the firms to which they are comfortable lending, many firms may not be attractive candidates for these loans.

There are also ways in which companies differ in their ability to obtain funds during this credit crunch. According to William Dunkelberg, chief economist for the National Association of Independent Businesses, companies that borrow from small local banks may still be able to obtain credit fairly easily if these banks have stayed away from subprime mortgage lending.²² These banks should not have the same balance sheet concerns as banks that hold subprime mortgages, thus they can continue to lend at normal rates. In the corporate world, asset-heavy industries are having an easier time obtaining credit than other industries, particularly in the service sector, because they can offer more reliable collateral.²³

B. How the Credit Crunch is Impacting Individual Borrowers and Consumer Spending

The credit crunch is also having a discernable impact on individual consumers. Consumer credit and spending are important

http://www.usatoday.com/money/economy/2008-02-15-greenspan-recession_N.htm.

¹⁹ Paul J. Davies, *Silver Lining Emerges from Credit Crisis*, FINANCIAL TIMES, Feb. 18, 2008, available at <http://www.ft.com/cms/s/0/56c01174-de47-11dc-9de3-0000779fd2ac.html>.

²⁰ *Id.*

²¹ *Id.*

²² Keith Girard, *Credit Crunch Sweeps Main Street Like Pernicious Virus*, ALLBUSINESS.COM, Feb. 5, 2008, available at <http://www.allbusiness.com/economy-economic-indicators/economic-conditions-recession/6630854-1.html>.

²³ *Id.*

indicators of economic stability, and it is important to understand the impact of the credit crunch on these two areas. Individual borrowers are having a more difficult time obtaining credit. Predictably, many banks have cut off lending to subprime borrowers entirely.²⁴ While a more cautious approach to lending is welcome, it has its drawbacks, as subprime loans allowed low income families to purchase homes and were also profitable assets for banks when loans were made to the right borrowers.²⁵ But it is not just individuals with substandard credit that are having difficulty obtaining home loans, as credit standards for mortgages have risen even for consumers with average and above-average credit.²⁶

Almost all individual consumers are also experiencing a shortfall of available credit in some fashion. In particular, credit card interest rates are increasing as companies try to recoup losses from subprime loans.²⁷ Even individuals with outstanding credit could experience higher credit card rates and fees, as well as reduced credit lines, according to Curtis Arnold, founder of Cardratings.com.²⁸ Credit bureau TransUnion is now recommending that consumers have a credit score of 680 or higher to receive prime rates on credit cards, up from the typical standard of 650.²⁹

A potential consequence of credit becoming scarce is that consumers will reduce their spending activity, which will tilt the economy further toward recession. The latest data from the Reuters/University of Michigan Surveys of Consumers index of consumer sentiment shows a sharp drop in consumer confidence from January 2008 to February 2008.³⁰ Survey director Richard Curtin remarked that "the sentiment index has only been this low during the recessions of the mid 1970s, the early 1980s, and the early 1990s."³¹ Surprisingly, though, retail sales have remained at

²⁴ Bernanke, *supra* note 1.

²⁵ *Id.*

²⁶ Senior Loan Officer Opinion Survey on Bank Lending Practices, *supra* note 13.

²⁷ Kathy Chu, *Housing Woes Have Domino Effect*, USA TODAY, Oct. 24, 2007, available at http://www.usatoday.com/money/economy/2007-11-25-credit-crunch_N.htm.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Consumer Confidence Plunges*, Reuters, Feb. 15, 2008, available at <http://www.reuters.com/article/businessNews/idUSN155402520080215>.

³¹ *Id.*

consistent levels through the early part of 2008.³² This could be a good harbinger for the economy if it indicates that consumers are still willing to spend despite having lower confidence.

As the conflicting reports indicate, it is probably too early to tell whether consumers will be deterred by the downturn in the economy. Adding to the uncertainty is the upcoming economic stimulus package approved by Congress, which was designed to boost consumer spending.³³ As the next section will discuss, the effectiveness of the stimulus bill and other government action will play a major role in whether or not the economy slips into recession.

C. Congress' Answer to the Credit Crunch and the Fear of Recession

On February 13th, 2008, President Bush signed into law a \$168 billion economic stimulus package that provides \$300 to \$1,200 rebates to households.³⁴ The stimulus package is intended to encourage consumer spending, which will help ward off a recession,³⁵ yet whether it will achieve this goal is uncertain. An Associate Press-Ipsos poll of taxpayers found that 45 percent will use the rebate to pay bills, 32 percent will invest the money, and only 19 percent will spend it on market goods.³⁶ The bill has received at least one notable advocate, as Fed Chairman Ben Bernanke predicts that the stimulus will have a positive effect on consumer spending and that these positive effects will be felt by the July-September quarter or earlier.³⁷

In addition to stimulating consumer spending, the Bush administration has also recognized that halting foreclosures is a key to preventing a recession. Consequently, the administration has acted to help thousands of homeowners refinance their mortgages and keep

³² Press Release, U.S. Census Bureau, Advance Monthly Sales for Retail and Food Services, (Feb. 13 2008), available at http://www.census.gov/svsd/www/marts_current.html.

³³ Sue Kirchhoff, *Ailing Economy Gets Its Booster Shot*, USA TODAY, Feb. 13, 2008, http://www.usatoday.com/money/economy/2008-02-13-stimulus-effect_N.htm.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ Barbara Hagenbaugh, *Fed Chief Predicts U.S. Will Avoid a Recession*, USA TODAY, Feb. 13, 2008, http://www.usatoday.com/money/economy/2008-02-14-bernanke_N.htm.

their homes.³⁸ Under the *FHASecure* plan, the Federal Housing Administration will allow families that have strong credit and that have been making timely mortgage payments to qualify for refinancing to prevent foreclosure.³⁹ The Administration has also established an organization called HOPE NOW, which is an alliance between counselors, mortgage market participants, and mortgage servicers that aims to provide information and guidance to households with mortgage trouble.⁴⁰ Those at risk of foreclosure are encouraged to contact the HOPE NOW hotline and website for assistance.

D. Action by the Federal Reserve to Fix the Credit Crunch and Avoid Recession

The Federal Reserve has taken a number of steps to alleviate the pressure of the credit crunch and to ensure that the economy returns to a healthy status. In an attempt to assist short-term money markets, the Fed cut the discount rate—the rate at which it lends to banks—by 50 basis points, and it has maintained the spread between the discount rate and the federal funds rate at 50 basis points rather than the traditional 100 basis points.⁴¹ The Fed has also made borrowing at the discount window easier than in the past by providing financing for as long as thirty days, renewable at the request of the borrower.⁴² These changes in the policy of discount window lending were designed to give banks a standby source of liquidity.⁴³ Banks have subsequently increased their collateral with Reserve Banks, which indicates that the policy changes have effectively encouraged banks to rely on the Fed to free up credit.⁴⁴

The Fed has stated that it will closely monitor the economy to determine if further rate cuts are necessary.⁴⁵ Chairman Bernanke

³⁸ Press Release, Department of Housing and Urban Development, Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes (Aug. 31st, 2007) (on file with author).

³⁹ *Id.*

⁴⁰ Press Release, Department of Housing and Urban Development, HopeNow Alliance Created to Help Distressed Homeowners (Oct. 10, 2007) (on file with author).

⁴¹ Bernanke, *supra* note 1.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Hagenbaugh, *supra* note 37.

has stated that the Fed is looking for the rate cuts to stabilize the housing market, the job market, and the credit market.⁴⁶ A downturn in the availability and affordability of credit could harm the economy, so the Fed would be quick to cut rates further in this scenario.⁴⁷ But the Fed's ability to cut rates is closely tied to trends in inflation. As of January 2008, inflation expectations were not excessively high, which allowed the Fed to encourage economic growth by cutting rates.⁴⁸ But this relative period of stability can change quickly. In particular, an increase in oil prices has the ability to lift prices on other consumer goods, as seen last year.⁴⁹ The Fed's current strategy for dealing with the slowing economy assumes that inflation will remain in check, but any indication that inflation will rise in the future will require to the Fed to reassess how much emphasis it should place on economic growth versus fighting inflation.⁵⁰

In addition to making the discount window more accessible, the Fed has initiated a term auction facility ("TAF") which auctions off specific amounts of discount window credit.⁵¹ The purpose of the TAF is to ease some of the strain in the interbank lending market while avoiding some of the problems associated with manipulating the discount window.⁵² There are two main drawbacks to the discount window: first it can be stigmatizing to banks since it indicates private sources of funding are unavailable,⁵³ and second, if banks borrow more than expected, it lowers the federal funds rate below the target set by the Federal Open Market Committee, which requires the open market desk to drain reserves from the system.⁵⁴ So far, because of Federal Reserve advertising efforts and encouragement, there has been essentially no stigma attached to the TAF, and since the amount to be auctioned is set in advance, there is

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Bernanke, *supra* note 1.

⁴⁹ *Id.*

⁵⁰ Ben Bernanke, Chairman, Board of Governors of Federal Reserve, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Feb. 14, 2008), *available at* <http://www.federalreserve.gov/newsevents/testimony/bernanke20080214a.htm>.

⁵¹ Bernanke, *supra* note 1.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

little uncertainty about the impact on the federal funds rate.⁵⁵ In December, 2007, the Fed was able to auction \$40 billion through the TAF, and central banks from other countries held similar auctions in a coordinated effort to have the greatest impact on the global economy.⁵⁶ The results appear to be positive, as term premiums in the interbank market have gone down significantly, which means that credit is available at a cheaper price.⁵⁷ The Fed has indicated that it will continue to use TAF auctions until the pressure on short-term funding markets dissipates.⁵⁸

E. The Future of the Credit Market and Its Impact on the Economy

Though there is still a question of whether the economy is headed for recession, it is apparent that the current downturn will continue through this year. As explained earlier, the availability of credit is closely tied to the state of the housing market, and in March 2008 the economy will see a record \$100 billion of adjustable rate mortgages reset to higher rates, which will likely precipitate even more foreclosures.⁵⁹ The Fed has stated that it will cut interest rates further if credit continues to tighten,⁶⁰ but that may become more difficult if inflation also starts to rise.

In response to the yearly outlook, it remains to be seen how effective the legislation Congress has enacted and seeks to enact will be in warding off a recession. If Congress's plans are successful in preventing a significant number of foreclosures, perhaps the assets containing subprime mortgages will become stable enough again to use as security in credit transactions in the market. The recently approved tax rebates that are part of the stimulus plan may alleviate the woes of a struggling economy by boosting commerce, but the availability of credit remains the underlying problem since it prevents businesses from adequately financing their future growth projects.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Les Christie, *Mortgage Resets: A Rude Awakening*, CNNMONEY.COM, Oct. 17, 2007, available at http://money.cnn.com/2007/10/16/real_estate/October_resets/index.htm.

⁶⁰ Hagenbaugh, *supra* note 37.

There are mixed opinions among the nations top experts about whether the U.S. will actually experience a recession in the near future. Former Fed Chairman Alan Greenspan, for example, predicts that the economy will enter recession, while Current Fed Chairman Bernanke believes it will not.⁶¹ Regardless of who is correct, the indicators as of February 2008 do at least predict a further economic decline. Even if the economy does stop short of full recession, the bigger question of economic growth still remains. For the economy to return to economic growth in the future, credit will have to become cheaper and more readily available to businesses and consumers. Time will tell whether the current action by the Fed and Congress will be sufficient to achieve this goal.

John Mangones⁶²

⁶¹ *Id.*; Porretto, *supra* note 18.

⁶² Student, Boston University School of Law (J.D. 2009).

VI. The Subprime Crisis: A Breeding Ground for Litigation

In 2007, the market for securities backed by subprime mortgages unraveled as a record number of homeowners defaulted on their loans.¹ The result is what has been deemed the “subprime and credit crunch crisis.” As with any crisis, one of the first things people do is look for someone to place the blame. Unfortunately, due to the complex nature of the subprime mortgage market, those looking to point fingers face difficulty determining where to aim them. The result is a mess of litigation rivaling the subprime crisis itself. A few law firms have even found it necessary to create new “subprime” practice groups to deal with the growing mass of litigation.² This article will explore the plethora of subprime-related lawsuits being filed, and will provide an overview of the nature of the suits, profiles of the typical plaintiffs bringing the suits, the defendants targeted in such lawsuits, and the claims and arguments being litigated. Although to date most lawsuits are still in their preliminary stages, there are a few cases that have been decided. The dispositions of these cases are important indicators for judging how future courts will handle similar lawsuits still to come.

A. The Parties and their Claims

Virtually all actors involved in the subprime mortgage market have suffered some type of injury or loss. Those feeling particularly victimized by the industry are exploring their legal remedies.³ It did not take long for plaintiffs to realize that many of the companies responsible for creating the subprime mortgages have

¹ See generally Ben S. Bernanke, Chairman, Fed. Reserve Board, At the Women in Housing and Finance and Exchequer Club Joint Luncheon, Washington D.C. (Jan. 10, 2008).

² Lynne Marek, *Subprime Crash May Be a Boon to Attorneys*, NAT'L L.J., April 25, 2007 (“Pillsbury Winthrop Shaw Pittman announced last week that it has launched a new practice group focused on the legal issues surrounding the subprime mortgage market.”); *The Finger of Suspicion; In America and Elsewhere Trial Lawyers, State Prosecutors and Regulators Look for the Crime in Subprime*, ECONOMIST, Dec. 19, 2007 (“[L]aw firms have been rushing to set up dedicated subprime practices.”).

³ Marek, *supra* note 2.

filed for bankruptcy or are currently in bankruptcy.⁴ Therefore, the search for “deep pockets” is a top priority for everyone involved.⁵

a. Individual Homeowners and Borrowers

Leading up to the subprime crisis, adjustable rate mortgages (“ARM’s”) were being originated freely on the false premise that housing prices would rise forever.⁶ A continual rise in housing prices meant that homeowners could use the appreciation of their homes to refinance and escape the shockingly high interest rate re-sets of ARMs.⁷ When housing prices began to drop, however, borrowers could no longer rely on home value appreciation to build equity, and as a result, these borrowers did not have the option of refinancing as they originally planned.⁸ Unable to re-finance and without sufficient funds to make the monthly payments, many homeowners predictably defaulted on their loans.⁹ It is estimated that approximately twenty-one percent of borrowers with subprime ARM’s are currently delinquent ninety days or more.¹⁰ Burdened by mortgages with high interest rates and prepayment penalties,¹¹ many borrowers have come to find that the terms of their loan have essentially trapped them into a no-win situation, thus it comes as no surprise that homeowners feel betrayed by the industry and are flooding the courts seeking redress. Borrowers are bringing common law claims of fraud and breach of fiduciary duties, as well as statutory claims for violations of state and federal predatory lending laws. In recent years, several states have adopted predatory lending laws that coincide with the Truth in

⁴ Robert S. Friedman & Eric R. Wilson, *The Legal Fallout From the Subprime Crisis*, 124 BANKING L. J. 420, 425 (2007).

⁵ Stephen Joyce, *Mortgages: New Entities Seen as Plaintiffs, Targets as Subprime Lending Fallout Continues*, BUREAU OF NATIONAL AFFAIRS, (July 23, 2007) (“A key component that will drive future litigation streams, practitioners agreed, will be that plaintiffs will likely target well funded defendants.”).

⁶ Bernanke, *supra* note 1.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ Dr. Faten Sabry & Dr. Thomas Schopflocher, *The Subprime Meltdown: A Primer June 21, 2007*, in THE SUBPRIME MORTGAGE MELTDOWN: WHO, WHAT, WHERE, AND WHY . . . INVESTIGATIONS & LITIGATION, PRAC. L. INST., 89, 92 (June 21, 2007).

Lending Act (“TILA”) and more specifically with the Federal Home Owners Equity Protection Act (“HOEPA”), an amendment to TILA.¹² State predatory lending laws provide plaintiffs with an extra layer of protection as well as an additional avenue for bringing suit.

Four recent cases brought against various mortgage lenders are illustrative of typical plaintiff-borrower claims. The first involves common law claims of breach of fiduciary duty and constructive fraud. In *Stetler v. Greenpoint Mortgage Funding Inc.*, the plaintiff alleged that Greenpoint Mortgage failed to inform him of the details of the loan he was receiving and also improperly advised him that this particular type of loan was the “best deal” available to him.¹³ The court granted the defendant's motion for summary judgment, finding that the lender did not owe the borrower a fiduciary duty because the terms of the agreement explicitly stated the lender was not acting as the borrower's agent.¹⁴ The court also found no constructive fraud based on evidence showing the plaintiff had read and signed the loan documents, which clearly explained the features of the loan.¹⁵

In a second example, a borrower brought suit against Tribeca Lending Corporation alleging common law fraud. The borrower's complaint stated that the lender “induced her to enter into an unfavorable loan by promising to provide a new loan once certain future conditions were met.”¹⁶ The borrower conceded that she understood she was entering into an ARM, but claimed that she

¹² Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change*, 12 N.C. BANKING INST. 21, 24 -25 (2008) (explaining that prior to the subprime crisis “the only recognition of a suitability standard in the mortgage industry came from statutory imposition . . . HOEPA amended the Truth in Lending Act to include . . . the requirement that the lender must consider the borrower's ability to repay and not just look to the value of the collateral . . . As of 2007, anti-predatory lending statutes have been passed in over thirty different states and regulations in at least seventeen municipalities.”).

¹³ *Stetler v. Greenpoint Mortg. Funding Inc.*, 2008 WL 192405 (E.D. Cal. Jan. 23, 2008) (addressing claim that failure to inform that loan was reverse amortization loan or that interest payments were to increase).

¹⁴ *Id.* at 5-7.

¹⁵ *Id.* at 6.

¹⁶ *Haywood v. Tribeca Lending Corp.*, 2007 WL 2237290 (N.D. Miss. 2007) (addressing claim that unfulfilled promise to provide new loan once certain conditions were met).

would not have agreed to the loan if it had not been for an oral promise to provide her with a new loan at a later date.¹⁷ The court once again granted the mortgage lender's motion for summary judgment, finding that the borrower failed to prove the elements of either fraud or misrepresentation.¹⁸

Although these two cases paint a bleak picture for borrowers in subprime litigation, two other cases suggests that there may be hope for would-be plaintiffs. Recently, a Massachusetts homeowner filed a six-count complaint against Ameriquest Mortgage Company, alleging a mix of common law and statutory claims.¹⁹ In count one of her complaint, the borrower alleged that “Ameriquest's conduct violated TILA . . . because the Defendant loaned money after failing to verify her income and without regard to her ability to repay the loan.”²⁰ Count one also alleged that this same conduct by Ameriquest violated the Massachusetts Consumer Credit Cost Disclosure Act (“MCCCDCA”).²¹ The remaining counts of the complaint put forth common law claims of fraud, breach of contract, breach of fiduciary duty, and unjust enrichment.²² The Court ultimately dismissed the breach of contract, breach of fiduciary duty, and unjust enrichment claims, finding that there was insufficient evidence to survive the defendant's motion for summary judgment.²³ The borrower's claim under TILA was also dismissed, though, not because of insufficient evidence, but instead because certain fee thresholds and timing limitations were not met.²⁴ MCCCDCA, which is closely modeled after TILA in substance, does not have these same timing and fee

¹⁷ *Id.*

¹⁸ *Id.* at 3, 6 (“One may not reasonably rely on oral representations (negligent or fraudulent) which contradict the plain language of the documents she signs.”).

¹⁹ *In re Vincent*, 2008 WL 176065 (Bankr. D. Mass. Jan. 18, 2008) (alleging misconduct in connection with preparation of residential mortgage refinancing transaction).

²⁰ *Id.* at 2.

²¹ *Id.* at 5 (“The MCCCDCA was closely modeled on TILA . . . sometimes referred to as the ‘Massachusetts TILA’ . . . claims under MCCDA [sic] can arise from nondisclosures, inaccurate disclosures, and with respect to certain transactions, untimely disclosures . . . [W]ith respect to high interest loans . . . liability can also arise by certain affirmative acts.”).

²² *Id.* at 2.

²³ *Id.* at 7-8.

²⁴ *Id.* at 4.

requirements.²⁵ As a result, the court found the plaintiff-borrower may have a claim under MCCCDA and allowed her an opportunity to amend her complaint.²⁶ If she sufficiently alleges a claim under the Massachusetts predatory lending statute, the court noted she is also likely to succeed on her claim of fraud.²⁷

An additional case decided in favor of the plaintiff involves a first-time homebuyer in New York who appeared in court on a foreclosure action, only to argue his case as the victim of fraud. In *Lasalle Bank N.A. v. Shearon*, the borrower answered his lender's action with allegations that he was the victim of predatory lending and was induced into taking on two unfit loans for a single residence.²⁸ The court found the claims were sufficiently detailed to withstand the lender's motion for summary judgment, and furthermore found that the lender was in clear violation of at least three provisions of New York's Banking Law, which, like Federal Law, prohibits predatory lending practices.²⁹ The court granted plaintiff's motion for summary judgment, and scheduled a hearing to determine the damages to which the borrower is entitled.³⁰

This snapshot of plaintiffs' suits suggests that common law claims such as breach of fiduciary duty and fraud may have a difficult time surviving motions for summary judgment. Borrowers may find it easier to get past dismissal by alleging federal or state statutory violations, but these borrowers must be sure to file within the appropriate time limitations and make sure to provide detailed complaints that will fit within strict statutory guidelines.

b. Shareholders

Aside from harming borrowers, the subprime mortgage crisis has also taken its toll on shareholders across the nation, who are

²⁵ *Id.* at 5.

²⁶ *Id.* at 5-6.

²⁷ *Id.* at 7.

²⁸ *Lasalle Bank, N.A. v. Shearon*, 850 N.Y.S.2d 871 (2008).

²⁹ *Id.* at 877-78 (finding the lender violated New York Banking Law § 6-L(2)(k), which requires "due diligence" on the part of the lender to verify with "detailed documentation" the borrower's ability to repay the loan; 6-L(2)(l)(I), which requires a list of credit counselors to be provided to any borrower receiving a high cost loan; and 6-L(2)(m), which provides that no more than 3 percent of the amount financed can be used to pay the fees associated with closing the loan).

³⁰ *Id.* at 878.

feeling the effects from the plummeting values of the mortgage companies in which they are invested.³¹ Upset at the decline in their stock holdings, shareholders are alleging that mortgage companies failed to disclose the risks that executives knew or should have known were involved in investing in subprime loans.³² Shareholders are also claiming that management issued misleading information regarding the health of the mortgage companies.³³ For example, in a complaint against American Home Mortgage, shareholders alleged that the company's share price dropped over six dollars per share in a single day, yet the company subsequently issued statements that concealed this deterioration and falsely led investors to believe the company was in a healthy financial state.³⁴ A similar complaint filed against the mortgage company Countrywide Financial Corp., also alleges that poor financial result resulting from subprime loans were hidden from its shareholders, which eventually led to big losses for investors.³⁵

Not only are shareholders of lending companies bringing suit, but shareholders of the investment banks responsible for underwriting the pooled mortgages are bringing suit as well.³⁶ In a recent complaint filed against Merrill Lynch in the Southern District of New York, the plaintiff alleges that the investment bank failed to adequately disclose the extent to which it was exposed to subprime

³¹ Friedman & Wilson, *supra* note 4 at 422 (“Since then, the termination of funding and the dramatic increase in repurchase demands by warehouse lenders and loan purchasers, has resulted in severe liquidity crunches for a number of originators, leading to bankruptcy filings by some of the industry's biggest players....”).

³² Stephen Joyce, *Mortgages: Subprime Mortgage Court Cases Expanding; Public Firms, Banks, and Builders Targeted*, *Banking Daily Highlights*, BUREAU NAT'L AFFAIRS, INC. (Nov. 19, 2007).

³³ *Id.* (“Several of the cases alleged companies and their senior executives violated the Securities Exchange Act of 1934 by misleading investors about the health of their firms.”).

³⁴ *Id.*

³⁵ *Abrams v. Countrywide Financial Corp.*, No 07 CV-05432 (C.D. Cal.), *available at* http://securities.stanford.edu/1038/CFC_01/2007820_o01c_Abrams.pdf (alleging that as a result of the defendant's false statements, “Countrywide's stock price traded at inflated priced during the class period.”).

³⁶ Joyce, *Mortgages: Subprime Mortgage Court Cases Expanding*, *supra* note 32.

investments.³⁷ Individual directors and officers of Citigroup and AIG are also facing shareholder suits.³⁸ Both cases allege that officers breached their fiduciary duties by failing to minimize the companies' exposure to risk, and by also concealing the true state of the companies' financial health.³⁹

The latest shareholder suit and perhaps one of the biggest cases yet arises from J.P. Morgan's buyout of Bear Stearns. On March 25, 2008, the Greek Orthodox Archdiocese Foundation filed suit in New York alleging that misleading statements made by Bear Stearns's CEO led to artificially inflated stock prices.⁴⁰ The foundation purchased 50,000 shares of Bear Stearns's stock on the day the alleged misstatement was made.⁴¹ Four days later J.P. Morgan, backed by the Federal Reserve, made an offer to buy Bear Stearns for the incredible price of \$2 per share.⁴² Although the purchase price has since been raised to \$10 per share, this is still a far cry from the \$64.67 for which the Foundation purchased the stock.⁴³ This dramatic drop in stock value will undoubtedly lead to more angry shareholders heading to court. Just how much relief shareholders will find and from where relief will come are interesting questions that will be answered in the coming months.

c. Class-Actions

Approximately 270 federal securities class-action suits were filed between August and October of 2007.⁴⁴ This is more than double the number filed in all of 2006.⁴⁵

³⁷ *Id.*; Life Enrichment Found. v. Merrill Lynch & Co., No. 1:07-cv-09633 (S.D.N.Y. 2007).

³⁸ John P. Doherty, Esq., & Richard F. Hans, Esq., *The Changing Landscape of Subprime Litigation*, 4 No. 18 ANDREWS BANKR. LITIG. REP. 2, (Jan. 14, 2008).

³⁹ *Id.*

⁴⁰ Elizabeth Amon, *AIG, Exxon Mobile, Morgan Stanley, KPMG in Court News*, <http://www.bloomberg.com/apps/news?pid=20601203&sid=aJweQ7vehrac&refer=insurance> (last visited on April, 1 2008).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *The Finger of Suspicion*, *supra* note 2.

⁴⁵ *Id.*

1. Borrower Class-Actions

Adopting the same arguments as the individual borrowers discussed, *supra*, some borrowers are banding together to file class-action suits against subprime industry players. A prime example is a suit brought in the summer of 2007 against Wells Fargo & Co.⁴⁶ The class alleged that Wells Fargo failed to provide them with accurate information about their subprime loans.⁴⁷ Instead of facing the 32,100 plaintiffs at trial, Wells Fargo chose to admit no liability and settled for \$10 million, thus effectively ending the litigation before engaging in prolonged difficult litigation.⁴⁸ But a class-action decided only months later and involving very similar allegations against BNC Mortgage Inc.⁴⁹ may make Wells Fargo wish it had reconsidered. BNC's motion to dismiss was granted on the grounds that the complaint consisted of merely vague and conclusory allegations.⁵⁰ Despite the mixed result, though, many borrower class-action suits are still being filed,⁵¹ so it too early to tell whether companies will be successful in defending themselves against class suites, or whether they will face huge potential liability in such suits.

2. Pension Funds

In addition to borrower class-action suits, members of pension funds that were damaged from the subprime mortgage meltdown are joining the fray as well.⁵² A pension fund, like any investment fund, enters into the open market to obtain a return on investment. In the case of subprime investing, pensions funds were exposed to the same type of subprime mortgage risk that other

⁴⁶ *Mortgages: \$10 Million Class Settlement Approved Over Wells Fargo's Subprime Practices*, BUREAU OF NATIONAL AFFAIRS, (July 20, 2007).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Tribett v. BNC Mortg., Inc.*, 2008 WL 162755 (N.D. Ill. Jan. 17, 2008).

⁵⁰ *Id.* at 3,5 (finding allegations vague and conclusory, but allowing the Plaintiffs 21 days to file an amended complaint).

⁵¹ Sabry & Schopflocher, *supra* note 11 at 103 (listing several additional subprime related class action suits filed as of May 2007.)

⁵² Joyce, *Mortgages: Subprime Mortgage Court Cases Expanding*, *supra* note 32.

entities faced.⁵³ Members of funds that invested in securities backed by subprime loans are now alleging that fund managers breached their fiduciary duty under the Employment Retirement Income Security Act (“ERISA”).⁵⁴ ERISA requires that participants be provided with information about the retirement plan's features and also specifies four explicit fiduciary duties to which all individuals managing the plans must adhere.⁵⁵

In a recent ERISA case brought against Citigroup Inc., the class of current and former employees alleges that Citigroup knew or should have known the securities backed by subprime mortgages were no longer a good investment.⁵⁶ The complaint states that Citigroup “failed to take steps to eliminate or reduce the amount of company stock in the plans, and failed to give . . . the Class complete and accurate information about Citigroup's loan loss exposure”⁵⁷ In an additional ERISA case, *Prudential Retirement Insurance & Annuity Co. v. State Street Bank & Trust*, the retirement unit of Prudential is alleging that its investment manager, State Street Bank, breached its fiduciary duties by severely modifying the fund's investment strategy without Prudential's approval, and by providing misleading information and exposing the fund to unnecessary risk.⁵⁸ Prudential claims that State Street's imprudent activities have resulted in a loss of approximately \$80 million to their retirement plans.⁵⁹

Besides these two examples, the latest pension fund action arises out of the highly controversial buyout of Bear Stearns, discussed *supra*. Two pension funds from Michigan filed a motion in a Delaware Court seeking a temporary restraining order against the

⁵³ See generally Jeffrey Mamorsky and Jose Jara, *Subprime Mortgage Crisis Impacts ERISA Plan Investment in Employer Stock*, 24 No. 1 J. COMPENSATION & BENEFITS 2 (Jan/Feb 2008).

⁵⁴ *Id.*

⁵⁵ *Id.* at 4 (These four duties are: (1) exclusive purpose (managers have a strict duty of loyalty which limits the use of plan assets); (2) prudence (managers must act with the amount of care and skill of a prudent man in a similar situation); (3) diversification (managers must diversify plan investments so as to minimize risk); and (4) duty to follow the terms of the plan).

⁵⁶ Joyce, *Mortgages: Subprime Mortgage Court Cases Expanding*, *supra* note 32.

⁵⁷ *Id.*

⁵⁸ Doherty & Hans, *supra* note 38.

⁵⁹ *Id.*

proposed buyout.⁶⁰ The funds allege that the purchase price is “grossly inadequate” and that Bear Stearns and J.P. Morgan “anticipating shareholder disapproval . . . have devised an improper plan to buy the necessary votes from the company.”⁶¹ Wayne County Employees' Retirement System of Detroit, Michigan, has also filed suit against Bear Stearns and Bear's board of directors alleging breaches of fiduciary duties.⁶² ERISA litigation in general varies widely across jurisdictions and often turns on fact-specific inquiries.⁶³ Therefore, there is no reliable predication of what is to come from this current and ensuing ERISA litigation related to pension fund claims. However, pension funds are an important group of litigants to watch as the subprime litigation picture continues to unfold.

3. Cities and Community Groups

With climbing foreclosure rates, homes have been abandoned and entire neighborhoods have been negatively affected.⁶⁴ Some state officials are resorting to legal action and filing suits on behalf of their municipalities against Wall Street Banks for aiding in the proliferation of high-risk home loans that caused skyrocketing foreclosures.⁶⁵ Led by Mayor Frank Jackson, Cleveland, Ohio, has filed suit against twenty-one lenders, investment banks and other mortgage-related businesses.⁶⁶ The city is seeking hundreds of millions of dollars in damages it claims are needed to rebuild its community.⁶⁷ New York Attorney General, Andrew M. Cuomo, has also brought suit against The First American Corporation, claiming that First American made business decisions

⁶⁰ Robin Sidel & Kate Kelly, *Heard on the Street, Big Task: Digesting a Bear*, WALL ST. J., March 26, 2008 at C1.

⁶¹ *Id.*

⁶² *Id.*

⁶³ See generally ROBERT N. ECCLES, ET AL., *Fiduciary Litigation Under ERISA*, in PENSION PLAN INVESTMENTS 2007: CURRENT PERSPECTIVES, 762 PRAC. L. INST. 97 (May 3, 2007).

⁶⁴ Bernanke, *supra* note 1.

⁶⁵ See generally Christopher Maag, *Cleveland Sues 21 Lenders Over Subprime Mortgages*, N.Y. TIMES, Jan. 12, 2008 (“The financial crisis has hit Cleveland especially hard, with more than 7,000 foreclosures in each of the last two years . . . [e]ntire city blocks have been abandoned.”).

⁶⁶ *Id.*

⁶⁷ *Id.*

based on artificially inflated property values.⁶⁸ The Cuomo suit alleges that eAppraisalT, a subsidiary of First American Corporation, allowed Washington Mutual to hand-select appraisers who then inflated appraisals on homes.⁶⁹ Inflated housing prices are the start of a destructive chain reaction, which Cuomo claims led to the ever-growing numbers of foreclosures that are wreaking havoc on the state of New York.⁷⁰ The NAACP has also stepped up to protect subprime borrowers by filing a class-action suit against fourteen subprime lenders.⁷¹ The NAACP complaint alleges predatory lending and discrimination, claiming that African Americans were specifically targeted for subprime mortgages with predatory terms that unfairly took advantage of borrowers on the basis of race.⁷²

d. Financial Services Companies

In 2007 twenty-eight percent of all lawsuits filed in the United States were claims being brought against financial services firms—a huge leap from an average of only 12 percent in the years 1997 to 2006.⁷³ Although individual borrowers and class actions make up a large portion of these claims, a number of financial firms are bringing suits against one another.

⁶⁸ Press Release, Office of the New York State Attorney General Andrew M. Cuomo: NY Attorney General Sues First American and its Subsidiary for Conspiring with Washington Mutual to Inflate Estate Appraisals (Nov. 1, 2007) http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html.

⁶⁹ *Id.*

⁷⁰ *Id.* (underlying the complaint is the premise that price inflations force subprime borrowers into large ARM's; once the interest rates re-set on these mortgages the monthly payments become too massive for the borrower to handle and the end result is foreclosure).

⁷¹ Complaint, NAACP v. Ameriquest Mortg., et al, filed July 11, 2007, available at <http://www.naacp.org/get-involved/activism/alerts/110aa-2007-7-11/index.htm>.

⁷² *Id.* (“[T]he Center for Responsible Lending . . . found that even when income and credit risk were accounted for, African Americans were *still* 31% to 34% more likely to receive higher rate subprime loans, and that the disparities between them and Caucasians with the same risk factors were ‘large and statistically significant.’”).

⁷³ Anuj Ganghar, *Market Volatility Brings Class-Action Suits*, FIN. TIMES (Feb. 4, 2008).

1. Mortgage Underwriters

In the subprime mortgage market underwriters are the entities responsible for taking bundled mortgages and selling them off to investors.⁷⁴ The most common underwriters are large investment banks.⁷⁵ Various underwriters are bringing suits against mortgage originators to recover subprime losses. When a mortgage lender sells pools of subprime mortgages to an underwriter, the mortgages often come with a “repurchase agreement.”⁷⁶ This agreement requires a lender to repurchase mortgages that have defaulted within a set time period.⁷⁷ With the rise in delinquent loans, underwriters are filing breach of contract claims against lenders that refuse to comply with their re-purchase clauses.⁷⁸ Underwriters are also pursuing claims similar to those claims borrowers asserted against mortgage lenders, including allegations that the lenders failed to disclose the true risk involved in the subprime loans being sold, and that the lenders generally engaged in unsound business practices by inflating home appraisals while ignoring borrowers’ ability to repay the loans.⁷⁹ Whether underwriters are successful in repurchase agreement suits is likely to turn on the specificity of contract language; whereas claims of unsound business practices seem likely bound to meet the same obstacles that individual borrower's are experiencing in proving the elements of their common law fraud claims.

2. Mortgage Lenders/Originators

Mortgage lenders and originators are bringing their own lawsuits as the subprime mortgage crisis continues to play out. These entities are clearly the favorite targets for disgruntled plaintiffs because they are responsible for originating the subprime loans from the outset. With limited avenues available to protect themselves from

⁷⁴ Sabry & Schopflocher, *supra* note 11 at 96.

⁷⁵ *Id.*

⁷⁶ *Id.* at 97.

⁷⁷ *Id.*

⁷⁸ See Vikas Bajaj, *If Everyone's Finger-Pointing, Who's to Blame?*, N.Y. TIMES, Jan. 22, 2008 (stating that Lehman Brothers is demanding the buyback of various defaulted and other problematic loans that it claims lenders sold to them under tainted business practices).

⁷⁹ *Id.*

the onslaught of suits, mortgage lenders are turning on each other. Originators of subprime mortgages are claiming that they were damaged from purchasing pooled subprime mortgages from a fellow originator—mortgages that are now in default.⁸⁰ Lenders, as purchasers, are bringing breach of contract claims that rest on the same repurchase agreements discussed *supra*.⁸¹ Some lenders are also claiming that their fellow mortgage lenders are guilty of inflating property appraisals and providing false information on borrowers before transferring those loans over to them as unsuspecting buyers.⁸² Some industry experts even hypothesize that it will not be long before lenders begin attacking underwriters as well, for issuing improper margin calls that have forced lenders into bankruptcy.⁸³ Whatever the avenue for mortgage lenders advancing their claims, it is certain that they will look for some form of recovery to offset the massive potential liability they face from millions of angry borrowers on the frontline.

e. Other Possible Parties

Aside from the plaintiffs discussed so far, some industry professionals expect to see more obscure parties head to court after emerging from the subprime mess. An attorney from Dykema Gosset, a law firm headquartered in Detroit, Michigan, has predicted that we will see employees of failed subprime lending companies bring lawsuits seeking lost compensation.⁸⁴ Lending companies like Ameriquest Mortgage and Fremont General have announced enormous layoffs; while other lending companies are simply going

⁸⁰ *DLJ Mortg. Capital Inc. v. Cameron Financial Group Inc.* WL 4325893 (S.D.N.Y. 2007) (holding that the plaintiff's action seeking specific performance of a contract including a repurchase provision, survives the defendant's motion to dismiss for lack of personal jurisdiction and improper venue); *Oak Street Mortg. v. Fundz R Us, Inc.*, WL 1970890 (N.D. Ind. 2007) ("Plaintiff Oak Street Mortgage lost a substantial amount of money when it made loans secured by mortgages based on bogus loan applications, or so it claims in a complaint filed in this Court.").

⁸¹ *DLJ Mortg. Capital Inc.*, WL 4325893 at 2.

⁸² *Oak Street Mortg.*, WL 1970890 at 1 ("According to Oak Street's complaint, five of the loans that it made in 2003 were based on inflated real estate appraisals, false information about the borrowers, and incorrect or false information about the titles.").

⁸³ Sabry & Schopflocher, *supra* note 11 at 102.

⁸⁴ Marek, *supra* note 2.

out of business leaving thousands unemployed.⁸⁵ There is also a prediction that it will not be long until we see the "legal equivalent of man bites dog, where a lender sues its borrowers for some breach of contract."⁸⁶ Perhaps intended to be humorous, after seeing the breadth of litigation so far, this prediction is probably not too far off.

B. How Will the Courts Respond to this Plethora of Litigation?

The complexity of securitized mortgages, along with the sheer number of parties involved, is bound to create challenges for the courts. Several commentators have suggested that originating, underwriting, buying, selling, transferring, and taking on subprime mortgages to the extent it was done was bad judgment by all those involved.⁸⁷ Defendants are likely to assert that far from committing fraud, they, along with the rest of the industry, were unaware of how the financial products being offered would play out in an unpredictable marketplace.⁸⁸ From examining the few cases that have received court response, it looks as though plaintiffs will face substantial challenges proving their claims. At least in the case of individual borrowers, the parties will find it difficult to survive motions for summary judgment on common law fraud and breach of fiduciary duty claims. This is partly because alleging these claims with sufficient specificity is usually difficult to accomplish in the first place, and partly because borrowers and lenders are engaged in a he-said-she-said back and forth.

⁸⁵ *Id.* ("NovaStar Financial Inc. of Kansas City, Mo., said last month that it would cut 350 employees, or 17 percent, of its work force, while Ameriquest Mortgage, a unit of Orange, Calif.-based ACC Capital Holdings, and Fremont General have also announced layoffs that will affect hundreds of workers.").

⁸⁶ *The Finger of Suspicion*, *supra* note 2.

⁸⁷ Carrie Johnson, *Mortgage Probes Face Big Hurdles, Scrutiny Grows, But Banks' Liability Remains Unclear*, WASHINGTON POST, Dec. 27, 2007, D01 ("This is one of those situations, kind of like the Internet bubble, where everybody and his brother guessed wrong . . .").

⁸⁸ *The Finger of Suspicion*, *supra* note 2 ("Banks that face lawsuits over mortgage debt they peddled have at least one strong argument in their favor: they themselves bought the stuff.").

Presently, a bill has passed in the House of Representatives working to establish greater protection for plaintiff-borrowers.⁸⁹ The Mortgage Reform and Anti-Predatory Lending Act of 2007, introduced by Representatives Brad Miller, Mel Watt and Barney Frank, is now working its way through the Senate. The proposed legislation calls for reform in three main areas of the current mortgage market: (1) a federal duty of care will be established and mortgage originators will be required to be registered and licensed; (2) a minimum standard for all mortgages will require that borrowers to have a reasonable ability to repay their loan; and (3) market securitizers will face limited liability for packaging and selling loans that fall outside of the legislations standards.⁹⁰ The Federal Reserve Board has also come up with a proposal to increase protection for consumers in the mortgage market. In December 2007, the board released a statement calling for public comment on proposed changes to HOEPA.⁹¹ The Federal Reserve's plan includes "four key provisions for 'higher-priced mortgage loans'" as well as several protections that would apply to all loans secured by a consumer's residence.⁹² Among the proposed changes are provisions that would require lenders to verify the income and assets that the loan is relying on, as well as a requirement for lenders to establish escrow accounts for tax and insurance purposes.⁹³ If either or both of these proposals become law, it may very well come too late for those already harmed by the market failures; but it will surely help prevent another crisis from occurring in the future.

As for cases brought by shareholders, city officials, mortgage lenders, and underwriters only time can tell how courts will respond. The courts are still seeing the early stages of the litigation process, so many of the intricacies of the cases have yet to play out in court and the courts have yet to build a workable jurisprudence in this area of

⁸⁹ Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong. (as passed by House, Nov. 15, 2007), <http://www.govtrack.us/congress/billtext.xpd?bill=h110-3915>.

⁹⁰ Press Release, House Committee on Financial Services, Comprehensive Mortgage Reform and Anti-Predatory Lending Legislation Introduced in the House (Oct. 22, 2007), http://www.house.gov/apps/list/press/financial_svcs_dem/press102207.shtml (last visited April 1, 2008).

⁹¹ Press Release, Federal Reserve Board, Banking and Consumer Regulatory Policy (Dec. 18, 2007), <http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm> (last visited April 1, 2008).

⁹² *Id.*

⁹³ *Id.*

law. However, it is clear that because the subprime issue is so complex, there is no way to accurately predict how the courts will handle their role in meshing out the details.

C. Conclusion

The subprime crisis is complex entanglement of issues and problems, and is replete with parties attacking each other from every angle. It is no surprise that law professors specializing in the finance industry have described the situation as a “multi-ring circus” and as “being tainted from A to Z.”⁹⁴ Some speculate that today's litigation is only the tip of the iceberg.⁹⁵ Whether this holds true rests largely on how favorable the court system is to these early cases. One thing is clear: there will be more litigation to come in the next year that will effectively decide the boundaries of blame and liability for all those who participated in and were affected by the subprime mortgage crisis.

Melissa Schulz⁹⁶

⁹⁴ *Bajaj, supra* note 78.

⁹⁵ *Joyce, Mortgages: New Entities Seen as Plaintiffs, supra* note 5.

⁹⁶ Student, Boston University School of Law (J.D. 2009).

VII. *Managing Investment Banks During the Mortgage Crisis*

By 2005, as housing prices rose to unsustainable levels, experts began to express concerns that mortgage lenders had loosened their lending standards too freely, and many experts predicted that the housing bubble would soon burst. Nevertheless, investment banks continued to aggressively underwrite subprime mortgage-backed securities well into 2007, ultimately resulting in billions of dollars in write-downs. Furthermore, some investment banks were simultaneously hedging against expected losses in subprime mortgage-backed securities. Goldman Sachs even went so far as to sell them short.

This article addresses conflict of interest issues within the management of investment banks. Part II addresses how the prospect of obtaining massive compensation may have led managers to promote further investment in subprime mortgage-backed securities despite having reservations about these securities' eventual worth. Accordingly, managers of investment banks may have breached their fiduciary duties by putting their personal financial interests ahead of the interests of their companies and their shareholders. Parts III, IV, and V, explore the market conditions that led to the subprime meltdown and how certain investment banks reacted to the impending subprime crisis. Evidence suggests that investment banks chose not to curb their practices because their managers had enormous personal financial incentives to ignore the warnings. Finally, Part VI offers ways that audit committees can help prevent managers' conflicts of interest from affecting their business judgment in the future.

A. *Knowledge of Subprime Investment Hazards*

A myriad of warning signs existed before the housing market eventually collapsed. Many banks had enterprise risk management programs, which used quantitative models to accurately predict the hazards of investing in subprime mortgages before accelerating delinquency rates catalyzed a "market meltdown."¹ As early as 2005,

¹ Christopher Westfall, *ERM May Have Prevented Writeoffs—if Banks Had Paid Attention*, AUDIT COMM. INSIGHTS (KPMG, Woodcliff Lake, N.J.), Nov. 29, 2007, available at <http://www.kpmginsights.com/aci/display>

many experts agreed that significant problems existed in the housing market.² For example, in 2005 *New York Times* columnist Paul Krugman wrote: “[I]t’s so ominous to see signs that America’s housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble.”³ Moreover, Federal Reserve Chairman Alan Greenspan acknowledged in testimony before Congress that he saw “signs of froth in some local markets where home prices seem to have risen to unsustainable levels.”⁴ By December 2005, even some traders of collateralized debt obligations (CDOs)⁵ warned that the bubble could burst.⁶ Jason Schechter, then head of CDO trading at Lehman Brothers, expressed concerns shared by others at the Opal Financial Group CDO Summit when he asked, “Is this liquidity here to stay, or are we at risk for a sizable downturn?”⁷ Steven Ricchiuto, chief economist at ABN Amro, suggested that liquidity can dry up almost instantaneously and historically had done so.⁸ He warned that, just as tighter lending rules burst the tech bubble, higher short-term interest rates could burst the housing bubble.⁹

_aci_analysis.asp?intAnalysisTypeID=3&intInsightsTypeID=1&edition_id=11522&content_id=1032537.

² Allison Pyburn, *Experts Predict Areas to be Hardest Hit by Housing Bubble*, ASSET SECURITIZATION REP., Sept. 19, 2005.

³ Paul Krugman, *Running Out of Bubbles*, N.Y. TIMES, May 27, 2005, at A5.

⁴ *Testimony Before the Joint Econ. Comm.*, 109th Cong., 3 (2005) (statement of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.), <http://www.house.gov/jec/hearings/testimony/109/ag06-09-05.pdf>.

⁵ Collateralized Debt Obligation: a pool of debt contracts housed within a special purpose entity whose capital structure is sliced and resold based on differences in credit quality. Frank Partnoy & David A. Skeel, Jr., *Debt as a Lever of Control: The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

⁶ Allison Pyburn, *Hedge Funds: Friend or Foe to U.S. Housing Market?*, ASSET SECURITIZATION REP., Dec. 12, 2005 (reporting that some participants at the 2005 Opal Financial Group CDO Summit suggested that the liquidity in the U.S. CDO market could begin to dry up in 2006).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

B. Continuing to Underwrite Securities Despite Warning Signs

Despite the mounting warning signs, investment banks continued to underwrite risky mortgage-backed securities backed by subprime loans. Along with underwriting, mortgage lenders also continued to loosen their credit and lending standards in 2005, even as fears were growing that such relaxed lending practices could augment risks for borrowers and lenders in already overheated housing markets.¹⁰ Novel loan policies proliferated, including: (1) offering interest-only mortgages to homeowners with poor credit, (2) reducing minimum credit scores needed for loan qualification, and (3) providing loans that did not require documentation.¹¹ A combination of these factors kept the already feverish housing market hot with new business and ensured that the market would continue to generate massive amounts in new loan business.

As the housing market worsened in 2006 and 2007, many investment banks continued to underwrite billions of dollars of subprime securities. But at the same time, some investment firms attempted to protect themselves from losses while others did not. Most notably, Goldman Sachs even sold short¹² the same subprime products that they were selling on the retail investment side.¹³ On the one hand, Goldman Sachs reduced its inventory of mortgages and mortgage-backed securities, purchased insurance to protect against losses, and bet that the subprime mortgage-backed securities would decrease in value by shorting the ABX index.¹⁴ On the other hand,

¹⁰ Ruth Simon, *Mortgage Lenders Loosen Standards—Despite Growing Concerns, Banks Keep Relaxing Credit-Score, Income and Debt-Load Rules*, WALL ST. J., July 26, 2005, at D1.

¹¹ *Id.*

¹² Short Sale: A sale of a security that the seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery. Such a sale is usually made when the seller expects the security's price to drop. If the price does drop, the seller can make a profit on the difference between the price of the shares sold and the lower price of the shares bought to pay back the borrowed shares. BLACK'S LAW DICTIONARY 1339 (7th ed. 1999).

¹³ Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Debt*, N.Y. TIMES, Dec. 6, 2007, at A0.

¹⁴ ABX Index: The ABX family of indexes was designed to reflect their values based on instruments called credit-default swaps. These swaps, in essence, are insurance contracts that pay out if the securities backed by

from January through September 2007, it continued to package and sell more than \$6 billion of new subprime mortgage-backed securities.¹⁵ The juxtaposed investment strategies that Goldman Sachs undertook made it a beneficiary of a market downturn in the very securities that it recommended to its clients.

Other investment banks also foresaw trouble. Credit Suisse, one of the major underwriters of subprime mortgages, scaled down its underwriting activities by 22% from 2004 to 2006.¹⁶ Other banks took similar action, taking steps to protect themselves by purchasing insurance and reducing their inventories of mortgages and mortgage-backed securities, even though they continued to aggressively underwrite subprime mortgage-backed securities.¹⁷ In January 2006, Deutsche Bank's global head of trading for asset-backed securities and CDOs, Greg Lippmann, began advising institutional investors to protect themselves from an imminent decline in the housing market.¹⁸ Yet Deutsche Bank underwrote \$28.6 billion of subprime mortgage securities in 2006 and another \$12 billion from January through September 2007.¹⁹ Likewise, Lehman Brothers started hedging its inventory of mortgage-backed securities in the second quarter of 2007, but continued to underwrite \$16.5 billion of new risky mortgage-backed securities from January to September 2007.²⁰

Other companies such as Citigroup, Merrill Lynch, and UBS failed to protect themselves altogether from the housing market collapse.²¹ Unlike Goldman Sachs, Credit Suisse, Deutsche Bank, and Lehman Brothers, these firms continued to aggressively underwrite subprime mortgage-backed securities without hedging their risks.²² Consequently, they lost billions of dollars, which led to the forced resignations of their chief executives.²³

The true impact of the subprime-induced market fallout remains to be seen. In late 2007 and early 2008, many of the major

subprime mortgages decline in value. Kate Kelly, *How Goldman Won Big on Mortgage Meltdown — A Team's Bearish Bets Netted Firm Billions; A Nudge From The CFO*, WALL ST. J., Dec. 14, 2007, at A1; *Id.*

¹⁵ Anderson & Bajaj, *supra* note 13.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

investment banks reported significant losses in the subprime mortgage-backed securities markets. Merrill Lynch recorded \$7.9 billion and \$1.6 billion losses in the third and fourth quarters of 2007, respectively.²⁴ Lehman Brothers ultimately wrote down \$830 million in the fourth quarter of 2007.²⁵ In one of the more dramatic fall-outs from the subprime write-downs, Bear Stearns wrote down \$1.9 billion in the fourth quarter of 2007.²⁶ Still reeling from this massive write-down, on Friday, March 14, 2008, Bear Stearns' stock lost roughly \$5.7 billion in value, almost half its market value, causing the Dow Jones industrial average to drop almost 200 points.²⁷ By Monday morning, Bear Stearns' stock price had declined over 90%.²⁸ Out of fear that the investment bank's impending failure would bring down the entire market, JPMorgan Chase and the Federal Reserve agreed to extend loans to Bear Stearns, and JPMorgan Chase announced that it was acquiring the troubled investment bank.²⁹ Describing the state of affairs as the worst since the Great Depression, billionaire hedge fund manager

²⁴ Press Release, Merrill Lynch, Merrill Lynch Reports Full-Year 2007 Net Loss From Continuing Operations of \$8.6 Billion (Jan. 17, 2008) (on file with author), *available at* http://www.ml.com/index.asp?id=7695_7696_8149_88278_88282_88436; Press Release, Merrill Lynch, Merrill Lynch Reports Third-Quarter 2007 Net Loss From Continuing Operations of \$2.85 Per Diluted Share (Oct. 24, 2007) (on file with author), *available at* http://www.ml.com/index.asp?id=7695_7696_8149_74412_82725_84064.

²⁵ Press Release, Lehman Brothers, Lehman Brothers Reports Record Net Revenues, Net Income and Earnings Per Share for Fiscal 2007 (Dec. 13, 2007) (on file with author), http://www.lehman.com/press/qe/docs/121307_4q07.pdf.

²⁶ Press Release, Bear Stearns, Bear Stearns Reports Full Year and Fourth Quarter 2007 Financial Results (Dec. 20, 2007) (on file with author), http://www.bearstearns.com/includes/pdfs/investor_relations/earnings/4q2007.pdf.

²⁷ Stephen Bernard & Joe Bel Bruno, *Fed and Rival Bail Out Bear Stearns*, ASSOCIATED PRESS, Mar. 14, 2008.

²⁸ Historical Prices for Bear Stearns—March 14-17, 2008, <http://finance.yahoo.com/q/hp?s=BSC&a=02&b=14&c=2008&d=2&e=17&f=2008>.

²⁹ Press Release, Bear Stearns, JPMorgan Chase to Acquire Bear Stearns (Mar. 16, 2008) (on file with author), *available at* http://www.bearstearns.com/sitewide/our_firm/press_releases/content.htm?d=03_16a_2008; Bernard & Bel Bruno, *supra* note 27.

George Soros predicted that the fallout of the entire subprime mortgage crisis will cause over \$1 trillion in worldwide losses.³⁰

C. *Managements' Conflicts of Interest*

The decision to continue underwriting subprime mortgage-backed securities even as the risks of a mortgage meltdown appeared clearer over time suggests that some investment bank managers may have breached their fiduciary duties. The duty of loyalty is a common law doctrine codified by statute in every state.³¹ To satisfy the duty of loyalty, managers must have a good faith belief that their actions are in the best interests of their corporations and shareholders.³² Any interests that managers have that are not shared by their shareholders generally are trumped by this duty.³³ Likewise, managers cannot cause detriment to their corporations or shareholders by utilizing their positions to gain personal benefits.³⁴ Problems occur when managers separate risk management from risk measurement.³⁵ Fast-changing markets, such as the subprime mortgage market, are particularly susceptible to these problems because managers do not have much time to react.³⁶ However, regardless of the amount of time they have to make choices, managers have a duty to act in good

³⁰ John Parry & Jennifer Ablan, *UPDATE 2—Soros: Global Subprime Losses Likely Above \$1 Trillion*, REUTERS NEWS, Apr. 9, 2008.

³¹ Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code*, 67 MO. L. REV. 279 (2002) (summarizing the development of the duty of loyalty).

³² *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) (“[D]irectors breached their duty of loyalty by failing to attend to their duties in good faith.”).

³³ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. Supr. 1993) (“the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.”).

³⁴ *In re Walt Disney Co. Derivative Litig.*, No. 15452, 2004 LEXIS 132, at *24 n.49 (Del. Ch. Sept. 10, 2004) (“a director may not allow his self-interest to jeopardize his unyielding obligations to the corporation and its shareholders” (quoting *BelCom, Inc. v. Robb*, No. 14663, 1998 LEXIS 58, at *10 (Del. Ch. Apr. 28, 1998))).

³⁵ Westfall, *supra* note 1.

³⁶ *Id.*

faith and make informed business decisions.³⁷ It appears in some cases that the investment banks' risk management processes, though designed to ensure compliance with these basic requirements, likely failed.

The highly lucrative nature of the subprime mortgage market provided a great temptation for managers to ignore the warning signs in order to gain personal benefits, thereby violating their fiduciary duties. The average total compensation in 2006 for managing directors in the mortgage division of investment banks was \$2.52 million.³⁸ Managing directors in other areas, however, only received \$1.75 million.³⁹ As the president of Risk Integrated, Christopher Marrison, recounted, "The good times were going and the commissions were flowing, even if [financial] models were showing risk . . . [T]he risk was high but people did not want to know about it."⁴⁰ If managers were so focused on receiving lucrative compensation that they ignored the warnings of the subprime market meltdown in favor of continued sales of subprime mortgage-backed securities, then they breached their fiduciary duty of loyalty by putting their personal interests ahead of the interests of their firms and shareholders.

Managers of investment banks who foresaw the market collapse claimed that they hedged against the risks as part of their fiduciary duty to shareholders.⁴¹ Hedging allows investment banks to minimize their downside risks. Thus, successful hedging can increase the overall value of the investment banks and their stocks. Indeed, hedging did help offset losses. Due to successful hedging, Lehman Brothers, which had previously announced an expected write-down of \$3.5 billion, was able to adjust its write-downs to \$830 million in

³⁷ *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27, 52 (Del. Supr. 2006) ("Our law presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.' Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders").

³⁸ Anderson & Bajaj, *supra* note 13.

³⁹ *Id.*

⁴⁰ Westfall, *supra* note 1.

⁴¹ Anderson & Bajaj, *supra* note 13.

the fourth quarter of 2007.⁴² Likewise, by betting against subprime mortgage-backed securities, Goldman Sachs generated almost \$4 billion of profits by the end of November 2007, offsetting \$1.5 to \$2 billion of mortgage-related losses.⁴³

Despite the fact that hedging helped limit some investment banks' losses, it still seems counter-intuitive and puzzling that an investment bank like Goldman Sachs would go so far as to sell short against something that it was simultaneously selling so aggressively on the retail investment side.⁴⁴ Even assuming that the "hedging" was legitimate, it is questionable how managers of Goldman Sachs acted in their shareholders' interests as the company still continued to sell billions of dollars worth of the risky securities—many of which defaulted.⁴⁵ Similarly, one of Deutsche Bank's managers started "really pounding the pavement" about protecting his firm from the coming decline in the market, yet all the while the company continued to bring in mortgages to package and sell as subprime mortgage-backed securities.⁴⁶ The double-dealing practices of Goldman Sachs and Deutsche Bank suggest that the managers knew there was something wrong with the investments and were not simply hedging as part of a prudent general protection plan. If this was indeed the case, by taking on the excessive risk of continuing to underwrite securities they believed would soon decline sharply in value, the managers likely breached their duty of loyalty by not reasonably believing that they were acting in the best interests of their corporations and shareholders.

Furthermore, it would be hard to believe that non-hedging firms, such as Citigroup, remained unaware of the danger of an impending collapse despite the many warning signs and the hedging activities of their competitors. If these non-hedging firms truly did not foresee the danger, then perhaps their managers breached their fiduciary duty of care. Either way, although the quantitative risk models "did their job, upper management did not."⁴⁷ Given the actions of the investment banks together with the highly lucrative

⁴² Dan Wilchins, *UPDATE 4—Lehman Q4 Earnings Fall Amid \$830 Million Writedown*, REUTERS NEWS, Dec. 14, 2007.

⁴³ Kelly, *supra* note 14.

⁴⁴ Ben Stein, *Tattered Standard of Duty on Wall Street*, N.Y. TIMES, Dec. 23, 2007, at 30.

⁴⁵ Anderson & Bajaj, *supra* note 13.

⁴⁶ *Id.*

⁴⁷ Westfall, *supra* note 1.

nature of the subprime mortgage loans, it is likely that their managers breached one or more of their fiduciary duties.

The details of what exactly the managers knew, how they handled that information, what they disclosed to the public, and the timings of such disclosures are under investigation.⁴⁸ New York Attorney General Andrew Cuomo is currently seeking evidence that some investment banks consciously failed to question the accuracy of the inflated appraisals of subprime mortgages so that they could package them and sell the lucrative subprime mortgage-backed products to investors without informing them of the securities' true risk.⁴⁹ It is also possible that investment banks even conspired with credit-rating agencies to inflate the appraisals.⁵⁰ Only when information is discovered as a result of public and private actions against the investment banks will the extent of the managers' breach of fiduciary duties be known.

D. Potential Audit Committee Actions to Minimize Future Risk Mismanagement

Although conflicts of interest inherently exist in any manager's decision-making process, an investment bank can ensure better risk governance decisions by increasing the role of its audit committee so that its directors gain more knowledge about the investment products they are approving. For instance, audit committee members are increasingly visiting work sites to learn more about the company's leaders, strategies, and risks.⁵¹ According to Wendy Lane, audit committee chair of Lab Corporation of America and audit committee member of Willis Holdings and UPM Kymmeme Corporation, an audit committee member may not truly understand how a company functions without actually observing it firsthand.⁵² The experience of

⁴⁸ Kara Scannell, *Credit Crunch: Wall Street Firms Are Subpoenaed — New York Examines Treatment of Debt Tied to Risky Mortgages*, WALL ST. J., Dec. 5, 2007, at C2.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ Gary Larkin, 'Kicking the Tires' Takes on New Meaning for Audit Committees, AUDIT COMM. INSIGHTS (KPMG, Woodcliff Lake, N.J.), Dec. 12, 2007, available at http://www.kpmginsights.com/aci/display_aci_analysis.asp?intAnalysisTypeID=1&intInsightsTypeID=1&edition_id=11522&content_id=1037761.

⁵² *Id.*

actually observing an investment bank's operations can change perceptions of risks.⁵³ Site visits give audit committee members the opportunity to understand complex situations, which in turn allows them to ask the most significant questions of company managers and employees.⁵⁴ An audit committee member who has visited the facilities can provide the board with a better informed presentation, thus helping the directors achieve a greater "awareness about the business . . . that may be important when they make board and committee decisions."⁵⁵

Along this line, KPMG, one of the world's largest accounting and audit firms, has formulated ten ways in which audit committees can help improve directors' risk management. The report, issued in January 2008, suggested that audit committees should:

1. Proactively identify problems in the company's risk management process and help the board coordinate oversight activities;
2. Monitor the management's disclosure committee to ensure adequate disclosures to directors;
3. Ensure that directors are knowledgeable about the most recent financial reporting issues and developments;
4. Aid the chief financial officer by ensuring adequate resources and by helping maintain focus on the company's long term financial health and on the impartiality of financial disclosures;
5. Ensure that the internal auditor is adequately trained, is working on exactly what the audit committee specifies, and is independent and accountable to the audit committee;
6. Encourage informal communication with the auditor in order to create strong relationships and better communication at audit committee and board meetings;
7. Develop a crisis management plan so that the company is prepared in case of a market meltdown;
8. Make sure that all directors understand all the current risks, emerging issues, and factors that affect financial reporting;
9. Promote compliance and financial reporting integrity throughout the company by implementing internal

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

- procedures such as creating employee surveys for monitoring company culture; and
10. Ensure effective self-assessments to make sure that the audit committee itself is performing well.⁵⁶

With better director education and more support from its audit committee, an investment bank can reduce the likelihood of its risk management being separated from its risk measurement.

E. Conclusion

The true causes of the subprime mortgage collapse are yet to be established. Major Wall Street banks including Deutsche Bank, Merrill Lynch, and Morgan Stanley have been subpoenaed by the state of New York in an effort to discover detailed information about the business of securitization, the review process for subprime mortgage-backed products, and the relationships between investment banks and credit rating agencies.⁵⁷ As the investigations continue, many questions exist, including what steps the audit committees of these banks took to oversee risk management, how thoroughly the management of these banks understood the products they agreed to invest in, and the extent of the managers' breach of any of their fiduciary duties. Perhaps when the answers come to light, better risk measurement, risk management, and corporate governance policies and procedures will help minimize the fallout from a future crisis.

Stephanie Tsao⁵⁸

⁵⁶ *Ten To-Do's for Audit Committees in 2008*, AUDIT COMM. INST. (KPMG, Woodcliff Lake, N.J.), Jan. 2008, http://www.kpmg.com/aci/docs/aci_publications/ACIs_Ten_To_Do_for_Audit_Committees_in_2008.pdf.

⁵⁷ Scannell, *supra* note 48.

⁵⁸ Student, Boston University School of Law (J.D. 2009).

VIII. Initial Public Offerings of Private Equity and Hedge Funds

The alternative investment management industry, namely private equity (“PE”) and hedge funds, has become an increasingly popular destination for highly sophisticated and experienced investors. As a result of the participation of these investors, a private equity or hedge fund can operate largely unregulated by the Securities and Exchange Committee relative to the more traditional investment vehicles, such as mutual funds.¹ These funds maintain regulatory avoidance through exemptions available under the the Investment Company Act, the Securities Act, and the Exchange Act,² in addition to the Investment Advisers Act of 1940.³ Recently, however, these entities have forgone the available exemptions and engaged in Initial Public Offerings (“IPOs”), subjecting the entity to SEC securities regulations. This article will examine two high-profile portfolio company IPOs: the IPO of the PE firm, The Blackstone Group L.P. and the IPO of the hedge fund firm, Fortress Investment Group LLC. Although these two offerings were highly anticipated and supported by strong past fund performance, both Blackstone and Fortress shares had disappointing performances after an initial strong IPO performance. Before beginning this discussion, this article will provide a brief overview of private equity and hedge funds.

A. Private Equity and Hedge Funds

¹ Cynthia Futter & Anne E. Wells, *What to Expect from Hedge Funds Today and in the Future: An Overview And Insolvency Perspective*, CAL. BANKR. J. 213, 216 (2007) (describing the relative degrees of regulation between traditional and alternative investment vehicles).

² Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, BUFF. L. REV. 251, 265 (2006) (explaining the alternative investment exemption opportunities).

³ *Implications of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission (September 2003)*, 1466 PLI/CORP 209, 226 (2005) [hereinafter *Implications*] (explaining exemption under Investment Advisers Act of 1940).

Private equity can be defined broadly as “an umbrella term that includes venture capital investments and private buyouts.”⁴ Following with this broad definition, these “pool[s] of money” can take many different forms.⁵ However, regardless of type and structure, a PE fund tends to focus on relatively illiquid holdings.⁶ Consequently, a PE investor must usually commit to a longer investment period compared to more traditional investment vehicles.⁷ A hedge fund can similarly be defined as an entity that pools together securities and other assets that are not registered with the SEC.⁸ However, although similar in definition to private equity funds, hedge funds tend to hold relatively more liquid, more position-oriented securities and assets, resulting in a more flexible vehicle.⁹

Structurally, most PE funds are organized as limited partnerships.¹⁰ This organizational structure is popular because of its flexibility to employ complex economic arrangements while retaining the “pass-through” tax benefit.¹¹ This “pass-through” exists because, as a partnership, the entity fund is not subject to any federal income tax obligations, resulting in a fund’s gains being reported only on the general and limited partnerships’ tax returns.¹²

⁴ Andrew R. Brownstein, Mitchell S. Presser & David E. Shapiro, *Private Equity Funds: Legal Analysis of Structural, ERISA, and Securities Issues*, 1276 PLI/CORP 7, 11 (2001).

⁵ Stephanie R. Breslow & Phyllis A. Schwartz, *Recent Trends in Private Equity Funds*, 1549 PLI/CORP 23, 25 (2006) (explaining the various forms that a private equity fund can take).

⁶ *Id.* (explaining the relative liquidity differences between hedge funds and private equity funds).

⁷ *Id.* (describing the three time-period investment life required by private equity funds).

⁸ *Implications*, *supra* note 3, at 224 (describing the general definition of a hedge fund)

⁹ Breslow, *supra* note 5 (explaining the difference in investment approaches of private equity and hedge funds).

¹⁰ Brownstein, *supra* note 4, at 12 (“Most private equity funds are . . . limited partnership interests.”).

¹¹ Marco V. Masotti, *Private Equity Funds: Current Terms and Trends*, 1614 PLI/CORP 49, 53 (2007) (explaining the advantages of the preferred structure of private equity funds).

¹² Brownstein, *supra* note 4, at 15 (describing the tax benefits of a partnership structure).

Furthermore, these gains are only taxed at the capital gains rates, and not the higher corporate tax rate of 35%.¹³

Hedge funds, like PE funds, also desire to retain a level of investment flexibility and therefore can be structured as a number of different legal entities, namely limited liability partnerships and limited liability companies.¹⁴ And hedge funds are structured in such a way to ensure only wealthy, sophisticated investors hold the interests in the fund's entity.¹⁵ These sophisticated investors typically qualify as "accredited investors," having either "a minimum annual income of \$200,000 (\$300,000 with spouse) or \$1 million in net worth and most institutions with \$5 million in assets."¹⁶ And, as seen below, this investor discrimination enables a hedge fund entity to operate relatively unregulated by SEC securities requirements.¹⁷

Registering a security with the SEC is both costly and time consuming, and it creates obligatory disclosure requirements.¹⁸ At the risk of oversimplification, the interests issued in a PE fund are considered to be "securities" under the Securities Act of 1933 and thus are required to be registered with the SEC.¹⁹ To avoid this regulatory burden, a PE fund generally attempts to issue or offer securities in such a fashion as to qualify for one of the many exemptions the SEC has allowed in the area of securities regulation.²⁰

A hedge fund, like a PE fund, will also not register the offer and sale of its interests as regulated securities under the Securities Act, but rather as private offerings.²¹ To qualify for this private offering exemption, fund interests must only be sold to the

¹³ *Id.* (describing the tax benefits of a partnership structure).

¹⁴ Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. ECON. PERSP. 189, 190 (Spring 1999) (describing how a hedge fund can be organized).

¹⁵ *Id.* (describing the intent behind the legal framework of a hedge fund).

¹⁶ *Implications, supra* note 3, at 226 (defining "accredited investors").

¹⁷ *Id.* (describing lack of regulation by SEC for hedge funds).

¹⁸ Brownstein, *supra* note 4, at 24 (explaining that the SEC registration process is time consuming and costly).

¹⁹ *Id.* (citing the broad definitional test of SEC v. W.J. Howey Col., 328 US 293 (1946)).

²⁰ *Id.* (discussing ways to avoid cost and delay that comes with registration).

²¹ *Implications, supra* note 3, at 226 (explaining that hedge funds sell interests as private offerings).

“accredited investors” discussed above.²² In addition, a fund will rely on the “qualified purchasers” exemption under the Investment Company Act, which requires relatively higher financial requirements than those demanded by the “accredited investors.”²³ Finally, hedge fund advisors may avoid registration under the Investment Advisers Act of 1940 through the *de minimis* exemption, which requires having 14 or fewer clients in the fund, where, importantly, only a fund qualifies as clients.²⁴

In late 2004, the SEC adopted a rule attempting to increase hedge fund regulation by requiring a hedge fund manager to “‘look through’ the fund and count each owner” as a client.²⁵ However, shortly after its adoption, the D.C. Circuit Court of Appeals struck down the rule in June of 2006,²⁶ leaving hedge funds largely unregulated except for the prohibition against securities fraud.²⁷

Although there appear to be clear differences, both structural and strategic, between PE and hedge funds, managers of alternative funds started to integrate the two as early as 2002.²⁸ By creating a hybrid fund, a manager is able to “diversify the revenue streams of private-equity firms by providing relatively stable fee income” from managing the hedge fund.²⁹ In addition, the skills required to research private companies for PE funds also are useful for recruiting top hedge fund managers.³⁰ As the alternative investment world became more popular, opportunities for “traditional” alternative

²² *Id.* (explaining that must only sell to accredited investors to be able to sell as private offerings).

²³ *Id.* (describing the “qualified purchasers” exemption under the Investment Company Act).

²⁴ *Id.* (describing the “de minimis” exemption under the Investment Advisers Act of 1940).

²⁵ Jean Price Hanna, McCausland Keen & Buckman, *Hedge Funds and Funds of Funds an Update on Regulations Governing Hedge Funds, and the Duties of Registered Representatives and Investment Advisers in Recommending Hedge Funds and Funds of Funds*, 1615 PLI/CORP 451, 456 (2007) (explaining the Hedge Fund Rule).

²⁶ *Goldstein v. SEC* 451 F.3d 873 (D.C. Cir. 2006) (finding the Hedge Fund Rule invalid).

²⁷ Hanna, *supra* note 25, at 456 (“Hedge funds are . . . against securities fraud.”).

²⁸ Allison Bisbey Colter, *Private-Equity Firms Diversify By Venturing Into Hedge Funds*, WALL ST. J., May 23, 2002.

²⁹ *Id.*

³⁰ *Id.*

investments profits became harder to find.³¹ This necessitated that managers develop newer investment strategies, namely a cross focus on PE investments.³² These “hybrid” funds will employ a “side pocket” to hold that private, less liquid investment, with the “side pocket” “segregated from the remainder of the assets” as the fund manager sees fit.³³ As a percentage of the fund, about 10 to 15% of a fund’s capital will be placed into a typical “side pocket.”³⁴ In addition to blending investment strategies, PE and hedge fund firms are also exploring ways to attract different types of investors. Traditionally only available to wealthy investors, PE and hedge funds are including mainstream investors as sources of capital by engaging in IPOs for interests in the funds.³⁵

B. The Blackstone Group L.P. IPO

Blackstone Group L.P. is one of the largest independent alternative asset managers in the world, with assets valued at approximately \$79 billion as of March 1, 2007 and with annual growth of approximately 39.5% from 2001 through 2007.³⁶ The original Form S-1 Registration Statement was filed with the SEC on March 22, 2007,³⁷ with a third, amended Form S-1, including the specific terms of the offer, being filed on June 4, 2007.³⁸ The IPO priced at \$31.00 a share³⁹ on June 21, 2007, which was the maximum

³¹ Gregory Zuckerman, *Private Equity Cozies Up Further To Hedge Funds*, WALL ST. J., Aug. 1, 2005 at C1.

³² *Id.*

³³ Danforth Townley, *The Convergence of Hedge Funds and Private Equity Funds*, 1607 PLI/CORP 381, 388 (2007).

³⁴ *Id.*

³⁵ Eleanor Laise, *Hedge Funds Beckon Small Investors—As a Major Private-Money Management Firm Goes Public, Individuals Face ‘Alternative’ Choices of Varying Risk*, WALL ST. J., Feb. 14 2007 at D1.

³⁶ The Blackstone Group L.P., Registration Statement (Form S-1), at 1 (March 22, 2007) [hereinafter *Blackstone Registration*].

³⁷ *Id.* at 1.

³⁸ The Blackstone Group L.P. Registration Statement Amendment 3 (Form S-1) (June 4, 2007) [hereinafter *Blackstone Registration A3*].

³⁹ Gregory Zuckerman & Henny Sender, *Blackstone’s Green Day—Firm, Co-Founders Stack Up Billions in IPO Priced at \$31 a Share*, WALL ST. J., June 22, 2007, at C1 (describing price of Blackstone’s IPO).

proposed offering price.⁴⁰ Blackstone offered approximately 10% of its management partnership publicly, the equivalent of 133,333,334 common units.⁴¹ And at \$31.00 a share, this 10% interest raised approximately \$4.6 billion of capital for Blackstone.⁴² Although these common units sold would be publicly held after the IPO, the holders of these new shares will only be allowed to exercise little, if any, form of voting rights.⁴³ More specifically, the holder of a common unit will not have the right to elect managing partners or directors, both of which are voted in by the corporation's founders.⁴⁴ In addition to the IPO of the common units, Blackstone also sold \$3 billion of non-voting common units to the State Investment Company (State) for a price equal to 95.5% of the IPO price, adjusting the shares sold to State as to keep State's interest in Blackstone at or below 10%.⁴⁵ In the aggregate, Blackstone will raise approximately \$7.6 billion of cash from the IPO.⁴⁶

Although the publicly traded units lacked meaningful voting rights, the IPO price exhibited a relatively high price-earnings ratio of almost 18.⁴⁷ Comparatively, other publicly traded financial institutions trade at a price-earnings ratio of about 10.⁴⁸ To further mystify the valuation process, there were numerous other risks that a potential shareholder would encounter by purchasing Blackstone shares. First, a small shareholder who purchases a share of Blackstone will expose herself to the relatively greater risks associated with private-equity funds.⁴⁹ Unlike the market risks associated with holdings of traditional stocks, the cyclical nature of

⁴⁰*Blackstone Registration A3*, *supra* note 38, at 20 (describing what the maximum offering price).

⁴¹Dennis K. Berman & Henny Sender, *Big Buyout Firm Prepares to Sell Stake Public—Blackstone Would Add to Its Financial Clout; A Sign of Market Peak?*, WALL ST. J., March 17, 2007 at A1; *See Blackstone Registration A3*, *supra* note 38, at 20.

⁴²Zuckerman, *supra* note 39 (describing the amount of money that was raised by the IPO).

⁴³*Blackstone Registration A3*, *supra* note 38, at 21 (describing voting rights of holders of common units).

⁴⁴*Id.*

⁴⁵*Id.* (describing sale to the State Investment Company).

⁴⁶*Id.* (describing amount of capital raised by offering).

⁴⁷Zuckerman, *supra* note 39 (“[T]he stock, at IPO price, trades at almost 18 times next year's expected earnings.”).

⁴⁸*Id.* (explaining that other traditional firms have a lower P.E. ratio).

⁴⁹Berman, *supra* note 41 (explaining risks for small shareholders).

the PE world creates incredible volatility. For example, in 2002 Blackstone recorded only \$39 million in net income, while recording net income of \$2.3 billion only four years later in 2006.⁵⁰ Even if Blackstone has the financial ability to weather such variability in its profits, the stock price may nonetheless still be affected by reduced investor confidence.⁵¹ Similarly, downward pressure on stock prices may be seen in the case of a tightened credit market, which has the ability to directly affect profit margins.⁵² A final risk associated with investing in shares of a PE firm is the ever-present risk of an increase in the tax burden shouldered by a PE fund.⁵³

By the end of 2007, these concerns had manifested themselves in the Blackstone trading price. At the end of trading on December 4, Blackstone was trading at \$21.34, representing a 31% decline in its price since the \$31 a share IPO.⁵⁴ Many market experts cited, in addition to the tax risks and limited voting rights, the relatively little disclosure made by Blackstone concerning its investment strategies as a reason for the price decline after the initial IPO stage.⁵⁵ Unlike other public companies, which maintain an ultimate duty to its shareholders, Blackstone invests primarily to benefit its limited partners and not its shareholders.⁵⁶

Recently, analysts believe that Blackstone's share price, closing at \$16.66 on March 26, 2008,⁵⁷ perhaps more adequately reflects the value of the publicly traded interest.⁵⁸ Although this may be an encouraging sign, Blackstone's IPO still "failed to match the hype as Wall Street counted down the days to the firm's much

⁵⁰Zuckerman, *supra* note 39 (explaining volatility of Blackstone).

⁵¹*Id.*

⁵²*Id.*

⁵³*Id.*

⁵⁴Karen Richardson, *With Blackstone, Worries Old and New*, WALL ST. J., December 5, 2007, at C1 (describing how the prices of Blackstone has decreased significantly).

⁵⁵*Id.*

⁵⁶*Id.*

⁵⁷BX Quote—BX Stock Quote—Blackstone Group L.P. Stock Quote, http://www.bigcharts.com/custom/wsje/wsjobb-historical.asp?symb=BX&sid=8630&close_date=3/26/2008 (last visited Apr. 6, 2008).

⁵⁸Richardson, *supra* note 54 (describing valuation of a Blackstone share).

publicized debut on June 22.”⁵⁹ On the whole, experts believe that the concerns regarding voting rights, disclosure, etc. express a more “fundamental” problem for publicly traded PE funds, namely, the inability to “combine their scrappy operating styles with the niceties of a public listing in the Sarbanes-Oxley era.”⁶⁰ The tension between the limited partners and shareholders, discussed briefly above, is most acutely felt when the interest of each participant is at odds.⁶¹ To address this problem, Blackstone set up “conflict committee[s]” to address these issues.⁶² However, in going public, a PE fund disavows the benefits of being a private entity, benefits which Blackstone kept in high regard.⁶³ This has led some cynics to suggest that a PE fund may go public primarily to cash out limited partnership interests in a bull market.⁶⁴

C. *Fortress Investment Group LLC IPO*

Fortress, founded in 1998, is an asset-based investment management firm that controlled roughly \$26 billion of assets at the time of its first Form S-1 filing.⁶⁵ Fortress, similar to Blackstone, increased its asset holdings in 2001 at close to a 97% compound annual asset growth rate, having only approximately \$1.2 billion worth of assets at the end of 2001.⁶⁶ In its Form S-1, Fortress identifies the retention of talented management personnel and increased efficiency in capital access while also raising capital its motivations of engaging in the IPO.⁶⁷

Although it is not the first asset-management firm to go public, Fortress, rather than structuring the offer as a fund, will offer

⁵⁹ Yvonne Ball, *Tech Led IPO Market in June—Blackstone Falls Flat, Others Yank Offerings; Deals Trail May's Level*, WALL ST. J., July 2, 2007, at C3.

⁶⁰ George Anders, *BUSINESS: KKR, Blackstone IPOs Put Their Style at Risk*, WALL ST. J., July 18, 2007, at A2.

⁶¹ *Id.* (looking at tension between limited partners and shareholders).

⁶² *Id.* (describing how Blackstone and KKR set up conflict committees to address conflict of interest issues).

⁶³ *Id.* (describing how both Blackstone and KKR advocated the benefits of being private).

⁶⁴ *Id.* (explaining why cynics think KKR and Blackstone went public).

⁶⁵ Fortress Investment Group LLC, Registration Statement (Form S-1), at 1 (Nov. 8, 2006).

⁶⁶ *Id.* at 2

⁶⁷ *Hedge Fund Fortress Files for IPO*, WALL ST. J., Nov. 9, 2006, at C3.

shares that represent interests in the actual management company itself, called Class A Limited Liability Company Interests (Class A shares).⁶⁸ Prior to the IPO of the 34,286,000 Class A shares, Fortress sold an additional 55,071,450 shares of the same Class A stock to Nomura Investment Managers U.S.A., Inc. (Nomura).⁶⁹ The interest sold to Nomura represents approximately 14% of the total interest in Fortress, valued at \$888 million, or \$16.12 a share.⁷⁰ Comparatively, the IPO price for a publicly listed share of Class A stock was \$18.50, which was at the higher limit of the expected range.⁷¹ After both the Nomura private placement and the IPO, Fortress principals will still retain approximately 78% of the interest in Fortress, with the remaining interests being held by Nomura and the IPO participants, at 15% and 8%, respectively.⁷² The 8% IPO interest sold at the above mentioned price of \$18.50 will raise approximately \$635 million for Fortress, with a net proceed of \$596.2 million before expenses are paid.⁷³

The public's initial reaction to the Fortress IPO was strong. After being first listed at \$18.50 a share, the stock opened for trading on February 9, 2007 at \$35.00 a share and eventually closed its first day at \$31.00, 68% higher than its IPO price.⁷⁴ The closing price of \$31.00 a share represented an incredible price earnings ratio of approximately 40.⁷⁵ Unfortunately, this early success would not last. After February 9, the trading price of Fortress shares generally declined, eventually falling to \$15.58 a share at the close of trading on December 31, 2007.⁷⁶ Although early 2007 saw a price increase

⁶⁸Lynn Cowan, *Alternative Invest Twist: Fortress Plans a Stock Listing*, WALL ST. J., Nov. 20, 2006, at C5 (describing the structure of Fortress's offering).

⁶⁹Fortress Investment Group LLC, Prospectus, at 1 (describing sale to Nomura Investment Managers) [hereinafter *Fortress Prospectus*].

⁷⁰*Id.*

⁷¹*Today's Agenda / A Look Ahead at Newsworthy events*, WALL ST. J., Feb. 9, 2006, at A2.

⁷²*Fortress Prospectus*, *supra* note 69, at Cover, 1 (stating the interest amount held by principals after the offer).

⁷³*Id.* at Cover.

⁷⁴Gregory Zuckerman, Henny Sender & Scott Patterson, *Hedge-Fund Crowd Sees More Green as Fortress Hits Jackpot with IPO*, WALL ST. J., Feb. 10, 2007, at A1 (describing the public's reaction to the Fortress IPO).

⁷⁵*Id.*

⁷⁶FIG Quote—FIG Stock Quote—Fortress Investment Group L.L.C. Stock Quote, <http://www.bigcharts.com/custom/wsje/wsjobb-historical.asp?symb=>

for Fortress with a high of \$34.03 on April 20, 2007,⁷⁷ it has since lost value through the beginning of the 2008 calendar year, falling to a 52-week low of \$9.50 on March 17, 2008.⁷⁸ Recently, the stock price has consistently remained between \$15.00 and \$12.00 a share,⁷⁹ representing approximately a 19% to 35% decline in price since.

Some experts attribute the decline in Fortress share price to “a flight to simplicity” where investors seek less-sophisticated investments.⁸⁰ To support this, experts point to recent demand increases for simpler vehicles, such as “long-short” funds and Ten-year Treasury bonds.⁸¹ The early success of the Fortress IPO had its roots in the desire of ordinary investors, traditionally unable to participate in hedge funds, to gain entry into these exclusive investment vehicles.⁸² However, the complexity of these vehicles, namely the use of leverage, also spurred its reduced performance.⁸³ As the credit markets tightened, investors saw the utilization of leverage not as a strength but as a weakness, and thus desired more of a stable, or simple, investment choice.⁸⁴

D. Conclusion

The Blackstone and Fortress IPOs were highly anticipated. However, after some time, the overall interest subsided as a result of

FIG&sid=8630&close_date=12/31/2007 (last visited Apr. 6, 2008) (describing the price on Dec. 31, 2007).

⁷⁷FIG Quote—FIG Stock Quote—Fortress Investment Group L.L.C. Stock Quote, <http://online.wsj.com/quotes/main.html?type=djn&symbol=fig> (last visited Apr. 6, 2008) (documenting general pricing information for Fortress Investment Group).

⁷⁸*Id.*

⁷⁹*Id.*

⁸⁰ Gregory Zuckerman, *Hedge Funds Feel New Heat*, WALL ST. J., February 23, 2008, at A1.

⁸¹ *Id.* (supporting the proposition that investors are seeking simpler investments).

⁸² Dennis K. Berman, Henny Sender & Gregory Zuckerman, *Blackstone Aims to Keep Control as Public Entity—Buyout Firm’s IPO Plan Sets Limits on Investors; Few Details on Top Pay*, WALL ST. J., March 23, 2007, at A1.

⁸³ Zuckerman, *supra* note 80 (listing the complex use of leverage as a reason for poor performing hedge funds).

⁸⁴ *Id.*

the unique investment strategy, partnership structure and inherently “private” nature of these investment vehicles. Kohlberg Kravis Roberts & Co., a private-equity firm, although having registered a Form S-1 in July 2007,⁸⁵ has not yet engaged in its IPO, only amending its Form S-1 to reflect the increased challenges the firm faces.⁸⁶ It is possible that PE and hedge funds no longer believe the benefits of going public outweigh the costs associated with such public listing.

Steve Ferrara⁸⁷

⁸⁵ See KKR & Co. L.P., Registration Statement (Form S-1), at Cover (July 3, 2007) (indicating KKR filed its S-1).

⁸⁶ Dana Cimilluca, *Deals & Dealmakers: KKR's Road to Offering Appears Bumpy—Costs for Deals Soar, Crimping Prospects of High Returns*, WALL ST. J., August 14, 2007, at C5 (indicating KKR filed an amendment to its original Form S-1); KKR & Co. L.P., Registration Statement A1 (Form S-1), (July 3, 2007) (indicating KKR filed an amendment to its original Form S-1).

⁸⁷ Student, Boston University School of Law (J.D. 2009).

IX. ETFs and Mutual Funds: Changes in the Industry

On February 1, 2008, the Securities Exchange Commission issued a notice that gave close-to-final approval to PowerShares Capital Management to issue actively managed Exchange-Traded Funds ("ETFs"). Prior to the SEC's February 1 notice, an ETF had been restricted to mirroring an index, like the Standard & Poor's 500. This new SEC ruling allows fund managers to actively choose investments for an ETF. PowerShares is the first to receive approval from the SEC to begin offering actively managed ETFs. This regulatory decision by the SEC has the potential to have a fundamental impact on the investment management market and on the mutual fund industry in particular.

This article examines traditional equity ETFs, the SEC regulation enabling actively managed ETFs, and the effects of this ruling on the investment management market. Part I provides background and history on the creation and regulation of ETFs. Then, Part II explores both favorable and unfavorable aspects of traditional ETFs. Part III next discusses the SEC's notice that gives near final approval to PowerShares to issue actively managed ETFs. Finally, Part IV analyzes the potential impact that actively managed ETFs will have on the investment management market.

A. Background and History of Exchange-Traded Funds

ETFs are "investment companies that are registered under the Investment Company Act of 1940 ('Act') as open-end funds" or unit investment trusts (UIT).¹ ETFs do not sell or redeem individual shares at net asset value ("NAV"), instead transacting at NAV only in large blocks (i.e. 50,000 ETF shares).² ETF shares are listed on national securities exchanges (i.e. NYSE) for trading at market prices throughout the day.³ A central characteristic of existing ETFs traded in the United States is that they are based on domestic or foreign market indices (i.e. S&P 500).⁴ ETFs hold either the securities of the index or a "representative sample of the securities in the index."⁵ In

¹ Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25,258, 66 Fed. Reg. 57,614 (Nov. 15, 2001).

² *Id.*

³ *Id.*

⁴ *Id.* at 57,615

⁵ *Id.*

2007, the exchange-traded fund industry grew rapidly in assets and new investment products. Through year's end, assets grew approximately 45%, increasing from \$422 billion to \$608 billion.⁶ The number of ETFs offered increased by 270, to a total of 629.⁷ Among the most popular ETFs are: SPDRs, based on the Standard & Poor's 500 index; Diamonds, based on the Dow Jones Industrial Average; and Vanguard's VIPERS, tracking the Wilshire 5000 Total Market Index.⁸

The first ETF was "carefully designed and issued in 1993."⁹ This ETF, a SPDR, was a UIT and was introduced by a subsidiary of AMEX.¹⁰ The first ETF organized as an open-end fund was introduced in 1996.¹¹ Before ETFs are issued, the SEC must grant exemptive relief from certain provisions of the Act.¹² Generally, ETFs obtain exemptive relief to (1) allow the ETF to register as a mutual fund and issue shares that are redeemable in large aggregations only; (2) to permit the trading of individual shares of ETFs in the secondary market at negotiated prices; (3) permit affiliated entities to purchase and redeem shares in kind rather than in cash.¹³

Regardless of whether the ETF is organized as either a UIT or an open-end fund, existing ETFs all operate in basically the same way.¹⁴ ETFs only issue shares in large aggregations called "Creation Units," and investors purchase a Creation Unit with a "Portfolio Deposit," whose value is equal to the aggregate NAV of the ETF Shares in the Creation Unit.¹⁵ The ETF sponsor must announce the contents of the Portfolio Deposit (contains a basket of securities that mirrors the composition of the ETFs portfolio) at the beginning of

⁶ Exchange-Traded Fund Assets December 2007 Investment Company Institute Statistics and Research, http://www.ici.org/stats/etf/etfs_12_07.html#TopOfPage (Jan. 30, 2008) (statistics listed in chart)

⁷ *Id.* (statistics listed on chart).

⁸ Peter N. Hall, *Bucking the Trend: The Unsupportability of Index Providers' Imposition of Licensing Fees For Unlisted Trading of Exchange Traded Funds*, 57 VAND. L. REV. 1125, 1130 (2004).

⁹ *Id.* at 1129.

¹⁰ Actively Managed Exchange-Traded Funds, *supra* note 1, at 57, 615.

¹¹ *Id.* (describing when the first open-end ETF fund was introduced)

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 57,616.

¹⁵ *Id.*

each business day.¹⁶ After buying a Creation Unit, the investor may hold the ETF shares or sell them to other investors on the secondary market.¹⁷ ETF shares purchased in the secondary market are redeemable only in Creation Unit aggregations, with the redeeming investor receiving a “Redemption Basket” priced at NAV.¹⁸ If the investor holds fewer shares than a Creation Unit, she may sell the shares on the secondary market for market price.¹⁹ Individual shareholders do not transact directly with the ETF but must deal with a broker.²⁰ The current structure of ETFs is popular with both individual and institutional investors.

B. Favorable and Unfavorable Aspects of Existing ETFs

The existing structure of an index based ETF has a number of benefits that have caused its popularity amongst investors. However, there are some drawbacks to ETFs that should also be examined before investing in an ETF. An important benefit of an ETF is that it offers the diversification benefits of a mutual fund coupled with the trading flexibility of a traditional stock.²¹ Because they are listed on the exchange, ETFs can be traded throughout the day at whatever price they are trading for that day, just like stocks.²² This “allows investors to dash in and out of the market while also using stop orders, orders to buy or sell when a specified price is reached, and limit orders, orders to buy or sell a stock at or close to a particular price.”²³ This is a significant difference from traditional

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* (explaining the redemption process of ETF shares purchased in secondary market).

¹⁹ *Id.*

²⁰ Jane Bryant Quinn, *New Managed ETFs Try to Beat the Market*, THE WASH. POST, Mar. 16, 2008, at F01 (describing that ETFs must be purchased from a broker).

²¹ Actively Managed Exchange-Traded Funds, *supra* note 1, at 57, 617.

²² Arden Dale, *Quarterly Mutual Funds Review—Building Portfolios With ETFs—Advisers Cite Benefits Of the Low-Cost Funds; Not Right for Everyone*, WALL ST. J., Oct. 4, 2005, at R1.

²³ Rebecca Knight, *Still Seeking the Holy Grail of the Industry*, FIN. TIMES, Nov. 5, 2007, at 4.

mutual funds, which “are priced once daily at the market close.”²⁴ In addition, because ETFs can be sold short—“investors can bet that an index will fall by selling borrowed shares, then buy them back when the price drops.”²⁵ Another benefit is the tax efficiency that comes with investing in an ETF. When selling shares of a mutual fund, a fund manager must sell some of the securities to raise money, which results in taxable capital gain distributions.²⁶ However, ETF shares are bought and sold by investors on the secondary market, which doesn't trigger capital gains that can be taxed.²⁷ Furthermore, when shares are redeemed “in kind” by a market maker in the shares, no distributable capital gains occur.²⁸ Overall, ETFs are taxed far less than traditional mutual funds. Moreover, another attractive feature of ETFs is their cost efficiency. ETFs can be “significantly less expensive than traditional mutual funds.”²⁹ “While the average mutual fund charges annual investment fees of about 1.5% of assets, the SPDR S&P 500 ETF, the largest ETF, levies just 0.09%, less than one-tenth of the average.”³⁰ Because ETF shares are purchased and sold through the secondary market, ETFs have lower shareholder recordkeeping and service expenses.³¹ Finally, with ETFs there is no minimum investment; permitting single share purchases.³²

While the above benefits make ETFs attractive to investors, there are certain disadvantages that accompany an investment in existing ETFs. The biggest disadvantage that comes with ETFs is that every time an investor buys or sells an ETF, she must pay a brokerage fee.³³ This is especially difficult if the investor makes

²⁴ John Spence, *Active ETFs to Make History but May Not Be a Hit Right Away—Investors Will Be Asked To Take a Leap of Faith On Unproven Product*, WALL ST. J., Mar. 7, 2008, at C11.

²⁵ Knight, *supra* note 23.

²⁶ Jen Ryan, *Actively Managed ETFs Will Be Arriving Soon—Goal Is to Exceed Returns, But Retain Main Benefits Of the Traditional ‘Basket’*, WALL ST. J., Sept. 19, 2005, at C11.

²⁷ *Id.*

²⁸ *Id.*

²⁹ Dale, *Quarterly*, *supra* note 22.

³⁰ Ian Salisbury, *Active ETFs to Come With Trade-Offs—Low Costs, Tax Efficiency May Be Hard to Maintain In Move Beyond Indexes*, WALL ST. J., Feb. 7, 2008, at C13

³¹ *Actively Managed Exchange-Traded Funds*, *supra* note 1, at 57,617.

³² Andrew Leckey, *Now May Be Good Time to Bargain-hunt for ETFs*, CHI. TRIB., Feb. 4, 2008, at 4.

³³ Dale, *Quarterly*, *supra* note 22.

small, frequent investments because the fee is applied to each transaction, amounting to heavy broker fees.³⁴ Existing ETFs are also limited to replicating the performance of a market index and thus investors who want to try to earn a higher return by beating the index, will not find ETFs attractive. Additionally, unlike mutual funds, ETFs don't necessarily trade at the net asset values of the underlying holdings, meaning an investor could end up buying an ETF at a premium to the portfolio's value and then selling at a discount.³⁵ Also, for investors who want to reinvest dividends or invest in bonds, ETFs are not an ideal choice as it is almost impossible to reinvest dividends with ETFs and there are only a few fixed income ETFs.³⁶ Finally, ETFs "are not widely held in company 401(k) retirement plans, which remain dominated by mutual funds."³⁷ Thus, while the existing ETF structure provides investors with many benefits, there are some disadvantages that investors should be aware of.

C. SEC Approval of Actively Managed ETFs

While index based ETFs have grown in popularity over the last few years, actively managed ETFs "[are] widely seen as the next frontier in ETF innovation."³⁸ The idea of actively managed ETFs has been around for years in the regulatory and mutual fund arenas. The SEC issued a concept release in November of 2001, which sought comments regarding the implementation of actively managed ETFs.³⁹ The SEC issued the concept release in order to solicit comments from the public about how the Commission should consider proposals for actively managed ETFs.⁴⁰ The SEC received a number of comments from investment companies and exchanges, like the American Stock Exchange and State Street advocating the implementation of actively managed ETFs, but the SEC was still reluctant to approve actively managed ETFs.⁴¹ The concept release

³⁴ *Id.*

³⁵ Actively Managed Exchange-Traded Funds, *supra* note 1, at 57,616.

³⁶ Dale, *Quarterly*, *supra* note 22.

³⁷ Leckey, *supra* note 32.

³⁸ Knight, *supra* note 23.

³⁹ Actively Managed Exchange-Traded Funds, *supra* note 1.

⁴⁰ *Id.*

⁴¹ See Letter from Agustin J. Fleites, Principal, State Street Bank and Trust Company, to Jonathan G. Katz, Secretary, Securities and Exchange

discussed a number of topics surrounding actively managed ETFs including operational issues, uses, benefits, risks, and potential regulatory issues. The SEC was worried about the level of transparency in actively traded ETFs, as transparency is necessary to allow for effective arbitrage activity in the shares of actively traded ETFs.⁴² For index based ETFs, the investment advisor informs the marketplace daily about the contents of the ETF portfolio, but investment managers will be less willing to do this for actively managed ETFs for fear that investors will then mimic the fund manager's investment strategy, resulting in increased securities prices for the fund's purchases.⁴³ Portfolio managers do not want investors copying their strategy or trading in advance of big transactions to take advantage of expected price movements.⁴⁴

Another area of concern for the SEC was whether actively managed ETFs should be "limited to certain investment objectives . . . to ensure that the portfolio securities are sufficiently liquid to permit effective arbitrage."⁴⁵ The SEC also expressed concern about the potential discrimination among shareholders due to significant differences between the market price and the net asset value of the ETF shares.⁴⁶ Additionally, the SEC was concerned that the increased investment discretion of the advisor of an actively managed ETF would increase the potential conflicts of interest that are inherent in the operation of ETFs, specifically the process in which a "Creation Unit is purchased by delivering a basket of securities to the ETF, and redeemed in exchange for a basket of securities."⁴⁷ These issues, among others, are the reasons behind the

Commission (Jan. 14, 2002) (on file with the Securities and Exchange Commission) (providing comment on SEC Concept Release IC-25258: Actively Managed Exchange-Traded Funds); Letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, American Stock Exchange LLC, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Mar. 5, 2002) (on file with the Securities and Exchange Commission) (providing comment on SEC Concept Release IC-25258: Actively Managed Exchange-Traded Funds).

⁴² Actively Managed Exchange-Traded Funds, *supra* note 1, at 57,619.

⁴³ John Waggoner, *A Half-hidden Manager*, USA TODAY, May 31, 2007, at 3B.

⁴⁴ Ryan, *supra* note 26.

⁴⁵ Actively Managed Exchange-Traded Funds, *supra* note 1, at 57,619.

⁴⁶ *Id.* at 57,622 (explaining the potential for discrimination amongst shareholders).

⁴⁷ *Id.*

SEC's reluctance in approving managed ETFs without sufficient research and analysis.

On February 1, 2008 the SEC finally issued a notice that it will grant the legal exemptions needed for Powershares Capital Management to launch four (3 equity and 1 bond) proposed actively managed ETFs.⁴⁸ The SEC is tying final approval of the request to the completion of a public review process.⁴⁹ This is the first application for actively managed ETFs that has been approved by the SEC.⁵⁰ Actively managed ETFs are the next logical step in the evolution of ETFs and as such, PowerShares hopes that these actively managed ETFs will generate greater returns, while retaining the benefits of traditional ETFs (i.e. tax efficiency).⁵¹ The PowerShares funds include a number of concessions to ease the concerns that the SEC posed in its 2001 Concept Release, including the issue of transparency.⁵² The PowerShares application argues that "fully transparent portfolios, liquid portfolio securities and dissemination of the ETF's intraday indicative value permits arbitrage opportunities for actively managed ETFs to the same extent as index-based ETFs, and should minimize differences between secondary market prices and the net asset value."⁵³ However, these concessions, including "restrictive measures on the timing and number of trades," have resulted in the "early reaction" that ETF filings are not "all that 'active.'"⁵⁴

PowerShares filed for three actively managed equity ETFs.⁵⁵ The first two funds, PowerShares Active AlphaQ and PowerShares Active Alpha Multi-Cap, are quantitative funds that can make up to

⁴⁸ PowerShares Capital Management LLC, et al.; Notice of Application, Investment Company Act Release No. 28,140, 73 Fed. Reg. 7,328, 7,329 (Feb. 7, 2008) (describing the types of actively managed ETFs PowerShares is applying for).

⁴⁹ *Id.* (explaining that SEC requires public review before final approval is given).

⁵⁰ See Diya Gullapalli, *Actively Traded ETFs: A Step Closer to Reality*, WALL ST. J., Feb. 5, 2008, at C3.

⁵¹ Knight, *supra* note 23.

⁵² See Legal Update, Ropes and Gray LLP, SEC issues notices for actively managed ETFs (Feb. 20, 2008) (on file with author).

⁵³ *Id.*

⁵⁴ Spence, *supra* note 24.

⁵⁵ PowerShares Capital Management LLC, et al.; Notice of Application, *supra* note 48 (explaining the proposed introduction of four actively managed ETFs).

three trades on the last business day of each week.⁵⁶ To prevent others from front running the stock selection, the trades will not be revealed until the following business day after the public announcement of the portfolio changes.⁵⁷ The third fund, PowerShares Active Mega-Cap will behave similarly to a quantitative mutual fund but human managers will also apply judgment.⁵⁸ The holdings of this fund will be published each day, but the managers can trade at any time.⁵⁹

In short, in order to resolve the transparency issue, PowerShares with the Alpha funds is limiting trading to a single day⁶⁰ and with the Mega-Cap fund, the manager is completely active, but only invests in equity securities of mega-capitalization companies,⁶¹ where the risk of front running is not as great. Another potential solution to the transparency problem is “disclosing a ‘proxy’ portfolio that is similar, yet not exactly the same as the portfolio,” which will “allow specialists to hedge their positions, while preventing traders from figuring out the real fund’s composition.”⁶² As another option, the actively managed ETF could also reveal only statistics about its portfolio, like average size of the stocks it holds, the number of stocks, and the industries the stocks are in.⁶³

After years of reviewing and contemplating the notion of actively managed ETFs, the SEC has finally approved the proposals by companies like PowerShares. The next question to consider, now that the SEC is willing to approve an actively managed ETF, is what effect they will have on the investment management market.

⁵⁶ Legal Update, Ropes and Gray LLP, *supra* note 52.

⁵⁷ *Id.*

⁵⁸ Michael Maiello, *ETF Tricks*, FORBES, Jan. 28, 2008, at 86.

⁵⁹ PowerShares Capital Management LLC, et al.; Notice of Application, *supra* note 48, at 7,330.

⁶⁰ Legal Update, Ropes and Gray LLP, *supra* note 52.

⁶¹ PowerShares Capital Management LLC, et al.; Notice of Application, *supra* note 48.

⁶² Knight, *supra* note 23.

⁶³ Waggoner, *supra* note 43.

D. The Potential Impact of Actively Managed ETFs on the Investment Management Market

The SEC notice to permit actively managed ETFs carries with it the potential to significantly impact the investment management market, and in particular traditional mutual funds. Mutual funds face the possibility of a major threat from aggressive actively managed ETF providers.⁶⁴ There is a great demand for actively managed funds, and ETFs could provide a good alternative for mutual funds. ETFs could be seen as more desirable to investors than mutual funds because they are more tax-friendly.⁶⁵ Active ETFs will still be able to eliminate the capital gains that come with mutual funds.⁶⁶ Furthermore, like mutual funds, actively managed ETFs allow fund managers to pick attractive stocks in order to try and outperform the market.⁶⁷ However, actively managed ETFs may still be more desirable because, unlike mutual funds, investors can more freely trade ETFs throughout the day, providing greater flexibility than mutual funds. Finally, traditionally ETFs have been cheaper than traditional mutual funds, but this cost advantage may not transfer to actively managed ETFs.⁶⁸

Even prior to the SEC's approval of the first actively managed ETFs, mutual fund companies were taking steps to protect themselves against this competitive threat by joining the ETF world. More banks and brokerage firms have added ETFs to their investment offerings including leading mutual fund companies like Fidelity and Vanguard Group.⁶⁹ Many mutual fund companies are joining forces with smaller ETF companies: Dreyfus and WisdomTree⁷⁰; TD Ameritrade Holding Corp and XShares Advisors LLC⁷¹; and Amvescap PLC and ETF provider PowerShares Capital

⁶⁴ Gullapalli, *supra* note 50.

⁶⁵ Salisbury, *supra* note 30.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* (explaining that the unique quality of active management may not produce the same cost-savings as traditional ETFs).

⁶⁹ Julie Earle-Levine, *ETFs Hot on the Heels of Mutual Funds: Recent Products Such as PowerShares are Outperforming Many Benchmarks*, FIN. TIMES, July 10, 2003, at 20 (explaining the introduction of ETFs by Fidelity & Vanguard).

⁷⁰ *New Funds*, FIN. TIMES, Feb. 4, 2008, at 12.

⁷¹ *New Funds*, FIN. TIMES, Oct. 8, 2007, at 14.

Management LLC.⁷² Another potential way for mutual funds to remain competitive with actively managed ETFs is through intra-day pricing.⁷³ Fund firms believe that intra-day pricing might help “stave off ETFs . . . especially . . . actively managed ETFs.”⁷⁴ However, this may not prove effective in keeping ETFs at bay as intra-day pricing may lead to higher costs which would give ETFs greater appeal to investors through cost savings.⁷⁵ However, one thing is clear as more actively managed ETFs begin trading and gaining popularity, the mutual fund industry needs to find a way to remain competitive.

The possibility remains that actively managed ETFs may not be a successful immediately especially since “they will be operating with no real-world track record and without investment managers who are known quantities with most investors and financial advisers.”⁷⁶ Mutual funds are still a good choice for investors who invest small dollar amounts regularly because ETFs are “impractically expensive” due to their brokerage fees.⁷⁷ Additionally, large investors like “hedge funds and other Wall Street traders, who were the first to adopt ETFs and still account for the vast majority of the funds' daily trading volumes, may find relatively little use for the new actively managed ETFs.”⁷⁸ Without these institutional investors, fund shares could be thinly traded, which will make them more expensive to buy and sell and less tax-friendly.⁷⁹ Also, much of the cost advantage associated with traditional ETFs may be lost because those savings were derived from the actual structure of the index fund.⁸⁰ Actively managed ETFs may still remain slightly cheaper than conventional mutual funds, but they will likely be more expensive relative to other ETFs.⁸¹ Furthermore, there is a chance actively managed ETFs will be incorrectly priced because of the lack

⁷² Arden Dale, *Amvescap Buys PowerShares And Gains Heft in ETF Market*, WALL ST. J., Jan. 24, 2006, at D3.

⁷³ Chuck Jaffe, *YOUR FUNDS; Will Mutual Fund Cos. Soon Adopt Intra-day Pricing for Customers?*, BOSTON GLOBE, Jan. 21, 2007, at 023.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ Spence, *supra* note 24.

⁷⁷ Dale, *Quarterly*, *supra* note 22 (explaining the potential costs associated with active managed ETFs for frequent investors).

⁷⁸ Salisbury, *supra* note 30.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

of daily disclosure of the actual portfolio.⁸² Finally, big mutual-fund companies may continue to have a competitive edge because of their huge marketing dollars and powerful distribution channels.⁸³ Barclays, an ETF provider, spends only an estimated one-fifth as much as a big mutual-fund company does on marketing.⁸⁴

Thus, the question of how much of an impact the introduction of actively managed ETFs will have on the investment management market is yet to be determined. It is safe to predict that actively managed ETFs will have some effect on conventional mutual funds, however, the magnitude of that effect cannot yet be determined.

E. Conclusion

The February 1, 2008 notice by the SEC giving PowerShares Capital Management near final approval to issue actively managed Exchange-Traded Funds (ETFs) signals a major change in the ETF industry. The SEC's approval allowing fund managers to actively choose securities for an ETF instead of passively mirroring an index has the potential to have a major impact on the entire investment management market, and in particular the mutual funds. However, it remains to be seen whether these new funds can adequately resolve the transparency problem, gain popularity with institutional and individual investors, and retain the cost and tax benefits of existing index based funds. As more actively managed ETFs are issued, these uncertainties will become clearer.

Nisha Patel⁸⁵

⁸² Adrienne Carter and Justin Hibbard, *The Hottest Funds In Town The fast growth of exchange-traded funds has the mutual-fund biz scrambling*, BUSINESS WEEK, June 6, 2005, available at http://www.businessweek.com/magazine/content/05_23/b3936086_mz020.htm.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Student, Boston University School of Law (J.D. 2009).

X. *The Effect of Sovereign Wealth Funds*

State-controlled investment vehicles, commonly called sovereign wealth funds (“SWFs”)¹ from Asian and the Middle Eastern nations have helped to rescue Wall Street banks embroiled in the sub-prime mortgage crisis, such as Merrill Lynch & Co., Citigroup Inc., and Morgan Stanley. Since December 2007, SWFs have invested a total of \$69 billion in financial institutions throughout the world.² While providing much needed capital to troubled banks and recycling excess funds back into the world’s markets, the movement by SWFs out of government debt obligations and into equity positions in the world’s leading financial institutions is raising issues presaged by the controversial take over of U.S. port facilities by Dubai Ports World in 2006. The government controlled SWFs, who have gained their strength in the wake of the ballooning U.S. trade deficit and rising oil prices,³ and who often lack transparency, have generated concerns that they may have political as well as commercial objectives and could threaten national security and sovereignty. This development article will address the recent activities of SWFs, the concerns they have generated, and the response by U.S. and world officials.

A. *Recent activities of SWFs*

Despite a 2007 fourth quarter loss of \$9.83 billion, and an \$18.1 billion write down of certain assets, investors, including SWFs, have flocked to Citigroup’s aid. Citigroup has received \$7.5 billion from the Abu Dhabi Investment Authority (ADIA), \$6.88 billion

¹ SWFs differ from other state controlled investment assets, such as public pension funds, because, in theory, their purpose is to increase the wealth of the controlling state, rather than to pay down a specific debt. They also have riskier investment portfolios that increasingly contain equity holdings, rather than just bonds. Lee Hudson Teslik, *Sovereign Wealth Funds*, CFR.ORG BACKGROUNDER (Council on Foreign Relations, New York, N.Y.), Jan. 18, 2008 available at <http://www.cfr.org/publication/15251/>

² The Invasion of the Sovereign-Wealth Funds, *ECONOMIST*, Jan. 17, 2008, available at http://www.economist.com/opinion/displaystory.cfm?story_id=10533866 (hereinafter *The Invasion*).

³ Another factor in the growth of SWFs is the devaluation of the U.S. dollar, which gives Asian exporters a greater incentive to sell their currency reserves, as well as Middle Eastern oil producers, given that oil is currently priced in U.S. dollars. Teslik, *supra* note 1.

from the Government of Singapore Investment Corp. (GIC), and \$1 billion from Saudi Prince Alwaleed bin Talal.⁴ In addition, the Kuwait Investment Authority (KIA) put a relatively small investment into the bank.⁵ While the total cash infusion is approximately \$12.5 billion, none of the investors will own more than 4.9% of Citigroup's stock.⁶ Investors were attracted by the prospect of obtaining a stake in a major Wall Street investment bank, as well as by Citigroup's decision to issue a 7% dividend on \$12.5 billion in preferred shares; allowing investors to gain a stake for about half the price it would have cost before the credit crunch.⁷

Merrill Lynch also had little trouble luring foreign government investors despite an \$8.6 billion net loss in 2007.⁸ The effort was helped by the promise of a 9% dividend \$6.6 billion in preferred stock that will issue.⁹ In December, Merrill received a \$4.4 billion investment from Singapore's state-run Temasek Holdings.¹⁰ Merrill's investors also include Korean Investment Corp., a government-controlled investment fund of South Korea.¹¹ In total, SWFs have contributed 80% of the \$6.6 billion total capital infusion received by Merrill.¹²

In addition, Morgan Stanley was the target of a \$5 billion investment by China Investment Corporation Ltd. (CIC), China's \$200 billion state controlled investment fund.¹³ In October of 2007, CIC bought a \$3 billion stake in Blackstone Group LP.¹⁴ Other banks

⁴ Lee Kuan Yew, *Asia's Growing Role in Financial Markets*, FORBES, Feb. 25, 2008, available at 2008 WLNR 2653060.

⁵ David Enrich, Robin Sidel, Susanne Craig, *World Rides to Wall Street's Rescue—Citigroup, Merrill Tap Foreign-Aid Lifelines; Damage Tops \$90 Billion*, WALL ST. J., Jan. 16, 2008, at A1.

⁶ *Id.*

⁷ *Id.*

⁸ Press Release, Merrill Lynch, Merrill Lynch Reports Full-Year 2007 Net Loss From Continuing Operations of \$8.6 Billion (Jan. 17, 2007), available at http://www.ml.com/index.asp?id=7695_7696_8149_88278_88282_88436.

⁹ Enrich, *supra* note 5.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ Bob Davis, *China Investment-Fund Head Says Focus Is on 'Portfolios'*, WALL ST. J., Feb. 1, 2008, at A13.

¹⁴ Jamil Anderlini, *China fund gears up for \$30bn drive*, FIN. TIMES, February 10, 2008, available at <http://www.ft.com/cms/s/0/4a1170d2-d805->

and companies have been also been the target of foreign investment, including the Swiss bank UBS AG., which received \$9.75 billion from Singapore's GIC, and \$1.77 billion from a Middle East investor.¹⁵

B. *The growth of SWFs and their plans*

1. Asia

The investment powers of SWFs are growing, and they are aggressively seeking investment vehicles and investment targets. China is using its \$1.5 trillion foreign exchange reserve to fund CIC and fuel its foreign investments.¹⁶ Looking for a relatively low profile strategy, and denouncing any desire to own controlling interests in its investment targets, China is seeking to use private equity fund bankers to manage its investments.¹⁷ CIC is expected to grant as much as \$30 billion to international fund managers to use in offshore investments.¹⁸ CIC announced plans to invest \$4 billion in a new JC Flowers & Co., LLC¹⁹ fund, for which China will be the sole investor.²⁰ The fund will be used to target ailing U.S. financial institutions.²¹ Similarly, the Singapore's GIC, a \$330 billion SWF,²² plans to be the dominant investor in a new TPG Capital fund.²³

11dc-98f7-0000779fd2ac,dwp_uuid=cf8c5ee0-aa15-11da-96ea-0000779e2340.html?nclick_check=1.

¹⁵ Yew, *supra* note 4.

¹⁶ Anderlini, *supra* note 14.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ See JC Flowers Home Page, <http://jcfco.com/>.

II. ²⁰ Henny Sender, *Sovereign Wealth Finds Private Equity Bedfellows*, FIN. TIMES, Feb. 14, 2008, available at <http://www.ft.com/cms/s/0/1a79fae6-db30-11dc-9fdd-0000779fd2ac.html>.

²¹ Anderlini, *supra* note 14.

²² *Asset-backed Insecurity*, ECONOMIST, Jan. 17, 2008, available at http://www.economist.com/opinion/displaystory.cfm?story_id=10533428.

Singapore also controls Temasek Holdings, another SWF with \$159.2 billion in assets. *Id.*

²³ Sender, *supra* note 20. TPG Capital, formerly Texas Pacific Group, is a private equity investment firm. See TPG Capital About Page, <http://www.texaspacificgroup.com/about/index.html>.

2. Middle East

Just as their Asian counterparts grow and seek new opportunities, SWFs from the Middle East are gaining strength as oil profits balloon. In 2008, SWFs controlled by Middle Eastern governments are expected to grow their foreign held assets by 10% to a total of \$2 trillion.²⁴ The United Arab Emirates' SWF the Abu Dhabi Investment Authority is the largest in the world, with assets valued at \$875 billion.²⁵ Saudi Arabia's SWFs are estimated to have assets of \$250 billion.²⁶ Kuwait's SWF is estimated to have assets valued at \$250 billion.²⁷ Qatar's prime minister recently declared that the state-controlled investment arm of his oil-rich sheikdom intends to invest \$15 billion in 10 to 12 blue-chip European and U.S. banks.²⁸

In addition to the \$7.5 billion investment into Citigroup by the Abu Dhabi Investment Authority, some other recent examples of activity by Middle Eastern SWFs include Dubai International Capital's, a state-owned holding company, acquisition of an undisclosed stake in Sony Corp.,²⁹ and a \$1.26 billion investment in the initial public offering of hedge fund Och-Ziff Capital Management Group.³⁰ Abu Dhabi's Investment Authority has invested \$622 million (an 8.1% stake) in California-based microchip-maker Advanced Micro Devices Inc.³¹ While, Dubai World has bought a \$2.7 billion (6.7%) stake in MGM Mirage.³²

²⁴ Andrew Critchlow, *Davos 2008: As West Pleads, Gulf Shrugs—Calls for Energy Help, Additional Investments May Fall on Deaf Ears*, WALL ST. J., Jan. 23, 2008, at A8.

²⁵ *Asset-backed Insecurity*, *supra* note 22.

²⁶ *Id.*

²⁷ *Id.*

²⁸ Bob Davis, Dennis K. Berman, *Lobbyists Smoothed the Way For a Spate of Foreign Deals*, WALL ST. J., Jan. 25, 2008, at A1[hereinafter Davis, *Lobbyists*].

²⁹ Yukari Iwatani Kane, *Dubai Fund Snags Sony Stake—Move Shows Hunger For Overseas Deals By Mideast Investors*, WALL ST. J., Nov. 27, 2007, at C3.

³⁰ Critchlow, *supra* note 20.

³¹ Don Clark, Chip Cummins, *AMD's Infusion From Emirate May Be Only Respite*, WALL ST. J., Nov. 17, 2007, at A3.

³² Kevin Kingsbury, *MGM, Dubai World to Raise Joint Tender Offer*, WALL ST. J., Jan. 17, 2008, at B6.

3. The Bear Stearns Effect

On March 17, 2008, J.P. Morgan Chase & Co. announced an offer to purchase Bear Stearns Cos., which had suffered heavily from its extensive exposure to mortgage backed securities, for just \$2 per share.³³ The proposed buyout of Bear could cause SWFs to rethink their strategy. After all, Citic Securities Co., the biggest Chinese brokerage, wanted to buy a 6% stake in Bear for 69 times the price of J.P. Morgan's \$2 offer.³⁴ In October 2007, China's CIC paid \$3 billion for a nine percent stake in Blackstone Group.³⁵ By mid March 2008, that stake was worth half of its original value.³⁶ Less than three months after CIC's \$5 billion investment in Morgan Stanley, their shares are worth 30% less.³⁷ As of mid-March, UBS stock had fallen 57% since December 10, 2007, when Singapore's GIC invested \$9.75 billion in the bank.³⁸

Thus, SWFs may find themselves joining some critics who have questioned their aptitude for investing and their value to their host countries.³⁹ Their recent experiences, along with the example of Bear Stearns, likely will cause them to be extra cautious when investing in U.S. financial stocks, but it is not clear if they will alter

³³ Robin Sidel, Kate Kelly, *Big Task: Digesting a Bear*, WALL ST. J., Mar. 26, 2008, at C1. On March 24, 2008, JP Morgan revised the offer to \$10.02 per share. *Id.*

³⁴ Andy Mukherjee, *Bear Stearns's Ruin Will Shake Sovereign Funds*, BLOMBERG, Mar. 17, 2008, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_mukherjee&sid=agH_B1U16Bok#

³⁵ *Id.*; *Asset-backed Insecurity*, *supra* note 22.

³⁶ *Id.*

³⁷ Mukherjee, *supra* note 34.

³⁸ *Id.*

³⁹ See Anders Åslund, *The Truth about Sovereign Wealth Funds*, Dec. 2007, available at http://www.foreignpolicy.com/story/cms.php?story_id=4056 (arguing that SWFs are "often a lousy bargain for the countries that have them" and "[i]t would be more economical and democratic to cut taxes and let citizens save and invest themselves", as evidenced not only by their marginally successful investment efforts, but by the fact that SWFs have been "developed mostly by authoritarian regimes in semi-developed countries, where citizens don't have a chance to demand smarter economic policies"); *The Invasion*, *supra* note 2 ("Ideally, the high-savings countries of the Middle East and Asia would liberalise [sic] their economies, allowing their own citizens to invest for themselves, rather than paying bureaucrats to do it for them.") (Anders Åslund, is a senior fellow at the Peterson Institute for International Economics, Washington, D.C.)

their plans as a result.⁴⁰ This is because SWFs have seemingly made their investments for the long term.⁴¹ In addition, some of their investments are structured as interest-paying securities convertible into equity at a future date, thus somewhat isolating their positions from immediate harm from falling share prices.⁴²

C. *Growing concern over SWFs*

As SWFs from China, other Asian countries, and Middle Eastern nations acquire positions in U.S. investment banks and seek ownership of foreign real estate and infrastructure, and with their current assets of \$3 trillion estimated to grow to over \$12 trillion by 2012,⁴³ concern among the target nations is also growing. Nonetheless, it is widely accept that not only did the infusion of capital from SWFs keep the U.S. financial crisis from worsening, but also continued foreign equity investment by SWFs could fuel economic growth.⁴⁴ The capital invested by SWFs will be, in theory, put to efficient uses such as funding research and development, paying salaries, and purchasing capital assets.⁴⁵ However, recipient countries are left to question how SWFs will be used in practice—for purely commercial reasons, or to achieve political objectives.⁴⁶ Thus,

⁴⁰ Mukherjee, *supra* note 34.

⁴¹ *E.g.*, *Id.* But see Peter Navarro, Business Professor University of California-Irvine, Testimony Before the U.S.-China Economic and Security Review Commission (Feb. 1, 2007), *available at* http://www.uscc.gov/hearings/2007hearings/written_testimonies/07_02_01_02wrts/07_02_1_2_navarro_peter_statement.php (arguing that “there may be times that China may want to short the broad U.S. market indices or major U.S. companies as a hedge against events it may either be anticipating—or, in the worst case, precipitate itself” such as if “China knows it is going to shift its currency policy to that of strengthening the yuan [sic]” or in “anticipation of events such as a move on Taiwan”).

⁴² Mukherjee, *supra* note 34.

⁴³ Teslik, *supra* note 1.

⁴⁴ *E.g.*, Teslik, *supra* note 1.

⁴⁵ *Id.*

⁴⁶ Lawrence Summers, *Funds That Shake Capitalist Logic*, FIN TIMES, Jul. 29, 2007 (arguing that because “governments are now accumulating various kinds of stakes in what were once purely private companies” the very nature of global capitalism is at stake because “[t]he logic of the capitalist system depends on shareholders causing companies to act so as to maximise [sic] the value of their shares” and “[it] is far from obvious that this will over

tensions exist between a desire to attract capital and maintaining liquidity and fears that SWFs may have politically motivated objectives.⁴⁷

The most prominent cause of these concerns is SWFs' lack of transparency. In contrast to other investment funds that regularly report and publish their activities, SWFs have not made their objectives clear and it is difficult to tell exactly how much money they manage, or where they have made their investments.⁴⁸ SWFs use a broad range of investment vehicles, and while it is believed that the use of private hedge funds and private equity firms will provide an extra layer of protection to target nations, these investment options help to "further cover [their] tracks."⁴⁹

Supporters of SWFs argue that the concerns over SWFs are not only misplaced, but also that such concerns are vague or exaggerated.⁵⁰ They note that SWFs have existed since the 1970s and have never been used to exert political pressure,⁵¹ that more than 60% of SWF assets are held in fixed-income securities and the rest represents minority stakes in public companies,⁵² and that the larger their investments the more interest they have in the continued economic prosperity of the target companies and countries.⁵³

time be the only motivation of governments as shareholders" who "may want to see their national companies compete effectively, or to extract technology or to achieve influence.") (Lawrence Summers is a former U.S. Treasury Secretary).

⁴⁷ See *E.g.*, *The Invasion*, *supra* note **Error! Bookmark not defined.** (suggesting that the U.S. is "weighing the risk of [posed by SWFs] against the rewards of hard cash, on the table, right now . . .")

⁴⁸ *Asset-backed Insecurity*, *supra* note 22.

⁴⁹ *Id.*

⁵⁰ Aleksey Kudrin, Dep. Prime Min. and Min. of Fin. of the Rus. Fed., *Myths and Realities of Sovereign Wealth Funds*, Statement Before the World Economic Forum (Jan. 24, 2008), *available at* http://www.weforum.org/en/knowledge/KN_SESS_SUMM_23264?url=/en/knowledge/KN_SESS_SUMM_23264.

⁵¹ Muhammad S. Al Jasser, Vice-Governor of the Saudi Arabian Monetary Agency, *Myths and Realities of Sovereign Wealth Funds*, Statement Before the World Economic Forum (Jan. 24, 2008), *available at* http://www.weforum.org/en/knowledge/KN_SESS_SUMM_23264?url=/en/knowledge/KN_SESS_SUMM_23264; *The Invasion*, *supra* note 2 ("So far there is no evidence of such 'mischievous' behaviour [sic] . . .").

⁵² Kudrin, *supra* note 50.

⁵³ See *e.g.*, *id.*

However, others respond that the threats are real and only more substantial now that SWFs holdings are becoming larger and bolder. Leading the charge in the U.S. Congress to address concerns over SWFs, is Senator Charles E. Schumer (D-NY), chairman of the Joint Economic Committee. At his committee hearing, Senator Schumer speculated that foreign governments could use their SWFs to control strategic assets, secure access to sensitive information or technology, and corner a market on raw materials.⁵⁴ Schumer also stated that the controlling governments of SWFs might have an interest in “promoting a political agenda.”⁵⁵ True to the criticism of backers of SWFs, Schumer failed to elaborate on what specific political objectives foreign nations would seek to achieve, and how they would use SWFs to do so. However, others have not been so discreet in stating their worries.

Those that have concerns over SWFs note that SWFs are now big enough to shift markets,⁵⁶ even if they hold only minority positions.⁵⁷ They point out that the governments that control the largest SWFs are not democracies, and generally do not have fully market driven economies.⁵⁸ These governments may have a motive for using their SWFs in a less than purely commercial manner: Middle Eastern nations may wish to protect OPEC and their controversial authoritarian governments, while China may want to protect its policy of maintaining an undervalued currency as well as its controversial trade, environmental and employment regulations.⁵⁹ It is these trade practices and political policies that have fueled the booming economic growth and ballooning trade reserves of the controlling governments. Their economic success in turn funds their military growth⁶⁰ and furthers their ability to maintain authoritarian

⁵⁴ *Wealth Funds and The U.S. Economy: Hearing Before the Senate Joint Economic Committee*, 110th Cong. (2008) (Testimony of David H. McCormick, Under Secretary for International affairs, Treasury Department) (Treasury Dept. News Release) available at 2008 WL 376759, *4 - 5 (hereinafter *Hearing*).

⁵⁵ *Hearing*, *supra* note 54. See also Teslik, *supra* note 1,

⁵⁶ *Asset-backed Insecurity*, *supra* note 35.

⁵⁷ Douglas Rediker, Heidi Crebo-Rediker, *Foreign Investment and Sovereign Wealth Funds*, WORKING PAPER # 1 (New America Foundation, Global Strategic Finance Initiative, Washington, DC), Sept. 25, 2007, at 3.

⁵⁸ *E.g.*, Navarro, *supra* note 41.

⁵⁹ *See id.*

⁶⁰ China has the largest standing army in the world and the growth of their military spending is twice that of their 10% per year economic growth. *Id.*

rule over their people.⁶¹ Today, not only is the West more dependent on China for production, and on Middle Eastern states to supply energy, but they are now turning to these nations for capital.⁶² As the U.S. and other Western nations become increasingly dependent on the continued investment by SWFs, their ability to challenge the controversial economic, political, and military policies of those investing governments will diminish.⁶³ Another concern is that the managers of SWFs have little accountability to regulators, shareholders or voters, a structure that makes them susceptible to a rogue trader,⁶⁴ such as what occurred at Societe General.⁶⁵

D. Recent action taken to address concern over SWFs

While recognizing the importance of continuing to attract investment by SWFs, those with concerns over SWFs have pointed to a number of reforms that would address national security and other risks. For instance, requiring that SWFs invest through intermediary asset managers,⁶⁶ restrictions on shareholder voting by SWFs,⁶⁷ and

(arguing that with a “budding deep water navy” and efforts to expand their military satellite program and space weaponry, China is seeking “to extend its military reach deep into traditional areas of American influence—from the oil rich Persian Gulf to the natural resource-rich countries of Africa and Latin America” and to exert “greater influence over both the Southeast Asian supply chain and the vast petroleum- and mineral-rich northern border countries of Central Asia.”).

⁶¹ *Id.*

⁶² *Id.* (“China now largely funds the U.S. budget by recycling surplus greenbacks back into the U.S. bond market.”).

⁶³ See *Id.* (arguing that “China now has the power to destabilize both U.S. financial markets and the broader U.S. economy by triggering a stagflation shock” and that this “weapon” may be used either as “a threat to deter U.S. foreign policy or trade policy reforms” or in “an actual act of retaliation for any one of a number of U.S. actions, e.g., passage of a Congressional bill to impose protectionist tariffs on China”). See also *Asset-backed Insecurity*, *supra* note 35 (conjecturing about what would happen if the U.S. attempt to take sides in a conflict between Taiwan and China, or if a foreign government made a move to acquire and break-up a critical U.S. industry).

⁶⁴ *The Invasion*, *supra* note 2.

⁶⁵ Colin Barr, *Update: Societe Generale, a Fraud for the Ages*, FORTUNE, Jan. 24, 2008, available at <http://dailybriefing.blogs.fortune.cnn.com/2008/01/24/societe-generale-a-fraud-for-the-ages/>

⁶⁶ *E.g.*, Summers, *supra* note 4846. China’s CIC is currently seeking to use just such an asset manager. *Infra* II.A..

ensuring that U.S. legislation can adequately evaluate and expose national security risks posed by SWFs.⁶⁸

1. Reforms to U.S. Regulations

Federal laws and agencies currently regulate and monitor SWF investments within the U.S.. However, in the recent string of investments in U.S. banks by SWFs, the transactions have avoided detailed review by the U.S. government.⁶⁹ Thus, some have called for strengthening these laws. Applicable U.S. laws⁷⁰ authorize the President to suspend or prohibit any “acquisition” of a U.S. business by a foreign entity that “threatens to impair the national security” after review by the Committee on Foreign Investment in the U.S. (CFIUS).⁷¹ However, CFIUS regulations provide that, “a passive stake—one in which investors don’t seek to influence a company’s behavior—is presumed not to pose national-security problems.”⁷² A voting stake of less than 10% is considered passive.⁷³ So long as the parties notify CFIUS that their deal meets these requirements, they avoid review by CFIUS.⁷⁴

In an attempt to address concerns regarding CFIUS review and the surrounding law, on January 23, 2008, President Bush issued

⁶⁷ *Id.*

⁶⁸ Rediker, *supra* note 57, at 3 (arguing current legislation, specifically CFIUS and FINSA (*see infra* FN 71, 75) were not designed to address “foreign direct investment on the scale that now confronts us” and that “it is unclear whether SWF investment at a level below that which would trigger CFIUS/FINSA review, but still material enough to exert material influence, is currently considered and addressed.”).

⁶⁹ Davis, *Lobbyists*, *supra* note 28 (stating that in “nearly every case” review has been avoided by SWFs).

⁷⁰ Exon-Florio Amendment to the Defense Production Act of 1950, 50 App. U.S.C. § 2170 (1950); Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. pt. 800 (2008) (implementing 50 App. U.S.C. § 2170).

⁷¹ 31 C.F.R. § 800.101. CFIUS is the interagency committee that reviews investments process. *See* <http://www.ustreas.gov/offices/international-affairs/exon-florio/>.

⁷² Davis, *Lobbyists*, *supra* note 28. *See also* 31 C.F.R. § 800.501.

⁷³ *Id.*

⁷⁴ *Id.*

reforms of CFIUS, reflected in FINSA⁷⁵ and Executive Order 11858.⁷⁶ These reforms included new regulations designed to promote accountability within CFIUS, plans to pressure international action by the International Monetary Fund and World Bank, and suggested that the Organization for Economic Co-operation and Development (OECD) identify best practices among nations that receive SWF investment.⁷⁷ In addition, the Joint Economic Committee, led by Senator Schumer (D-NY), is focused on determining whether SWF transparency, the most prominent concern regarding SWFs, would be best achieved by voluntarily working through the IMF, or via legislation.⁷⁸ At the committee's first meeting, Schumer expressed his preference for legislation.⁷⁹

While SWFs seek passive interests—mainly to avoid scrutiny by U.S. agencies, U.S. companies who are the recipient of SWF investments may prefer SWFs to domestic investors, who “might demand a bigger say or board seats for a similar stake.”⁸⁰ For instance, Merrill Lynch turned away possible investments from domestic hedge funds in favor of sovereign funds from Korea and

⁷⁵ *Foreign Investment and National Security Act of 2007*, H.R. 556, 110th Cong., (2007) (directing the executive branch to review how business transactions will affect national security). FINSA was enacted after the public expressed outrage over the Dubai World Port's deal, and which directs the government to investigate investments by foreign governments to determine if there may be any effect on national security. See <http://www.govtrack.us/congress/bill.xpd?bill=h110-556>

⁷⁶ Exec. Order No. 11,858, 40 F.R. 20263 (1975), available at 1975 WL 21469 (giving the US government power for “obtainment, consolidation, and analysis of information on foreign investment in the United States.”). Executive Order 1158 was issued by President Ford in 1975.

⁷⁷ *Hearing*, *supra* note 54, at 4 -5. Other recent activity on the part of the U.S. included a G-20 meeting of Finance Ministry and Central Bank officials hosted by the Treasury Department in May of 2007, and an October 2007 G-7 outreach meeting hosted by Secretary Paulson with Finance Ministers and heads of sovereign wealth funds from China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the UAE involving discussions of best practices. *Id.*

⁷⁸ *Wealth Funds and The U.S. Economy: Hearing Before the Senate Joint Economic Committee*, 110th Cong. (2008) (statement of Charles E. Schumer, Chairman, Senate Joint Economic Committee).

⁷⁹ *Id.* Schumer also noted that all the major SWFs refused to testify before the committee. *Id.*

⁸⁰ Davis, *Lobbyists*, *supra* note 28.

Kuwait.⁸¹ U.S. businesses may not be the only parties influenced by commercial considerations; the U.A.E. has launched a three-year, \$15 million Washington lobbying campaign, the U.S.-Emirates Alliance.⁸² The U.A.E. is determined not to see a repeat of the collapse of the Dubai World Ports deal.⁸³ Their lobbying efforts may influence the extent of reforms to CFIUS and FINSA.

2. Attempts at international regulation

On February 21, 2008, a U.S. Treasury delegation met with executives SWFs to negotiate the drafting of rules to regulate SWFs.⁸⁴ The talks concerned the IMF's efforts to devise a voluntary code of best practices, which would cover how the funds are structured, and their investment and disclosure practices.⁸⁵ On March 20, 2008, officials from U.S. Treasury, the governments of Singapore and Abu Dhabi, and from GIC and ADIA, met and agreed to support the IMF and OECD's development of voluntary code of best practices.⁸⁶ However, they also agreed to devise regulations of "inward investment regimes" for SWFs in recipient countries.⁸⁷ Thus, the proposed code of best practices will not only govern the behavior of SWFs, but will also address what actions recipient governments can take and the scope of laws they can pass concerning

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Bob Davis, *U.S. Pushes Sovereign Funds To Open to Outside Scrutiny—Treasury Has Talks With Abu Dhabi, Seeks Set of Rules*, WALL ST. J., Feb. 26, 2008, at A1.

⁸⁵ *Id.* Currently, Abu Dhabi's fund makes no disclosures whatsoever. *Id.* (referencing ADIA's single page website which contains no financial information). In January 2008, Singapore's fund deputy chairman, Tony Tan, stated that the fund "was ready to make changes, including regularly announcing its rate of return on investments and clarifying the objectives of those investments," but maintained that it "wouldn't disclose all [of] its purchases . . . because that would put it at a 'competitive disadvantage' to hedge funds and private-equity funds." *Id.* (citing an interview with Singapore's Straits Times newspaper).

⁸⁶ Press Release, U.S. Dep't of the Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (Mar. 20, 2008), available at <http://www.ustreas.gov/press/releases/hp881.htm>.

⁸⁷ *Id.*

SWFs—giving credence to the fears that equity investments by SWFs may result in loss of national sovereignty.⁸⁸

The agreed to principles dictate that SWFs should invest solely on commercial grounds, seek greater transparency, and establish strong governance structures. They also agreed that recipient governments should avoid “protectionist barriers”, have clearly articulated and published rules and laws, should treat “like-suited investors equally”, and impose restrictions proportional to “genuine national security risks”⁸⁹ The IMF plans to hold a “roundtable” with SWFs from around the world in April 2008, and to come up with a draft proposal for the best practices code by August 2008.⁹⁰

E. Conclusion

SWFs have aided Wall Street through the sub-prime crisis. Moreover, as their portfolios of foreign investments expand, SWFs help to recycle excess trade reserves back into world markets. In addition, more nations will have a mutual interest in each other’s continued prosperity.⁹¹ Consequently, the world may become not only wealthier, but also safer. Nevertheless, the U.S. is currently grappling with the desire, and need to attract and retain capital investments from SWFs, and with concerns that SWFs may challenge national security and sovereignty. Underlying this debate is that fact that pre-eminent Wall Street banks have averted crisis by turning to investment funds controlled by developing nations, perhaps revealing a fundamental infirmity in the U.S. economy. The strength of SWFs, and perhaps the weakness of the U.S. economy, is the result of ballooning trade and budget deficits.⁹² Before its malady

⁸⁸ See Navarro, *supra* note 41 (“China has emerged, largely unchallenged, as an economic superpower with an ever-growing ability to exert significant influence over U.S. economic, financial and political institutions.”).

⁸⁹ *Id.*

⁹⁰ Tom Barkley, *IMF Clears Way for Development of Sovereign Wealth Funds Code*, WALL ST. J., Mar. 24, 2008, at A12.

⁹¹ See *The Invasion*, *supra* note 2 (“[Cr]oss-border [investing] gives developing countries a bigger direct stake in capitalism’s future.”).

⁹² See *The Invasion*, *supra* note 2 (“Until East and West even out the surpluses and deficits in their economies, sovereign-wealth funds will not go away.”).

becomes terminal,⁹³ the U.S. might find it prudent to address trade relations with countries that have non-reciprocating trade laws and to seek measures to alleviate its dependence on foreign oil and OPEC. In addition, cutting taxes and promoting savings and investment by U.S. citizens and corporations could provide additional capital to Wall Street.⁹⁴ By addressing the underlying problems, the U.S. would not only hinder the ability of foreign governments to use SWFs for leverage in achieving political agendas, thereby quelling the fears of critics of SWFs, but it would also strengthen its economic health. To stave off the prostration of U.S. economic and political hegemony, U.S. voters and U.S. businesses will have to become active; coordinating efforts to pressure politicians to implement these policies.⁹⁵

Steven J. Pacini⁹⁶

⁹³ See e.g., *The Invasion*, *supra* note 2 (“America is either in recession or near one”)

⁹⁴ Daniella Markheim, Anthony B. Kim, *Sovereign Wealth Funds No Cause for Panic* (The Heritage Foundation, Washington, DC), Nov. 30, 2007, available at <http://www.heritage.org/Research/Economy/wm1713.cfm>

⁹⁵ See Navarro, *supra* note 41 (arguing that to overcoming the threats posed by foreign economic powers, businesses will have to engage in a “comprehensive and highly coordinated lobbying efforts across countries aimed at both domestic governments and international agencies.”).

⁹⁶ Student, Boston University School of Law (J.D. 2009).

XI. American Microfinance: Opportunities and Challenges

Microfinance is the most promising weapon to emerge in recent years in the fight against global poverty. Although the idea of microfinance has only recently gained wider attention in the United States, the history of microfinance in the United States goes back more than twenty years.¹ Despite its recent growth, microfinance has an estimated market penetration of less than 1%.² Thus, domestic microfinance has enormous growth potential, but micro-entrepreneurs and providers of microfinance services face many unique challenges in deepening the roots of microfinance in American society and the domestic economy.

This developments article will discuss the concepts and history of microfinance, and will focus on the importance of sustainability. This article will then turn to a discussion on the role of public and private institutions in furthering microfinance objectives. This article will then explore how the subprime mortgage crisis and the tightening credit markets have impacted microfinance.

A. The ideas and history behind microfinance

Microfinance is most simply defined in economic terms as the supply of loans, savings, and other basic financial services to the poor.³ Microfinance began with efforts abroad in the 1950's to provide subsidized credit to specific poor communities, which largely failed due to poor capital retention, poor repayment discipline, and funds often not reaching the targeted poor clients.⁴ In the 1970's, efforts began to extend microloans to groups of poor women to start microenterprises, which introduced lending based on the self enforcing solidarity group structure, in which every member

¹ William Burrus, President and CEO, ACCION USA, Address at the CEAMI Conference: Lessons and Trends of Microcredit in the United States (Mar. 16-17, 2005).

² *Id.* Burrus's data in calculating the 1% figure is based on comparing the potential need in the market of those microentrepreneurs who have not received bank credit to the current number of outstanding loans.

³ CGAP Frequently Asked Question 1, <http://www.cgap.org/portal/site/CGAP/menuitem.b0c88fe7e81ddb5067808010591010a0> (last visited Apr. 3, 2008).

⁴ CGAP: About Microfinance, <http://www.gcap.org/about/microfinance.html> (last visited Apr. 3, 2008).

of the group guaranteed the repayment obligations of all members, and other group members would not receive funds until other loans were paid.⁵ Pioneers at the forefront of this effort, namely the Grameen bank, provided loans consisting of less than \$200.⁶ The key to such successful microfinance efforts lay in the recycling of loans, as when each loan is repaid, the proceeds are put into providing a loan to another microentrepreneur.⁷ The combination of the self-enforcing solidarity group and loan recycling structure of Microloans provided through organizations such as the Grameen bank have shown an astonishing repayment rate of between 95-98%.⁸

On the domestic front, Federal Reserve Board Chairman, Ben Bernanke, explained that the goals of the microfinance movement in the United States are “to expand economic opportunities for individuals and to foster community economic development by providing small loans and other business services to people who have been traditionally underserved by mainstream financial institutions.”⁹ The funds and services of microfinance are used to develop microenterprises, which are defined as businesses with five or fewer employees that require \$35,000 or less in start-up capital, and which do not have ready access to the commercial banking sector.¹⁰ According to ACCION USA, of the more than 13.1 million microentrepreneurs in the United States, the overwhelming majority did not receive and were unlikely to apply for commercial bank loans.¹¹ Domestically, certain microenterprise development

⁵ *Id.*

⁶ Frequently Asked Questions about Microfinance, http://www.grameenfoundation.org/what_we_do/microfinance_in_action/faqs/

⁷ *Id.*

⁸ *Id.*

⁹ Ben S. Bernanke, Chairman, Fed. Reserve Bd., Address at the ACCION Texas Summit on Microfinance in the United States (November 6, 2007) (available at <http://www.federalreserve.gov/newsevents/speech/bernanke20071106a.htm>.)

¹⁰ ELAINE L. EDGEComb & JOYCE A. KLEIN, OPENING OPPORTUNITIES, BUILDING OWNERSHIP: FULFILLING THE PROMISE OF MICROENTERPRISE IN THE UNITED STATES 7 (The Aspen Institute 2005).

¹¹ William Burrus, Microlending: How ACCION USA Partners with Commercial Banks. (Transcript available at ACCION.org). According to Burrus, 82% of microentrepreneurs never received a bank loan, and of those, 86% never applied for one. 14% applied but were rejected for commercial bank loans.

organizations offer peer group loans in amounts ranging from \$500 to \$35,000.¹²

Although the primary social and economic goals of microfinance are the same throughout the world, domestic micro-entrepreneurs require greater management skills to successfully compete in U.S. markets than would be required to compete in the markets of developing countries.¹³ As a result, domestic micro-finance programs distinguish themselves from foreign programs by offering new entrepreneurs a far more diverse program of services beyond simply providing credit. Such additional services include up-front business training, specialized technical assistance, mentoring programs, sector-specific advice and support, networking opportunities, coordinated sales and marketing programs, and the development of formal links with banks, local community colleges, and other institutions.¹⁴ Moreover, the diversified services offered improve the survival rate of the start-up businesses and reduce the lender's credit risks.¹⁵

The microenterprise development field in the United States expanded greatly during the 1990's, largely as a result of three major socioeconomic trends; growing doubt as to the effectiveness of government welfare programs; the growing loss of domestic blue-collar jobs; and shifts in demographic populations, including increased numbers of women in the workforce and greater immigration rates.¹⁶ The welfare reforms passed during the 1990's on both the state and federal level included the tenet that individuals should be encouraged to support themselves through employment, including self-employment.¹⁷ Furthermore, in 1991, the U.S. Small Business Administration recognized microenterprises as a separate category of business and established the Microloan Demonstration Project.¹⁸ As a result of the growth of microenterprises, providing

¹² *Microenterprise Development in the U.S.*, Microenterprise Fact Sheet Series, Issue 1, at 3 (Spring 2005). See also http://www.accionusa.org/site/c.lvKVL9MUIsG/b.1388813/k.99E8/Socially_Responsible_Investing_The_ACCION_USA_Loan_Fund.htm. ACCION USA's average loan size is \$5,700.

¹³ See Bernanke, *supra* note 9.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See Burrus, *supra* note 1, at 1- 2.

¹⁷ *Id.* See also Edgecombe and Klein, *supra* note 10, at 9.

¹⁸ Burrus, *supra* note 1, at 1.

capital to these microenterprises through microfinance is increasingly important.

Microfinance in the United States shows enormous potential. The U.S. market has caught the attention of the original pioneer of the global microfinance movement, The Grameen Bank, which entered the U.S. market in February 2008 by providing loans to micro-entrepreneurs in New York.¹⁹ Grameen founder, Muhammad Yunus, indicates that the problems facing mainstream banks in the wake of the subprime mortgage crisis encourages people to turn to fringe financial institutions that offer credit at exorbitant interest rates.²⁰ Because the mainstream financial system fails to serve large numbers of individuals, there is a significant opportunity for microfinance to expand its domestic base.

B. Sustainability of Domestic Microfinance

If microfinance is to survive as a global poverty fighting tool, microfinance institutions and governments must foster an environment where microfinance is self sustainable. Given that the goals of microfinance are both social and economic, microfinance organizations must be careful to keep a close watch on the economic viability of their operations.²¹ Inefficient operations can lead a microfinance organization to run out of sources of capital, thus, finding itself out of business.²²

Self sustainability would have the benefit of increasing organizational stability, as microlenders would not be dependent on donor decisions to continue operations, but would rather be able to look to customer patronage.²³ Currently, microfinance institutions are exploring a multitude of business models to promote self sustainability, including offering increased fee based services and

¹⁹ Daniel Pimlott, *Grameen Bank's loans to U.S. Poor*, FIN. TIMES, Feb. 16, 2008.

²⁰ *Id.* According to Yunus, there are 28 million people in the US with no bank accounts and another 44.7 million with only limited access to financial institutions. Such unbanked individuals are forced to rely on fringe or black-market financial operations, such as loan-sharking and payday lending.

²¹ Kenneth Anderson, *Microcredit: Fulfilling or Belying the Universalist Morality of Globalizing Markets?*, 5 YALE HUM. RTS. & DEV. L.J. 85, 101 (2002).

²² *Id.*

²³ Emily Berkman, Note, *Microloans as a Community Reinvestment Act Compliance Strategy*, 3 N.Y.U. J.L. & BUS. 329, 333-334 (Fall 2006).

using technology to reduce their costs.²⁴ A microfinance organization's sustainability also serves as a measure against defaults, as borrowers would be more inclined to avoid default so that they may develop a continuing relationship with the microlender, and be able to access new loans in the future.²⁵ In contrast, borrowers have less incentive to remain credit worthy in the eyes of the microlender if the lender's very existence is in doubt.²⁶

To attain sustainability, microfinance organizations require revenues to exceed cost of funds and loan losses, and must have enough of a surplus to allow reinvestment in new products.²⁷ The most fundamental tools to attain sustainability are the ability to raise sufficient revenue and adequately control costs. Just as a commercial bank, a microfinance institution's main source of revenue stems from charging adequate interest rates and fees to cover the lender's cost of funds, borrower's default risk, and administrative costs of originating and servicing the loans.

One of the largest revenue hurdles faced by microfinance institutions is the presence of well meaning, but misguided, state usury laws and interest rate ceilings.²⁸ Although the usury laws aim to protect individuals who have poor credit and lack financial sophistication, the effectiveness of such laws is questionable, as such laws may inadvertently cause credit rationing.²⁹ In the global microfinance field, banks have indicated that state usury laws affect their decisions to become involved in microfinance, as usury laws and rate caps directly constrain the institution's revenue generating

²⁴ Bernanke, *supra* note 9. Such fee based services include check cashing and assistance in remitting profits. Technological innovations to reduce costs include using internet initiatives to facilitate transactions, underwriting, and servicing at lower costs.

²⁵ Berkman, *supra* note 23.

²⁶ *Id.* See also Jay Rosengard, *Banking on Social Entrepreneurship: The Commercialization of Microfinance*, 32 *Mondes en Developpement* 25, 28 (2004).

²⁷ Rosengard, *supra* note 26.

²⁸ Amanda Katherine Sadie Hill, *State Usury Laws: Are they Effective in a Post-GLBA World?* 6 *N.C. BANKING INST.* 411, 427 (2002).

²⁹ *Id.* Hill indicates that from bank's perspective, consumers considered to be high credit risks are more likely to have access to financing if there is flexibility in the level of interest charged and that if rates are set artificially low, without regard to risk profiles, there will be credit rationing.

potential.³⁰ Similarly, American microlenders do not charge as exorbitant rates as payday lenders, microlenders have faced hurdles in reaching sustainable revenue levels due to their exposure to state imposed interest rate ceilings, but which payday lenders and other non-traditional lenders can easily circumvent.³¹ Moreover, states with strict usury laws have tended to see capital and jobs leave their states,³² further undermining the environment and resources available to the population which would benefit most from microfinance.

Microfinance lenders also face a significant barrier to attracting clientele due to the presence of state and federal laws and regulations that inadvertently dissuade potential microentrepreneurs from starting microenterprises.³³ Certain microentrepreneurs would be dissuaded from seeking microloans that would inadvertently increase their assets to above the level required to receive government provided housing assistance and health benefits.³⁴ Furthermore, domestic microlenders themselves may be dissuaded from providing microcredit because they must navigate substantial governmental bureaucracy, including complying with IRS regulations, consumer protection laws, credit-reporting practices, as well as a litany of other state and federal laws.³⁵

American Microfinance programs have had an exceptionally difficult time attaining self sufficiency largely because of the costs of providing training and technical assistance services for which clients have traditionally paid little or nothing.³⁶ Various domestic microfinance programs have had various degrees of success in

³⁰ See JENNIFER ISERN & DAVID PORTEOUS: COMMERCIAL BANKS AND MICROFINANCE: EVOLVING MODELS OF SUCCESS, CGAP Focus Note. No. 28, (June 2005) available at <http://www.cgap.org>; hyperlink to "publications;" Hyperlink to "Focus Note. No. 28".

³¹ Hill, *supra* note 28, at 426-427. Payday lenders can avoid state usury laws by partnering with national banks, channeling the loan through the bank to take advantage of federal preemption of state usury laws available to national banks.

³² *Id.* at 422.

³³ Lewis D. Solomon, *Microenterprise: Human Reconstruction in America's Inner Cities*, 15 HARV. J.L. & PUB. POL'Y 191, 209 (1992).

³⁴ *Id.*

³⁵ Jay Lee, Note, *Equity and Innovation: Using Traditional Islamic Banking Models to Reinvigorate Microlending in Urban America*, 16 IND. INT'L & COMP. L. REV. 523, 540 (2006).

³⁶ Edgecombe and Klein, *supra* note 10, at 44.

recovering the costs of such programs, and have used cost control measures such as utilizing graduate students as program trainers and charging fees for access to such training programs.³⁷ Despite such measures, most programs have yet to attain complete sustainability.³⁸

A significant cost associated with microloans is the cost of originating, monitoring, and servicing the loans, which regardless of a loans size requires significant time, expertise, and cost.³⁹ Most notably in the international context, the Grameen Bank attained significant success in reducing such costs and increasing efficiency by promoting the formation of borrower solidarity groups.⁴⁰ Solidarity groups tie each member's receipt of funds to the repayment of loans other members, thus providing significant benefits to both the borrower and lender, as group members would monitor one another's behavior, thus reducing lender monitoring costs.⁴¹ Lenders further benefit from economies of scale because group members would generally have very similar types of loans to be serviced.⁴²

Domestic microlenders replicated some of the successes of the Grameen Bank's solidarity group structure, most notably the Women's Self-Employment Project.⁴³ The project further demonstrated benefits to the microlenders, as the solidarity groups proved effective mechanisms for self-monitoring.⁴⁴ Moreover, the group collected deposits for each member's savings account, which contributed to a collective emergency fund to provide group insurance, emergency loans to a group member, or additional working capital for member businesses.⁴⁵ Such activities greatly reduced the likelihood of default and thus lowered significant costs and risks to the lender.

³⁷ *Id.*

³⁸ *Id.*

³⁹ Solomon, *supra* note 33, at 192.

⁴⁰ *See id.* at 195. In such instances, bank field workers would bring the bank to the borrower's villages to disseminate information, help form borrower groups, as well as collect and service loans.

⁴¹ *Id.* at 196-97.

⁴² *Id.* at 195.

⁴³ *Id.* at 203-04. The Women's Self-Employment Project is based in Chicago, and starting in the 1980's, provided training and microfinancing for low income women to start businesses.

⁴⁴ *Id.* at 205.

⁴⁵ *Id.*

Despite the successes of some peer lending experiments, overall, the peer lending model has had very limited domestic success, with only a small number of domestic microfinance institutions currently offering loans to peer groups.⁴⁶ As a result, microfinance in the US has tended to be more expensive than elsewhere, and has had to find other alternative strategies for cost reduction.⁴⁷ One of the main avenues that microlenders in the US have explored in finding alternative strategies to reduce costs are developing cooperative efforts with commercial banks and financial institutions to meet the needs of American microentrepreneurs.⁴⁸

Despite their number, microentrepreneurs have largely been ignored by commercial banks because microentrepreneur needs are often too small for the banks to profitably address.⁴⁹ However, commercial banks have taken an interest in the activities of microfinance lenders as a possible way to improve Community Reinvestment Act requirements.⁵⁰ As a result, commercial banks have stepped in as an important source of financial support for major microfinance organizations like ACCION USA.⁵¹ Large financial institutions such as Citigroup have started charitable funds to help wealthy clients donate money to microfinance institutions.⁵² Moreover, microlenders and commercial banks have created channels to refer microentrepreneurs who wouldn't normally qualify for a bank loan and wouldn't know about the services of microlenders, thus

⁴⁶ Burrus, *supra* note 1, at 4.

⁴⁷ Berkman, *supra* note 23.

⁴⁸ Solomon, *supra* note 33, at 217.

⁴⁹ Burrus, *supra* note 11.

⁵⁰ See Aaron Jones, Comment, *Promotion of a Commercially-Viable Microfinance Sector in Emerging Markets*, 13 GEO. J. ON POVERTY L. & POL'Y 187, 196 (2006). The CRA, 12 U.S.C. §§ 2901-2908, creates a legal obligation for banks covered by the statute to meet the credit needs of its local community, including those of low income neighborhoods. Regulations implemented in 1993 allow and encourage banks to cooperate with and provide support to microfinance institutions as a way to meet their CRA obligations.

⁵¹ Burrus, *supra* note 11. ACCION New York alone has a \$1 million line of credit from Chase bank, which is used as a typical line of credit or as a guarantee for other credit initiatives. Moreover, the loans provided by commercial banks are generally at zero interest or below prime.

⁵² Kristen McNamara, *Citi Fund Backs Entrepreneurs*, WALL ST. J., Jun. 13, 2007, at B3.

furthering the exposure of domestic microlenders.⁵³ The financial support provided by commercial banks has included collaborative lending.⁵⁴ In addition to financial support, commercial banks have stepped in to provide training programs, technology and infrastructure, market data, and governance support.⁵⁵ Such financial and strategic support greatly benefits the efficiency of microlenders, and directly strengthens the sustainability of microlender operations.

C. The Impact of the Subprime Crisis on Domestic Microfinance

As domestic and global credit markets have tightened since 2007, the global microfinance field has shown a remarkable insulation from market turbulence.⁵⁶ ACCION International and Grameen Bank have both reported that they have not seen any credit tightening in their global operations, despite wider market uncertainty.⁵⁷ ACCION and Grameen indicate that the relatively small amounts of global capital funding sought by the microfinance institutions, as well as the funding from the savings of the poor, which are not as sensitive to global financial interest rates, have contributed to the lack of disturbance in the microfinance field.⁵⁸ Similarly, donor contributions to microfinance institutions are possibly seen as a more viable alternative than a straight donation to a charity in times of economic downturn because there is a repayment expectation by the donor.⁵⁹ During the downturn, not only has the volume of funds available to the poor remained unaffected, but repayment rates of the microloans have also been unaffected. Such insulation is largely the result of microloan payments coming

⁵³ Burrus, *supra* note 11. Bank Referrals to ACCION New York account for 25% of its client base. Furthermore, commercial banks act as distributors of ACCION promotional materials to potential clients.

⁵⁴ *Id.* Collaborative lending would mainly be targeted to the microlender's larger clients who have a difficult time obtaining capital for growth. Collaborative efforts reduce the risk exposure of the bank.

⁵⁵ *Id.* Bank officers often sit on the boards of directors for larger known microfinance organizations.

⁵⁶ Daniel Altman, *Microfinance Seems Fairly Insulated from Credit Turbulence*, INT'L HERALD TRIBUNE, Feb. 12, 2008.

⁵⁷ *Id.* ACCION International's network has almost \$3 Billion in microloans.

⁵⁸ *Id.*

⁵⁹ *Id.*

from the proceeds of businesses operating in the informal economic sector, a sector not as susceptible to global market turbulence.⁶⁰

However, despite the current status of microfinance, future stability is far from certain. Microfinance insulation from capital markets is not absolute because some microfinance institutions rely on the capital markets to raise capital.⁶¹ Most notably, Mexico based Compartamos raised \$467 million in capital in public offerings in Mexico City and New York.⁶² Similarly, Indian Bank ICICI pioneered efforts to securitize microloans in India.⁶³ As a result of global economic contraction and the increasing mistrust of securitization models, it is uncertain whether the securitization of microloan based assets will remain a viable form of funding microfinance organizations.

Although global microfinance has remained relatively stable in the wake of the credit crunch, very little information has been available about the impact of the credit crunch on domestic microfinance efforts. However, considering the more developed and formal economic environment in which many microentrepreneurs operate, and the partnerships between commercial banks and microfinance institutions, microfinance institutions are likely to be on the lookout for more conservative funding from donors and commercial banks alike.

However, despite the challenges, the optimism expressed by Muhammad Yunus at the February 2008 opening of a Grameen Bank branch in New York indicates that microfinance still has a very strong demand and potential market in the United States.⁶⁴ Moreover, the slowing domestic economy and tightening of credit from mainstream sources leaves many to seek credit from fringe financial sources, offering loans at exorbitant interest rates.⁶⁵ As a result, the market for legitimate microfinance institutions may have found an opportunity to expand in the current domestic economic downturn.

⁶⁰ *Id.*

⁶¹ Richard Lapper, *Big Business in Small Loans*. FIN. TIMES, Jun. 7, 2007.

⁶² *Id.*

⁶³ Bindu Ananth, *Financing Microfinance—The ICICI Bank Partnership Model*, 16 SMALL ENT. DEV. 1, 7 (2005).

⁶⁴ See Pimlott, *supra* note 19.

⁶⁵ *Id.*

D. Conclusion

As microfinance has become a globally recognized poverty fighting tool, so too has its potential to expand in the American economy and society. However, despite the successes of the Grameen Bank and other microfinance institutions in the developing world, microlenders face unique and significant challenges in the U.S. U.S. microlenders have evolved to meet the challenges related to generating sufficient revenues and controlling costs, dealing with existing banking and consumer protection laws, obstacles related to welfare benefits. The remarkable resilience U.S. microlenders have shown in collaborating with commercial banks and creatively spreading into new markets and populations demonstrates that microfinance has a promising future as a weapon in the fight against global poverty.

Zahir Virani⁶⁶

⁶⁶ Student, Boston University School of Law (L.L.M. 2009).

XII. The Role of Banking Regulation in Data Theft and Security

This article will highlight the problems and developments in identity theft legislation in the wake of the TJX, Inc.'s massive security breach. Specifically, financial institutions have been forced to shoulder the majority of the liability to consumers whose identities have been stolen. Unfortunately, in situations such as TJX, financial institutions that are not responsible for the security breach still must bear the burden. Federal legislation has not yet been enacted to affirmatively shift liability onto the entity responsible for the security breach. Thus far, only one state, Minnesota, has enacted legislation to affirmatively impose liability onto the retail institutions while other states have seen similar proposals struck down or languishing in committee. However, the financial institutions' action against TJX was allowed to survive summary judgment and TJX recently agreed to settle with the financial institutions.

A. TJX: An Introduction to the Identity Theft and Security Breach Problem

Identity theft has become a prevalent problem in the United States. Just in the past two years alone the news has been riddled with reports of large-scale identity theft incidents that have threatened the government, retailers, and financial institutions alike. In May 2006, computer equipment containing the personal information of an estimated 26.5 millions veterans and 1.1 million active military personnel was stolen from the Department of Veterans Affairs ("VA").¹ The VA security breach spurred a massive congressional campaign for more effective and comprehensive identity theft legislation, especially relating to security within the VA.² In addition to high-profiled government breaches, major concern exists within the retail industry, where numerous retail institutions are requiring stricter standards on handling their customers' information in the midst of several lawsuits being filed for security breaches into their systems. And, outside of the government and retail industry, there are also concerns about

¹ Damian Paletta, *VA Data Breach Sparks Flurry of Bills*, WALL ST. J., June 21, 2006, at B3D.

² *Id.*

individuals' personal information being stolen from dumpsters³ and from thieves hacking into websites.⁴

Perhaps the largest known identity theft in United States history occurred the following year at TJX, Inc., the parent company to discount retailers Marshalls and T.J. Maxx.⁵ In January 2007, after auditors expressed concern over the adequacy of its data security, TJX discovered a massive security breach resulting in more than 45.7 million debit and credit card numbers being stolen.⁶ Investigators discovered that the security breach had been on-going since 2005 and that the 'intruders' had decoded the encryption keys TJX used to store customer information.⁷ The hackers also obtained customers' drivers license numbers, names, addresses and phone numbers.⁸ Investigators believe that the hackers obtained the information by aiming an antenna inside the store and decoding the data streaming between TJX's cash registers, hand-held scanning devices and TJX's computers.⁹ TJX's wireless computer system was said to be less secure than a personal home computer.¹⁰

Customers affected (and those even possibly affected) by the security breach instituted a class action suit against TJX on January 29, 2007.¹¹ TJX also faces lawsuits by financial institutions that incurred losses as a result of the breach.¹² A major concern over identity theft legislation involves whether the entity responsible for the security breach, such as TJX, should bear the cost of such breach or whether the financial institutions should continue to bear the ultimate burden. In *In re TJX Companies Retail Security Breach Litigation*, a federal court in Massachusetts allowed the financial

³ Michael Hudson, *Dumped Mortgage Files Invite Identity Theft*, WALL ST. J., Oct. 23, 2007, at B1.

⁴ *Hacker Gains Access to Art.com's Data*, WALL ST. J., October 29 2007, at A16.

⁵ Joseph Pereira, *Breaking The Code: How Credit-Card Data Went Out Wireless Door—In Biggest Known Theft, Retailer's Weak Security Lost Millions of Numbers*, WALL ST. J., May 4, 2007, at A1.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *See, e.g., Mace v. TJX Companies, Inc.*, No. 1:07-CV-10162-WGY, 2007 WL 736440 (D. Mass. Jan. 29, 2007) (original complaint).

¹² *In re TJX Companies Retail Security Breach Litigation*, 524 F.Supp.2d 83 (D. Mass. 2007).

institutions to continue their action against TJX on a negligent misrepresentation theory, but dismissed the banks' negligence and breach of contract claims.¹³

B. Existing and Relevant Identity Theft Statutes

Although regulators may be struggling to keep up with the massive growth of identity theft as a serious crime, there are currently several federal statutes and corresponding regulations governing the issue. The federal statutes vary in their scope and purpose but do establish a minimal framework for understanding the current legislative response to the identity theft crisis. Below is a brief description of the major federal statutes governing identity theft.

1. Gramm-Leach-Bliley Act Provisions

Gramm-Leach Bliley Act ("GLBA")¹⁴ states in pertinent part that "each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information."¹⁵ Within GLBA is the "Financial Privacy Rule,"¹⁶ which governs the disclosure of personal financial information by various financial institutions.¹⁷ Particularly this provision requires that the consumer be notified annually of any information that is being used and distributed by the institution.¹⁸ Another important provision within the GLBA is the "Safeguards Rule,"¹⁹ which requires financial institutions to protect personal information, specifically by designating an employee to (1) manage the data protection safeguards; (2) conduct a risk management profile for all departments handling financial information within the financial institution; (3) develop and test a program that secures the personal

¹³ *Id.* at 90-92.

¹⁴ 15 U.S.C. §§ 6801-6809 (2000).

¹⁵ Federal Financial Modernization Act § 501, 15 U.S.C. § 6801(a) (2000).

¹⁶ 12 C.F.R. § 332.1 (2007); Corey A. Ciocchetti, *E-Commerce and Information Privacy: Privacy Policies as Personal Information Protectors?*, 44 AM. BUS. L.J. 55, 80 (2007).

¹⁷ 12 C.F.R. § 332.1; Ciocchetti, *supra* note 16.

¹⁸ 12 C.F.R. § 332.6 (2007); Ciocchetti, *supra* note 16.

¹⁹ 12 C.F.R. Pt. 30 App. B (2007).

information; and (4) make changes to all protections and safeguards as problems develop.²⁰

2. Electronic Funds Transfers Act

The Electronic Funds Transfers Act²¹ (“EFTA”) also contains provisions for protecting personal information from identity theft. EFTA limits the personal liability of a consumer for an unauthorized electronic fund transfer conducted in the consumer’s name.²² The consumer is responsible for up to fifty dollars of unauthorized transfers, depending on how quickly the consumer reports the unauthorized transfer to the financial institution.²³ This law protects consumers because it places the burden of proving that the transfer was authorized upon the financial institution.²⁴

3. Fair Credit Reporting Act and the Fair and Accurate Credit Transactions Act of 2003

The Fair and Accurate Credit Transactions Act of 2003 (“FACT Act”)²⁵ amended the Fair Credit Reporting Act²⁶ and extended the federal preemption of state law.²⁷ The FCRA “restricts the dissemination of ‘consumer reports’ by ‘consumer reporting agencies’ and the use of consumer reports by banks and other companies.”²⁸ A bank or corporation could become a consumer reporting agency if it regularly provides consumer reports to another entity.²⁹ The FACT Act required the Federal Trade Commission

²⁰ 16 C.F.R. § 314.4 (2007).

²¹ Electronic Funds Transfer Act, 15 U.S.C. § 1693a-1693r (2000).

²² 12 C.F.R. § 205.6 (2007).

²³ *Id.*

²⁴ 15 U.S.C. § 1693g(b) (2000).

²⁵ Fair and Accurate Credit Transactions Act of 2003. H.R. 2622, 108th Cong. (2003).

²⁶ 15 U.S.C. §§ 1681 (2000).

²⁷ Lawrence A. Young, *The Fact Act: Fair And Accurate Credit Transactions Act of 2003 (H.R. 2622) and Related Developments*, 58 CONSUMER FIN. L.Q. REP. 36, 36 (2004).

²⁸ L. Richard Fischer, Symposium, *Financial Services Institute 2007: Privacy, Data Security and Identity Theft Prevention*, L. Richard Fischer, *Privacy, Data Security and Identity Theft Prevention*, SN007 ALI-ABA 157, 179.

²⁹ *Id.*

(“FTC”) to prepare a model summary of consumer rights in identity theft.³⁰ Financial institutions must develop procedures to identify identity theft.³¹ Although the Fact Act implemented important developments in combating identity theft, such as mandatory truncation of credit and debit card numbers on receipts, it has been criticized for pre-empting state laws that are actually more stringent than the Fact Act.³² Thus, the Fact Act might better combat identity theft by repealing federal preemption when the state’s identity theft laws are more stringent than the Fact Act.

C. Agency Response to TJX and Similar Security Breaches

1. Identity Theft Task Force Strategic Plan

In May 2006, President Bush issued an executive order commanding various federal agencies to form an identity theft task force (“Task Force”) to combat identity theft and strengthen enforcement tools against perpetrators.³³ The task force includes the Federal Trade Commission (“FTC”), the Securities and Exchange Commission (“SEC”), the Federal Deposit Insurance Commissions (“FDIC”) and the Department of Justice (“DOJ”) among others.³⁴ The Task Force released its strategic plan in April 2007, and the plan recommended establishing national security standards that require the private sector to safeguard stored personal data and provide notice to potential victims of security breaches.³⁵ Also, the strategic plan proposed expanding current regulations under the GLBA beyond just financial institutions.³⁶ Instead, the regulations would apply to any institution that regularly handles “covered data,” including social security numbers and financial account numbers, such as credit or debit cards.³⁷ To enforce these regulations, the FTC, SEC and the federal bank regulatory agencies could initiate investigations and take

³⁰ Young, *supra* note 27, at 36.

³¹ *Id.*

³² *Id.*

³³ Exec. Order No. 13,402, 71 Fed. Reg. 27,945 (May 10, 2006).

³⁴ *Id.*

³⁵ THE PRESIDENT’S IDENTITY THEFT TASK FORCE, COMBATING IDENTITY THEFT: A STRATEGIC PLAN 35 (2007).

³⁶ *Id.*

³⁷ *Id.* at 36.

action against institutions which violate the new national standards.³⁸ Consequently, financial institutions would no longer be solely responsible for handling the legal and consumer aftermath following a security breach. Upon adoption of the strategic plan, the federal agencies tasked with monitoring security breaches and enforcing identity theft laws would shoulder some of the responsibility for issues of data security along with the financial institutions and retailers.

2. FDIC Regulations for Financial Institutions

The FDIC requires financial institutions to develop and implement a written program that will more accurately safeguard customer information.³⁹ As of January 1, 2007, financial institutions were required to use more effective methods of customer identification, specifically in the use of electronic banking systems.⁴⁰ In addition, financial institutions must notify customers of any unauthorized access to their accounts or personal information.⁴¹ To aid in this, the FACT Act directed the FDIC and other regulatory agencies to promulgate regulations and guidelines that focus on ‘red flags’ for identity theft and discrepancies in customer addresses.⁴² The “Red Flag” guidelines “require financial institutions and creditors to establish a program to identify patterns, practices and specific form of activity that indicate the possible existence of identity theft.”⁴³ The guidelines also require debit and credit card issuers to make sure that any request for a change of customer’s address is valid and confirmed.⁴⁴

3. Regulation S-P

In March 2008, the SEC proposed an amendment to Regulation S-P.⁴⁵ Regulation S-P “governs the treatment of

³⁸ *Id.* at 37.

³⁹ 12 C.F.R. § 364 App. B (2007); FDIC Financial Institution Letter, FIL 32-2007, *Supervisory Policy on Identity Theft* (April 11, 2007).

⁴⁰ FIL 32-2007, *supra* note 39.

⁴¹ FDIC Financial Institution Letter, FIL-27-2005, *Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice* (April 1, 2005).

⁴² FDIC 32-2007, *supra* note 39.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ Release Nos. 34-57427; IC-28178; IA-2712; File No. S7-06-08, *available at* <http://www.sec.gov/rules/proposed/2008/34-57427.pdf>.

nonpublic personal information about consumers by . . . financial institutions.”⁴⁶ Regulation S-P applies to “brokers, dealers, and investment companies” and “investment advisers that are registered with the” SEC.⁴⁷ The proposed amendment would revise the GLBA’s Safeguards Rule.⁴⁸ Institutions covered under Regulation S-P would need to develop an “information security program” detailing the institution’s safeguards for protecting personal information and its response to a security breach.⁴⁹ Specifically, financial institutions would be required to monitor any affiliate that handles personal information.⁵⁰ The amendment would expand Regulation S-P’s coverage to include all “transfer agents.”⁵¹ Transfer agents include all individuals who register the transfer of securities or even perform bookkeeping functions in transferring securities, among others.⁵² Thus, although TJX would not specifically be covered under this amendment, it is clear that the SEC is concerned about the problem of identity theft and beginning to expand its enforcement powers to combat this problem.

D. Proposed Additions to the Federal Statutory Framework

After the increase in identity theft crimes, several bills were introduced into Congress but none have been passed as of this date. Thus far, only the Identity Theft Enforcement and Restitution Act passed the Senate. H.R. 964, currently pending in the House of Representatives, has not passed in previous attempts and is unlikely to pass this year either.

1. Identity Theft Enforcement and Restitution Act

⁴⁶ 17 C.F.R. 248.1(a) (2007).

⁴⁷ 17 C.F.R. 248.1(b) (2007).

⁴⁸ 12 C.F.R. Pt. 30 App. B (2007).

⁴⁹ SEC Proposal, *supra* note 45, at 13.

⁵⁰ *Id.* at 18.

⁵¹ *Id.*

⁵² 15 U.S.C. § 78©(25) (2000).

In November 2007, the Senate unanimously passed the “Identity Theft Enforcement and Restitution Act.”⁵³ Senators Leahy and Spector, who originally introduced the Personal Data Privacy and Security Act in 2005, sponsored the bill.⁵⁴ If enacted, the Act will enable victims of identity theft to seek restitution for money spent restoring their credit and fixing other harms associated with identity theft.⁵⁵ Also, the bill expands the criminal definition of identity theft to encompass individuals who steal the identity of a corporation, reflecting the reality that a corporation can also be a victim of identity theft.⁵⁶ Additionally, the bill proposed harsher federal sentencing guidelines for those convicted of identity theft crimes.⁵⁷

2. S.1178

In April 2007, Senator Inouye introduced S. 1178, the “Identity Theft Prevention Act.”⁵⁸ Still pending in the Senate, S. 1178, if enacted, would require any covered institution to implement and maintain a program to safeguard sensitive personal information.⁵⁹ A covered institution would include any entity or organization that maintains personal information, including names, addresses and financial account information.⁶⁰ Corporations such as TJX that maintain a database of personal information would thus be included under the Act. Under the Act as proposed, any violators other than financial institutions already regulated by other federal agencies would face fines as high as eleven thousand dollars per day without any cap.⁶¹

⁵³ S. 2168, “Identity Theft Enforcement and Restitution Act,” 110th Congress (2007) (as passed by Senate Nov. 15, 2007).

⁵⁴ Press Release, Office of Senator Patrick Leahy, Senate Passes Leahy-led Anti-Cyber Crime Bill (Nov. 16, 2007), available at <http://leahy.senate.gov/press/200711/111607a.html>.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Identity Theft Prevention Act, S. 1178, 110th Congress (2007) (placed on Senate Legislative Calendar under General Orders Dec. 5, 2007).

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Press Release, United States Senate, Chairman Inouye Introduces Identity Theft Prevention Bill (April 20, 2007).

3. H.R. 964

The “Securely Protect Yourself Against Cyber Trespass Act”⁶² (“Spy Act”), sent to the Senate in June 2007, is extremely broad legislation that would make it unlawful for any unauthorized individual to take control of a protected computer.⁶³ A protected computer is defined as a computer used by a financial institution or the federal government or a computer used in interstate commerce or communication.⁶⁴ The Spy Act includes language that would make it a crime to even change a computer’s bookmarks.⁶⁵ Notice and consent would be required if any information is to be taken from a protected computer.⁶⁶ If enacted, the Spy Act would be much larger in scope than the Senate bills. However, previous versions of the Spy Act have not been passed by the Senate in two attempts.⁶⁷

4. State Legislative Response

In contrast to proposed federal legislation, seven states have introduced bills that attempt to shift liability for identity theft from the financial institutions to the businesses and institutions actually responsible for the security breach.⁶⁸ Minnesota became the first state to enact such legislation.⁶⁹ House File 1758 requires any person or entity responsible for the breach to indemnify the financial institution for any costs associated in reimbursing the consumer as a result of a breach.⁷⁰ The statute also gives a financial institution

⁶² See H.R. 964, “Securely Protect Yourself Against Cyber Trespass Act” (SPY Act), 110th Congress (2007) (referred to Senate Committee on Commerce, Science and Transportation on June 7, 2007).

⁶³ *Id.*

⁶⁴ 18 U.S.C. § 1030(e)(2) (2000).

⁶⁵ H.R. 964, *supra* note 62.

⁶⁶ *Id.*

⁶⁷ H.R. 29, “Securely Protect Yourself Against Cyber Trespass Act”, 109th Congress (2005); H.R. 2929, “Securely Protect Yourself Against Cyber Trespass Act”, 108th Congress (2004).

⁶⁸ Erin Fonté, *Who Should Pay the Price of Identity Theft?*, 54 FED. LAW. 24, 30-31 (2007).

⁶⁹ *Id.* at 31.

⁷⁰ H.F. 1758, 85th Leg., Reg. Sess. (Minn. 2007).; Fonté, *supra* note 68, at 32.

harmed by a security breach or violation of the statute a private right of action against the entity responsible.⁷¹

There is also legislation pending in some states, such as Illinois. Illinois's Credit Card and Debit Card Liability Act⁷² would amend current Illinois identity theft legislation to make any data collector, such as TJX, liable to any financial institution for costs associated with identity theft originating with the data collector.⁷³ Liability would include reimbursement from fraudulent transactions.⁷⁴ In June 2007, New Jersey proposed similar legislation.⁷⁵

On the other side, Governor Arnold Schwarzenegger, in October 2007, vetoed⁷⁶ Assembly Bill 779,⁷⁷ which would have shifted liability for costs associated with providing notice to consumers in the wake of a security breach.⁷⁸ In contrast to California, Connecticut's Senate Bill 1089⁷⁹ would have imposed liability on any business in Connecticut that maintains computerized personal data, but the provisions imposing liability were not enacted.⁸⁰ That bill would have made businesses responsible for the security breach, and would have required them to reimburse financial institutions for costs incurred, including any refund or credit given to a customer because of an unauthorized transaction.⁸¹ The Texas legislature has left a bill similar to the Connecticut bill pending in the Business and Commerce Committee since May 2007.⁸² And even in Massachusetts, the state where the TJX security breach originated,

⁷¹ *Id.*; Fonté, *supra* note 68, at 32.

⁷² S.B. 1675, 95th Gen. Assem, Reg. Sess., (Ill. 2007) (no action taken on bill since Feb. 2007).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ Assem. 4413, 212th Leg., Reg. Sess. (N.J. 2007) (no action taken since committee referral in June 2007).

⁷⁶ Marc Lifsher, *Schwarzenegger Vetoes 12 of 12 Proposals that the State Chamber of Commerce had Slammed as 'Job Killers'*, L.A. TIMES, Oct. 16, 2007, at C1.

⁷⁷ A.B. 779, 2007-2008, Reg. Sess. (Cal. 2007).

⁷⁸ Fonté, *supra* note 68, at 31.

⁷⁹ S.B. 1089, Reg. Sess., (Conn. 2007) (provision shifting liability not enacted).

⁸⁰ Fonté, *supra* note 68, at 31.

⁸¹ *Id.*

⁸² H.B. 3222, 80th Leg., Reg. Sess. (Tex. 2007); Fonté *supra* note 68, at 32.

legislators were unsuccessful in passing a bill similar to both Texas and Connecticut.⁸³

5. Shifting of Liability by the Judiciary

As the states and federal government remain hesitant to enact legislation affirmatively shifting liability away from the financial institutions and onto the entity responsible for the breach, a federal court in Massachusetts allowed financial institutions to bring a claim for damages against TJX for reimbursement of costs incurred because of the security breach.⁸⁴ The case is believed to be the first to survive a motion to dismiss at the federal level.⁸⁵ If financial institutions are allowed to bring actions directly against the retailers, the retailers will be forced to provide better security safeguards of its customers' information. Although this is a novel approach in this context, allowing the banks' claims to survive summary judgment is consistent with the Uniform Commercial Code's treatment of loss allocation in check processing.⁸⁶ The liability in check processing is allocated based on the party or bank that dealt with the wrongdoer.⁸⁷ In December, TJX proposed a settlement with the financial institutions for an undisclosed amount to reimburse some of the costs incurred as a result of the security breach.⁸⁸ Financial institutions choosing not to participate in the settlement can continue to pursue their claims in court.⁸⁹ If courts continue to allow claims for reimbursement, financial institutions may get some relief after massive security breaches.

⁸³ H.213, 186th General Ct., Reg. Sess., (Mass. 2007) (section shifting liability not enacted); Fonté, *supra* note 68, at 31.

⁸⁴ *In re TJX Companies Retail Security Breach Litigation*, 524 F.Supp.2d 83 (D. Mass. 2007).

⁸⁵ Joseph Pereira, *TJX Ruling Gives Banks a Breakthrough—Burden of Protecting Customer Card Data May Shift to Retailers*, WALL ST. J., Oct. 26, 2007, at B3.

⁸⁶ U.C.C. §§ 3-416 & 3-417 (2002).

⁸⁷ *Id.*

⁸⁸ Joseph Pereira, *TJX Settles With Banks Over Data Breach*, WALL ST. J., Dec. 19, 2007, at A18.

⁸⁹ *Id.*

E. Conclusion

In sum, the TJX and related identity theft scandals indicate a need for increased consumer protection in the wake of a security breach. Current legislation requires financial institutions to bear the majority of liability for consumer's loss. However, several states are proposing shifting some or all of the liability to the entity responsible for the security breach, relieving some liability from the financial institutions. Until such legislation is passed, the courts may have to continue to step in to shift liability onto the entity responsible for the security breach.

Rebecca Dent⁹⁰

⁹⁰ Student, Boston University School of Law (J.D. 2009).

XIII. Climate Risk Disclosure and Corporate Filings

There is a growing sense in the investment community that risk associated with climate change needs to be accounted for. In 2008 proxy season alone, fifty-four shareholder resolutions were filed related to global warming—almost twice the number of resolutions filed two years ago.¹ Voluntary disclosure of climate risk is very common. The Carbon Disclosure Project (“CD Project”), a nonprofit organization seeking climate-related information on behalf of its 385 signatory investors² holding \$57 trillion in assets under management,³ sent its sixth annual questionnaire on carbon emissions to more than 3,000 public companies in February 2008.⁴ Last year, 77% (383) of Fortune 500 companies responded to the fifth questionnaire, and 286 of those companies reported some kind of Greenhouse Gas reduction initiative.⁵ While generally, the responses to the Carbon Disclosure Project questionnaire are not inferior to those companies’ 10-K reports, the focus of the questioning is on carbon emissions, not financial risk to the company.⁶ In addition, not all of the responses are public (some instead are available only to CD Project signatories) and vary in quality and detail.⁷ This and other variations in voluntary reporting indicate that “voluntary efforts do

¹ Press Release, Ceres, Investors File Record Number of Global Warming Resolutions with U.S. Companies (Mar. 6, 2008), *available at* <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=854&srcid=705>; Jim Efstathiou, Jr., *Investors Press Companies for More Global Warming Information*, BLOOMBERG.COM, Mar. 6, 2008, *available at* http://www.bloomberg.com/apps/news?pid=email_en&refer=energy&sid=aDm9tFyG0FzE.

² Carbon Disclosure Project, <http://www.cdproject.net/whatiscdp.asp>.

³ *See* Carbon Disclosure Project Home Page, <http://www.cdproject.net>.

⁴ Carbon Disclosure Project 2008 questionnaire, <http://cdproject.net/questionnaire.asp>.

⁵ Carbon Disclosure Project, CARBON DISCLOSURE PROJECT REPORT 2007—FORTUNE 500, at ii, (2007), *available at* <http://cdproject.net/cdp5reports.asp>.

⁶ *See* Michelle Chan- Fischel, FRIENDS OF THE EARTH, FIFTH SURVEY OF CLIMATE RISK DISCLOSURE IN SEC FILINGS OF AUTOMOBILE, INSURANCE, OIL & GAS, PETROCHEMICAL, AND UTILITIES COMPANIES, at 35 (2006), *available at*, <http://www.foe.org/camps/intl/SECFinalReportandAppendices.pdf>.

⁷ Carbon Disclosure Project questionnaires are only available to signatories of the Project or from companies who choose to make their own responses public.

not meet the market's need for consistent and uniform information that will allow investors to compare and evaluate corporations' exposure to climate risk."⁸

In September 2007, a group of state financial officers, asset managers, and non-governmental organizations (NGOs), and non-profits filed a petition for interpretive guidance with the SEC to clarify that companies are currently required to disclose material risk associated with environmental change.⁹ The petition asks for clarification that narrative disclosures including material climate risk on the nature of the business, legal proceedings, and financial conditions are required by Regulation S-K on a public corporation's 10k filings.¹⁰ Petitioners, however, do not advocate a change in current disclosure laws, but stress that they are advocating for disclosure of only material climate risk. They remind that "[a]ssessment of whether the registrant faces material risks requiring public disclosure does not impose any legal obligations beyond those long required under the securities laws and the Commission's regulations and guidance."¹¹

A. *Relevant Law*

Petitioners contend that Items 101,¹² 103¹³ and 303¹⁴ of Regulation S-K will require disclosure of climate risk for most

⁸ PETITION FOR INTERPRETIVE GUIDANCE ON CLIMATE RISK DISCLOSURE, 45, (Sept. 18, 2007) File No. 5-547, before the SEC, *available at* <http://sec.gov/rules/petitions/2007/petn4-547.pdf>. [hereinafter PETITION]

⁹ *Id.* Signatories are California Public Employees' Retirement System, California State Controller John Chiang California State Teachers' Retirement System, California State Treasurer Bill Lockyer, Ceres, Environmental Defense, F&C Management, Florida Chief Financial Officer Alex Sink, Friends of the Earth, Kentucky State Treasurer Jonathan Miller, Maine State Treasurer David G. Lemoine, Maryland State Treasurer Nancy K. Kopp, The Nathan Cummings Foundation, New Jersey State Investment Council Chair Orin Kramer, New York City Comptroller William C. Thompson, Jr., New York State Attorney General Andrew M. Cuomo, New York State Comptroller Thomas DiNapoli, North Carolina State Treasurer Richard Moore, Oregon State Treasurer Randall Edwards, Pax World Management Corporation, Rhode Island General Treasurer Frank T. Caprio, Vermont State Treasurer Jeb Spaulding.

¹⁰ *Id.* at 13-14.

¹¹ *Id.* at 55.

¹² 17 C.F.R. § 229.101 (2007).

corporations, regardless of industry affiliation.¹⁵ For all three subsections of the regulation, information must be disclosed if it reaches the ‘materiality’ standard. In discussing materiality, the Supreme Court has reminded that it is both flexible and subjective: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”¹⁶ Climate related risk that has not yet reached the threshold of materiality would not need to be disclosed even if the SEC were to issue interpretive guidance.

Petitioners capitalize on previous changes to Reg. S-K that specifically remind registrants to disclose certain material environmental risks. Item 101, “Description of Business” includes instructions for the cost of compliance with environmental laws:

Appropriate disclosure also shall be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries.¹⁷

The petition similarly contends that the Office of the Chief Accountant affirmatively addressed the disclosure of environmental liabilities in item 103, Legal Proceedings.¹⁸ Commission staff, in SAB 92, instructed corporations to disclose “reasonably probable” results of litigation which would have an impact on companies’ “environmental liabilities.”¹⁹

Item 303 requires that the corporation, in its MD&A²⁰, disclose information about liquidity, capital resources, results of

¹³ 17 C.F.R. § 229.103 (2007).

¹⁴ 17 C.F.R. § 229.303 (2007).

¹⁵ PETITION at 15.

¹⁶ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

¹⁷ 17 C.F.R § 229.101(c)(1)(xii).

¹⁸ PETITION at 17. See SEC Staff Accounting Bulletin No. 92, 58 Fed. Reg. 32,843 (June 8, 1993).

¹⁹ SEC Staff Accounting Bulletin No. 92, 58 Fed. Reg. at 32,845.

²⁰ Management’s Discussion and Analysis of Financial Condition and Results of Operations.

operations, off-balance sheet arrangements and contractual obligations as well as “other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.”²¹ This, the staff of the SEC has said, includes any “known trends or uncertainties”²² that are likely to come “to fruition.”²³ The Eleventh Circuit has understood this element “to require an assessment of whether an observed pattern accurately reflects persistent conditions of the particular registrant’s business environment.”²⁴ Petitioners argue that “the fact that climate change carries significant to severe long-term risks for many companies places it squarely within Item 303’s disclosure requirements.”²⁵

Petitioners further argue that certain companies, such as those which emit significant levels of greenhouse gasses and are subject to direct regulations, must already disclose climate risk on their balance sheets because of *Accounting for Contingencies*,²⁶ an instruction from the Financial Accounting Standards Board. The standard dictates that if an uncertainty is probable and reasonably estimable, it must be expressed on the balance sheet.²⁷ As climate warming is a scientific certainty, petitioners argue that associated risk is already becoming reasonably estimable for some companies. For example, companies that emit large quantities of greenhouse gases and are or expect to be subject to regulation should be able to estimate the cost of these regulations.²⁸ Similarly, companies whose physical operations are at risk “due to developments such as melting permafrost or storm damage” should, according to Petitioners, disclose the risks in the MD&A.²⁹

Although Petitioners emphasize that current law already mandates disclosure, they are asking that the SEC clarify procedures

²¹ 17 C.F.R. §229.303.

²² 17 C.F.R. §229.303(a)(3)(ii).

²³ SEC Staff Accounting Bulletin, No. 87, 54 Fed. Reg. 22,427 (May 24, 1989).

²⁴ *Oxford Asset Management, Ltd. v. Jarvis*, 297 F.3d 1182, 1191 (11th Cir. 2002) (cert. denied, 540 U.S. 872 (Oct. 6 2003)).

²⁵ PETITION at 20.

²⁶ PETITION at 15; ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5, (Fin. Accounting Standards Bd., Mar. 1975), available at <http://www.fasb.org/pdf/fas5.pdf>.

²⁷ ACCOUNTING FOR CONTINGENCIES at 6.

²⁸ PETITION at 15.

²⁹ *Id.*

through which registrants arrive at their choices for material risks. They ask that the SEC clarify that registrants must “carefully review the implications of climate change for their financial condition and operations”³⁰ and disclose material risks. That review would entail a review of “the adequacy of [registrants’] internal mechanisms for gathering information about, and assessing, climate risk, and should establish institutional mechanisms necessary to ensure careful and well-informed review of potential climate risks.”³¹ They also ask the SEC to clarify that an appropriate review would include a review of physical risks and legal proceedings connected to climate change, as well as financial risks and opportunities associated with greenhouse gas regulation.³²

B. Investors

That part of the investing community that has responded to the petition has greeted it warmly, as it has to the prospect of greater disclosure of climate risk in general. The two largest institutional investors in the United States, the California Public Employees’ Retirement System (CalPERS)³³ and California State Teachers’ retirement System (CalSTRS)³⁴ are co-signatories of the petition. Comments filed with the SEC were all positive and included asset managers with a combined \$131 billion under management.³⁵ The SEC, however, has not responded to the petition or to other requests to clarify the level of environmental risk which will necessitate disclosure.³⁶ If the Commissioners were to indicate interest in

³⁰ *Id.* at 52.

³¹ *Id.*

³² *Id.* at 53.

³³ CalPERS is the largest U.S. public pension fund, with membership of 1.5 million and investment portfolio valued at \$241.9 billion as of Apr. 3, 2008. See <http://www.calpers.ca.gov/>.

³⁴ CalSTRS is the second largest U.S. public pension fund, with membership of 795,000 and \$173.7 billion under management. See <http://www.calstrs.com/About%20CalSTRS/ataglance.aspx>.

³⁵ See comments to SEC File No. 5-547: Tapblin, Canida & Habacht; Dwight Asset Management; Smith Breeden Associates; Sterling Capital Management; Calvert investments; Institutional Investors Group on Climate Change, available at <http://sec.gov/comments/4-547/4-547.shtml>.

³⁶ REQUEST FOR INTERPRETIVE GUIDANCE UNDER THE SECURITIES ACT OF 1933 THAT WOULD REQUIRE REGISTRANTS TO DISCLOSE TO SHAREHOLDERS THE BUSINESS RISKS OF LAWS AND REGULATIONS INTENDED TO ADDRESS

climate related risk reporting, other investors, including those less amenable to the Petitioner's objectives could be expected to way in.

There is also demand for disclosure about climate risk outside of public filings. In 2007 alone, forty-five shareholder resolutions were filed dealing directly with carbon emissions and other types of environmental impact.³⁷ In the 2008 proxy season, a total of fifty-four resolutions pertaining to global warming were filed by shareholders.³⁸ On February 14, 2008, Ceres and the Investor Network on Climate Risk convened an Investor Summit on Climate Risk in partnership with the United Nations at UN headquarters in New York. There, the Investor Network on Climate Risk released an action plan, in which signatories state their "intentions to manage our investments; to engage companies, investors, and others; and to support policy action. . . ."³⁹ Signatory investors hold a combined \$1.75 trillion in assets under management.⁴⁰ In another indication of the importance of climate-related risk to investors, the Carbon Disclosure Product has increased the number of signatories from 315 with \$41 trillion under management to 385 with \$57 trillion under management.⁴¹ The Carbon Disclosure Project's questionnaire⁴² asks for more detailed disclosure than do the Petition's signatories including information on "total greenhouse gas emissions", "regulatory risk/opportunity (e.g. limits on emissions)", "physical risk/opportunity (e.g. changes in weather patterns impacting operations)", "consumer sentiment risk/opportunity (e.g. reputa-

GLOBAL WARMING CONCERNS, (Oct. 22, 2007) File No. 5-549, before the SEC, available at <http://sec.gov/rules/petitions/2007/petn4-549.pdf>.

³⁷ Carolyn Mathiasen, *2007 Proxy Season Preview: Environmental Issues, RISK & GOVERNANCE WEEKLY*, available at http://issproxy.com/governance_weekly/2007/004.html.

³⁸ Efstathiou, *Investors Press Companies for More Global Warming Information*, *supra* note 1.

³⁹ INVESTOR NETWORK ON CLIMATE RISK ACTION PLAN (Feb. 13, 2008) available at <http://www.ceres.org/NETCOMMUNITY/Document.Doc?id=279>.

⁴⁰ *Id.*

⁴¹ Press Release, Carbon Disclosure Project, The World's Largest Investor Coalition Seeks Further Disclosure on Climate Change and Shareholder Value (Feb. 4, 2008) available at <http://cdproject.net/pressreleases.asp>.

⁴² See Carbon Disclosure Project 2008 questionnaire, *supra* note 4.

tion)”, “steps taken to manage and reduce emissions.”⁴³ The Carbon Disclosure Project reports that 77% of Fortune 500 companies responded to their 2007 questionnaire, their highest participation rate ever.⁴⁴

C. *Public Companies*

To date, no publicly traded companies have filed negative comments on the petition with the SEC. There are, however, indications in the marketplace that corporations are interested in action from the federal government on climate change. The United States Climate Action Partnership is an alliance of business and climate action groups “that have come together to call on the federal government to enact legislation requiring significant reductions of greenhouse gas emissions.”⁴⁵ Members include Alcoa, Rio Tinto, Caterpillar, Shell, General Motors, and Dow Chemicals. On February 4, 2008, the Wall Street Journal reported that Citigroup, J.P. Morgan Chase & Co, and Morgan Stanley will require utility companies seeking project financing to prove that their plants will be viable even under a stringent cap on green house gas emissions.⁴⁶ Bank of America has since joined the group.⁴⁷ In addition, most of the major investment banks have released white papers on climate related risks and opportunities and many have begun programs to assess and take advantage of a changing energy economy.

⁴³ Press Release, Carbon Disclosure Project, The World’s Largest Investor Coalition Seeks Further Disclosure on Climate Change and Shareholder Value *supra*, note 41.

⁴⁴ Carbon Disclosure Project, CARBON DISCLOSURE PROJECT REPORT 2007-GLOBAL FT 500, *supra* note 5, at ii.

⁴⁵ United States Climate Action Partnership Home Page, <http://www.us-cap.org/about/index.asp>.

⁴⁶ Jeffrey Ball, *Wall Street Shows Skepticism Over Coal*, WALL ST. J., Feb. 4, 2008 at A6, available at http://online.wsj.com/public/article_print/SB120209079624339759.html.

⁴⁷ Keith Johnson, *Bank of America: more heat on coal*, WALL ST. J., Apr. 2, 2008, <http://blogs.wsj.com/environmentalcapital/2008/04/02/bank-of-america-more-heat-on-coal/?mod=WSJBlog>.

D. Responses

New York Times Business writer Joe Nocera described the Petition as “environmental tyranny described as public policy.”⁴⁸ He described the Petitioners’ efforts as “little more than sideshows.”⁴⁹ Beyond this September 2007 op-ed, criticism of the petition and its request for an interpretive ruling has been notably sparse. The usual suspects for environmentalists—companies in the utility and energy sector—are among the best reporters of climate-related risk due to the highly exposed nature industries.⁵⁰

On October 31, 2007, the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs held a hearing on the risks and opportunities associated with climate disclosure. Witnesses were positive about more information for investors on material environmental risk⁵¹ and Senators Christopher Dodd and Jack Reed subsequently wrote to the Commissioners.⁵² In their letter, the Senators urged Commissioners to issue interpretive guidance “to ensure greater consistency and completeness in disclosure of material information related to climate change. . . .”⁵³ They further requested that the SEC state that companies should assess climate risk or explain why they believe the assessment is unnecessary, provide guidelines for conducting a climate risk assessment, and clarify that material climate risks should be reported under Items 101 and 303 of Regulation S-K.⁵⁴

This is not to say that all interested parties have wholeheartedly supported the position. Some, like Nocera, think that the request and estimation of the importance of climate-related risk is

⁴⁸ Joe Nocera, *This Climate is Surely Full of Hot Air*, N. Y. TIMES, Sept. 22, 2007, at C1.

⁴⁹ *Id.*

⁵⁰ PETITION at 32.

⁵¹ See *Climate Disclosure: Measuring Financial Risks and Opportunities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (statements of Mindy S. Lubber, Russell Read Jeffrey A. Smith, and Gary W. Yohe), available at http://banking.senate.gov/_files/ACF1DD9.pdf.

⁵² Letter from Christopher Dodd, U.S. Sen., and Jack Reed, U.S. Sen., to Christopher Cox, Chairman of the U.S. Sec. Exch. Comm’n (Dec. 6, 2007), available at http://dodd.senate.gov/multimedia/2007/120607_CoxLetter.pdf.

⁵³ *Id.*

⁵⁴ *Id.*

unnecessary.⁵⁵ For others, an interpretive ruling is only problematic if the Commission responds in the specific manner that Petitioners request. Petitioners are not arguing for a change in any regulation, but are instead asking for the interpretive release on the strength of current law. Some disagreement seems to come from the details of “materiality” as to climate risk that the Petitioners urge the SEC to adopt. Petitioners ask for instructions for compliance with the materiality requirement in the climate context. They urge that the SEC adopt the framework similar to that announced by the Investor Network on Climate Risk⁵⁶ in guiding companies to an assessment of the materiality of their climate related risks.⁵⁷ Under the Global Framework for Climate Risk Disclosure, adequate disclosure requires an assessment of the registrant’s greenhouse gas emissions, a strategic study of the risks those emissions pose to facilities and operations, regulatory risks, and physical risks all related to climate change.⁵⁸ A specific instruction from the SEC as to these requirements would impose costs in the form of internal environmental audits that may not actually result in material disclosures for many companies.

In his testimony before Congress, Jeffrey A. Smith, Head of Environmental practice at Cravath, Swain, and Moore LLP, and past chair of environmental disclosures for the ABA, pointed out that the specifics of disclosure argued by petitioners may be immaterial for many companies.⁵⁹ Smith argues that aside from emission-intensive

⁵⁵ E-mail from Jeffrey A. Smith, head of environmental practice at Cravath, Swaine & Moore LLP, to the author (Feb. 22, 2008) (on file with author) (describing some of the interested parties in the debate over the petition and climate risk disclosure).

⁵⁶ See Ceres, GLOBAL FRAMEWORK FOR CLIMATE RISK DISCLOSURE (Oct. 2006), available at <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=593&srcid=592>.

⁵⁷ PETITION at 53.

⁵⁸ *Id.*

⁵⁹ See *Climate Disclosure: Measuring Financial Risks and Opportunities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (statement of Jeffrey A. Smith), available at http://banking.senate.gov/_files/ACF1DD9.pdf (“Compelling such companies to disclose would serve no useful purpose in the market and could undermine the integrity of mandated data and material market developments.”); Jeffrey A. Smith, *Disclosure of Climate Change Risks and Opportunities*, REV. OF SEC. & COMMODITIES REG., Jan. 2, 2008.

industries, such as utilities, the total carbon footprint would be immaterial under Reg. S-K.⁶⁰ Greenhouse gas emissions are only relevant insofar as they result in material costs or uncertainties for a company. Thus a company with a high quantity of carbon emissions would view a regional or national cap and trade system as a material fact. A company with lower emissions would not be impacted by a cap above its emission levels and thus disclosure of the carbon footprint would be immaterial. In addition, the amount of uncertainty associated with the risks of physical climate change, which petitioners argue should be disclosed as a known uncertainty under Item 303, would, for most companies, overstate a risk that is generally so uncertain as to be immaterial.⁶¹ For example, a company with infrastructure on top of melting permafrost faces a known uncertainty: the stability of the ground on which capital assets lie. A company with a plant on the gulf coast of Florida similarly faces risks of storms, but the likelihood of a devastating hurricane is not a known uncertainty per FASB 5. Insurance, cash reserves, and contingency plans can mitigate the financial exposure in the event of a storm. Smith argues that an overly comprehensive statement from the SEC, particularly on these guidelines can thus lead to certain companies over-reporting their material risks just to fill out the categories.

E. Precedent

While the petitioners are careful to argue that the legal basis for disclosure of climate related risk is grounded in existing regulation, they argue that climate change has far-reaching consequences for businesses because of risks to the physical environment and changes in the legal and regulatory landscape. Were the SEC to rule on the petition, it would not be the first time that the Commissioners have responded to evolving risks related to the environment.⁶²

⁶⁰ Smith, *Disclosure of Climate Change Risks and Opportunities* at 5.

⁶¹ PETITION at 19.

⁶² Jeffrey A. Smith, has argued that the SEC's response to Superfund regulation and litigation and the SEC's response to the impending Y2K crisis are instructive precedents for this particular request. See *Climate Disclosure: Measuring Financial Risks and Opportunities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (statement of Jeffrey A.

In 1973, the SEC amended Instruction 5 to Item 103 to require “more meaningful disclosure of environmental information.”⁶³ After the amendments, registrants were instructed to disclose material costs of compliance with environmental regulations and material pending or contemplated judicial or administrative proceedings.⁶⁴ However, this instruction eventually obscured the relative importance of legal or regulatory proceedings, and prevented investors from ascertaining the import of any given action.⁶⁵ The SEC addressed these concerns with a series of amendments and interpretive releases and eventually proposed amendments to the instruction establishing a minimum threshold. Instruction 5, in its current form was enacted in spring of 1982.⁶⁶ The amendment clarified the threshold of proceeding arising under environmental regulations. Now, a proceeding is only material if it involves a claim for damages that would exceed ten percent of the corporation’s assets or if the registrant believes it will result in sanctions greater than \$100,000.

Smith), available at http://banking.senate.gov/_files/ACF1DD9.pdf; Jeffrey A. Smith, *Disclosure of Climate Change Risks and Opportunities*, REV. OF SEC. & COMMODITIES REG., Jan. 2, 2008 at 1.

⁶³ See SEC Release Number 33-5386 (Apr. 20, 1973) cited in Proposed Amendments to Item 5 of Regulation S-K Regarding Disclosure of Certain Environmental Proceedings, 46 Fed. Reg. 25,638 (May 8, 1981).

⁶⁴ See 17 C.F.R. § 229.303.

⁶⁵ Proposed Amendments to Item 5 of Regulation S-K Regarding Disclosure of Certain Environmental Proceedings, 46 Fed. Reg. 25, 638 (May 8, 1981).

⁶⁶ Adoption of Integrated Disclosure System, Securities Exchange Commission, 47 Fed. Reg. 11,380 (Mar. 16, 1982). Instruction 5 now reads in part: “[A]n administrative or judicial proceeding . . . arising under any Federal, State or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment shall not be deemed ‘ordinary routine litigation incidental to the business’ and shall be described if. . . (b) such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges or charges to income the amount involved. . . exceed[s] 10 percent of the current assets of the registrant . . . or (c) a governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions . . . of less than \$100,000.

After CERCLA created Superfund, many companies found themselves subject to the disclosure section in item 103.⁶⁷ By the end of the 1980s, the SEC had clarified that remedial costs paid to the Superfund normally are “charges to income” or “capital expenditures” rather than sanctions.⁶⁸ In addition, the registrant could consider the availability of insurance, indemnification, or contribution to determine whether the criteria have been met.⁶⁹ Thus a company with a well developed contingency or risk management plan could avoid reporting climate-related legal risk.

F. Conclusion

In spite of growing interest from investors as to the materiality of climate risk to their investment decisions, it seems unlikely that the Commissioners will respond to the petition in the near future. The Petitioners are asking for climate-oriented instructions on the materiality requirement and the political winds are certainly not blowing in the Petitioners’ favor. This administration has been lukewarm toward climate change and has shown reluctance to address the problem through treaties and other affirmative actions. It would be strange for the SEC to take on the issue even while the EPA is dragging its heels.⁷⁰ Further reducing the odds of action, both of the Democratic commissioners have stepped down without replacements, essentially eliminating the possibility of bipartisan compromise.

Inaction, however, has a cost. The information marketplace is currently being filled by voluntary disclosure and non profit projects, such as the Carbon Disclosure Project. The result is information that is not comprehensive, and in many different formats and contexts. Some reporting is self-promotion and much is targeted at environmentalists rather than educated investors. Petitioners assert that “[t]he low rate of meaningful climate risk disclosure and the

⁶⁷ Comprehensive Environmental Response, Compensation and Liability Act of 1980, 42 U.S.C. §§9601-9675 (2000).

⁶⁸ Management’s Discussion and Analysis of Certain Financial Conditions and Results of Operations, 54 Fed. Reg. 22,427 (May 24, 1989), note 30.

⁶⁹ *Id.*

⁷⁰ See Tom Pelton, *States Sue to Push Limits on Vehicle Emissions*, L.A. TIMES, Apr. 3, 2008 at A14 (reporting that the states that successfully sued the EPA last year are taking the agency back to court for its failure to comply in a timely fashion with the Supreme Court’s ruling).

inconsistency in how companies are addressing this subject in their filings are denying investors the information they need and demand about climate risk.”⁷¹ “It has become important for the SEC to move with deliberate speed to reassert its gatekeeper role for the market and to clarify its expectations” in order to fill its traditional role as an information clearinghouse for public companies.⁷² It is clear that this area of disclosure will be slow to develop without some sort of centralized guidance.

Rachel Phillips⁷³

⁷¹ PETITION at 20.

⁷² Jeffrey A. Smith, *Disclosure of Climate Change Risks and Opportunities*, *supra* note 59, at 9.

⁷³ Student, Boston University School of Law (J.D. 2009).

