andrews REPRINT

Securities Litigation & Regulation

LITIGATION REPORTER

Reprinted from Volume 8, Issue 6

Commentary:

Is Financial Integration Under Gramm-Leach-Bliley To Blame for the Crisis of Investor Confidence In Post-Enron America? A Brief Analysis

By Scott D. Brenner*

"The only limit to our realization of tomorrow will be our doubts of today." —Franklin Delano Roosevelt

Today, as America's post-Enron economy continues to suffer from prolific corporate fraud, our nation's financial markets, and those abroad as well, are reeling in an environment of deep suspicion and mistrust. FDR's words ring as true today as they did when they were first uttered — to signify the prevailing mandate for landmark legislation.

The Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA), is currently being re-evaluated to determine the extent of its contribution to the current crisis. Should America's banking laws once again digress to the provincial separation of commercial lending (commercial mortgage and other debt financing transactions) from investment banking (underwriting and other dealings in securities)?

Just prior to the date of the completion of this article, allegations were made that Citigroup Inc. and J.P. Morgan Chase committed securities fraud in connection with the formation and use of Enron Corporation's offshore special purpose vehicles in a "commodity prepay" scheme. The apparent goals were to inflate profits, income over debt, and to fool investors by hiding debt from the equity analysts. These special purpose vehicles enabled Enron and other energy trading firms to account for commodity prepay income as trading activity, while intentionally ignoring the corresponding obligation to provide the commodity (the debt). Instead, they hid the obligation as deferred revenue or obscure trading liabilities.

Utilizing this scheme, "Citigroup, Inc. and J.P. Morgan Chase reportedly made more than $200 million in fees for transactions that helped Enron Corp. and other energy companies boost their cash flow and hide debt, according to congressional investigators and others."[1] The debt bubble expanded throughout the 1990s without ratings exposure in the Capital Markets, until it burst for many of the companies, including Enron, earlier this year. The Securities and Exchange Commission believes that the involved banks irresponsibly "stuck their heads in the sand like ostriches," failing to conduct proper due diligence with respect to improprieties in their clients' financial statements.[2]

... [T]he basic rubric of GLBA ... should be kept intact.

Citigroup Inc. may also be under judicial scrutiny for allegedly touting Enron bond issues through its subsidiary, Salomon Smith Barney Holdings Inc., to the Toronto-based investment firm Silvercreek Management Inc. Citigroup is accused of knowing at the time through lending transactions that Enron's finances were in a quandary. Nevertheless, Salomon Smith Barney recommended the purchase of Enron's bonds, with the involvement of Banc of America Securities and Goldman, Sachs & Co. Citigroup's defense points out that its lending and securities underwriting arms were *de facto* separate entities, so the relevant information was not known to those recommending the bonds.

At the time of this writing, the status of *Silvercreek Management Inc. v. Salomon Smith Barney et al.*, No. 02-413, *complaint filed* (S.D.N.Y. Jan. 16, 2002), is not known. However, the case raises interesting questions about the famed "Chinese Wall" where

underwriting and lending affiliates within the same financial institution must separate themselves to avoid conflicts of interest. Such separation means not sharing pertinent information that would otherwise be a necessary disclosure to investors. However, the sharing of rating or due diligence information between a financial institution's banking and securities affiliates is now consistent with the banking environment, and may be a way to avoid liability for securities fraud.[3]

At most, regulation or legislation may be considered to permit the flow of financial information between various affiliates of financial institutions. But the basic rubric of GLBA, enacted to facilitate banking realities and bring them under the umbrella supervision of the Federal Reserve Board, should be kept intact. These banking realities that must be recognized are the historical market-driven affiliation of banks with financial service companies (including securities firms and insurance agencies), and the movement of the industry in the wake of Glass-Steagall toward full financial service integration.

The Banking Act of 1933 (Glass-Steagall Act)[4]

The Banking Act of 1933, known also as the Glass-Steagall Act, was passed in the midst of the Great Depression. It was enacted to address widespread bank failures resulting from investment in securities that risked commercial and savings deposits — unsound lending practices to boost the value of companies the banks invested in — and to address banks' pressure on companies to invest in securities for which the banks themselves had a financial interest. The necessity for the bill was quickly reconsidered by Senator Carter Glass himself, former Treasury secretary and "father of the Federal Reserve System," only two years after sponsoring the bill. In 1935 he led an effort to repeal the Glass-Steagall Act.

Sections 16, 20, 21 and 32 of the GSA erected a wall between "commercial banking" and "investment banking." Banks could not engage in underwriting or dealing in anything but "bank eligible securities." However, an exception was made under Section 20, whereby banks could have affiliations with organizations that do not *principally* engage in such activities. The GSA left interpretation of the term "principally" to the administrative discretion of the Federal Reserve Board.

Section 20 of the GSA is historically the most significant because its language ultimately led to the formation of a roundabout method of achieving limited financial integration under what is known as a "Section 20 subsidiary." Section 20 subsidiaries are banking entities formed under a 1986 Federal Reserve regulation that engage mostly in permitted activities such as commercial lending, but do maintain a small percentage of revenues in activities that would otherwise be prohibited by the GSA. The rate of these restricted activities was initially set by the Fed at 5 percent of the subsidiary's total gross revenue on average over eight quarters. It was raised twice until it reached 25 percent (*see the Federal Reserve's Web site at http://www.federalreserve.gov*). The Federal Reserve authorized its first such subsidiary in 1987.[5] As of today, the Federal Reserve Board reports authorization for at least 80 broker-dealer subsidiaries to engage in securities underwriting, dealing or market-making (*see http://www.federalreserve.gov/generalinfo/subsidiaries*).

Cutting back on the advances achieved by GLBA would reverse decades of maturing economic history ...

Various other hybrid banking-financial relationships also surfaced under other integration models, such as depositary "non-bank" banks ("industrial loan" and "credit card" banks for example) and "unitary thrifts" allowing financial, insurance and even non-financial firms to acquire single thrifts, "linking up" with depositary institutions.[6]

The Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act)[7]

Shortly after the passage of GLBA in November 1999, Senator Phil Gramm, chairman of the Senate Banking Committee, summarized the lasting significance of the legislation: "I believe we have passed what will prove to be the most important banking bill in 60 years. It overturns the key provision of the Glass-Steagall Act that divided the American financial system. Over time, the market and the regulators have used a variety of innovations to try to undo this separation. As a result, we have substantial competition occurring, but it is competition that is largely inefficient and costly, it is unstable, and it is not in the public interest for this situation to continue. The Gramm-Leach-Bliley Act strikes down these walls and opens up new competition. It will create wholly new financial services organizations

in America. It will literally bring to every city and town in America the financial services supermarket."[8]

GLBA was signed into law by former President Bill Clinton, on Nov. 12, 1999 (Public Law 106-102). An excellent summary of its various provisions can be found at the U.S. Senate Web site, http://www.senate.gov/%7Ebanking/conf/grmleach.htm.

GLBA's objectives are:

- to facilitate affiliations among banks, securities firms and insurance companies (Title I);
- to provide "functional regulation" of bank securities activities (Title II);
- to provide "functional regulation" of bank insurance activities (Title III);
- to phase out sales of unitary thrift holding companies except to financial companies (Title IV);
- to prevent disclosure of non-public personal information by financial institutions to affiliates, etc. (privacy) (Title V);
- to modernize the Federal Home Loan Bank system (Title V); and
- to address other miscellaneous issues (Title VI), such as clarification that nothing in the act repeals any provision of the Community Re-development Act, and mandatory posting of transaction fees at ATM machines.

GLBA removes the barriers that previously restricted full affiliation of commercial banking with securities underwriting and insurance agency activities; it also permits commercial and merchant banks to seek affiliation. Under the act, there are two models under which such affiliations can take place, along with hybrid combinations. The first model allows the formation of holding company affiliates under Section 4 of the Bank Holding Company Act of 1956, as amended, called *financial holding companies* (insurance underwriting and merchant banking may only be integrated using FHCs). The second model allows for the utilization of an existing financial subsidiary or the creation of a new one (in both cases in the second model, the subsidiary must have no more than the lesser of $50 billion or 45 percent of total consolidated assets).

The Federal Reserve certifies proposed FHCs under current law. According to GLBA, the Federal Reserve may not certify a proposed financial holding company if any of its insured depositary subsidiaries are not "well capitalized and well managed," or if any did not receive a Community Reinvestment Act rating acceptable to the Federal Reserve. The CRA rating results from an examination required by GLBA — essentially an egalitarian compromise promoting the participation of banking institutions in making credit available for investment in disadvantaged communities.[9] For example, since GLBA, two of the largest banking institutions, J.P. Morgan Chase and Citigroup Inc., have participated in substantial urban redevelopment projects extending to the outer reaches of New York City's most impoverished neighborhoods.

Further, the Federal Reserve has discretion to limit an FHC's ability to engage in new financially related activities depending on the level of its satisfaction that the affiliates-subsidiaries are well capitalized, well managed, and have adequate financial or managerial resources to conduct the activities in a safe and sound manner. Accordingly, the regulations reserve "general supervisory authority" to the Federal Reserve to restrict or limit the financially related activities of an FHC.

In sum, GLBA now permits on the main road those vehicles that banks have been utilizing primarily off-road, under GSA, to reach the same destination. The destination: the ability to meet the demand of the market that the full range of integrated financial services be delivered as efficiently and cost-effectively as possible.

Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002[10]

Consistent with the Federal Reserve's far-reaching authority to regulate banking under GLBA, the SEC was left to untangle conflicts-of-interest problems under the newly enacted Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, which President Bush signed on July 30.

Conflict theorists may opine that CAARTA fell short of laying blame for the rash of corporate fraud on the doorstep of the ever-growing banking institution. Undoubtedly, some may assert that GLBA permitted too much leniency by enabling wholesale integration of banking, financial and insurance activities. As a result, it would follow, cases like *Silvercreek Management*

Inc. v. Salomon Smith Barney et al., discussed above, will continue to surface.

In truth, the current regime under GLBA merely permits financial institutions to progress in the same direction in which they were headed using creative legal engineering. The displaced provisions of the Glass-Steagall Act, by comparison, were intended to protect investors under socioeconomic circumstances far more dire than today's state of affairs. The wall separating the various functions of financial institutions has already been eroding over time, as a result of market forces — not as a result of the sudden unexpected drop of the congressional gavel in November 1999.

Cutting back on the advances achieved by GLBA would reverse decades of maturing economic history without sufficient evidence to suggest that the banking industry is even culpable. The fundamental issue for the future will be whether the various vehicles for integrated financial services can communicate with one another and to what degree — not whether they can exist at all. If Citigroup's defense in *Silvercreek* is ultimately held to be valid, then the communication barriers should be re-examined — not GLBA.

The Securities and Exchange Commission is well equipped to examine conflicts of interest between the roles of analysts and investment bankers. There are nuances in the banking world that require separate treatment, so the question becomes whether the SEC or the General Accounting Office (with a mandate to review the role of investment banking firms) is best equipped for the task ahead.[11] In all of this, it is imperative that Gramm-Leach-Bliley be recognized not as misguided legislation to tear down but as a foundation from which market forces can continue to move the financial world forward.

Notes

[1] Beckett, Sapsford, *Citigroup, J.P. Morgan Take Hits as Hearing Probes Roles at Enron*, WALL ST. J., July 24, 2002, p. 1, col.5.

[2] *Ibid.*

[3] *See, generally*, Boraks, *Image Risk Outweighs Legal in Suit vs. Lenders*, THE AMERICAN BANKER, Feb. 4, 2002.

[4] *See, generally, Understanding How Glass-Steagall Act Impacts Investment Banking and the Role of Commercial Banks*, http://www.cftech.com/BrainBank/SPECIALREPORTS/GlassSteagall.html; *see also*, Kwan, *Cracking the Glass-Steagall Barriers*, FRBSF (Federal Reserve Bank of San Francisco) Economic Letter No. 97-08 (March 21, 1997); Henriques, *The Glass-Steagall Act: 1930's Division of Financial Power*, N.Y. TIMES, April 7, 1998.

[5] Furlong, *The Gramm-Leach-Bliley Act and Financial Integration*, FRBSF (Federal Reserve Bank of San Francisco) Economic Letter No. 2000-10 (March 31, 2000).

[6] *Ibid.*

[7] *See, generally*, the U.S. Senate Web site, http://www.senate.gov/~banking/conf/grmleach.htm.

[8] News from the Senate Banking Committee, *Senate Approves Gramm-Leach-Bliley Act, Vote Paves Way for Financial Services Modernization*, Issued for immediate release on Thursday, Nov. 4, 1999.

[9] *See* Federal Reserve Board Web site, http://www.federalreserve.gov/dcca/cra, for more information.

[10] Also known as the Sarbanes-Oxley Act of 2002. *See, generally*, the text of CAARTA at http://frwebgate.access.gpo.gov/cgi-bin/etdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

[11] The role of the SEC is a unclear because under Section 18 of CAARTA, the General Accounting Office is mandated to study "whether investment banks and financial advisors assisted public companies in manipulating their earnings and obfuscating their true financial condition."

* *Scott D. Brenner is associated with the Manhattan law firm of Barton, Barton & Plotkin LLP, where he focuses his practice on corporate and banking law.*
The author gratefully acknowledges the research and editing assistance of Daniel Michaeli, a student of the Dalton School in New York.