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The Citigroup and J.P. Morgan Chase Enron Settlements: The Impact on the Financial Industry

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I. INTRODUCTION

Corporate executives at financial institutions must increase their awareness of their companies' transactions because corporate governance is a vital issue in today's financial industry. Since the establishment of the Corporate Fraud Task Force in July 2002, federal prosecutors have charged more than 354 defendants with some type of corporate fraud and have convicted or obtained guilty pleas in more than 250 corporate fraud cases, including some related to the Enron debacle. In the wake of the Enron scandal, over 5,600 jobs have been lost, 28,000 employees' pensions have been drained, and Arthur Anderson has collapsed. Accountants and investment bankers have been held criminally responsible for their actions, while civil lawsuits have been filed against two law firms that participated in the Enron fraud. As the Enron scandal continues to unravel, the financial institutions primarily involved with Enron, Citigroup, Inc. (Citigroup) and J.P. Morgan Chase (J.P. Morgan), are now being held accountable for their actions.


2. President Bush's Corporate Fraud Task Force focuses on increasing the criminal enforcement activities within the U.S. Department of Justice on corporate fraud. The Task Force was established to increase the federal law enforcement on corporate officials' actions and to restore the integrity of the marketplace. First Year Report to the President-Corporate Fraud Task Force, available at http://www.usdoj.gov/dag/cftf/first_year_report.pdf, at 8.

3. Francis, supra note 1, at 2.


Both Citigroup and J.P. Morgan, two financial giants, financed transactions for Enron that allowed Enron’s management to present misleading financial results to shareholders, analysts, and the marketplace.\(^9\) Citigroup and J.P. Morgan primarily used “prepay” transactions that allowed Enron to disguise loans as commodities transactions.\(^10\)

“Prepay” transactions involve triangular deals where an original company (Enron) enters into a transaction with another company (a shell corporation) which enters into a transaction with the financial institution, which enters into a transaction with the original company.\(^11\) “The net effect of these deals [is that the original company ends up] being the shipper and receiver of the same commodity, due at the same price on the same day.”\(^12\) Under these transactions, all the multiple deals cancel each other out, except the original company who receives a large amount of cash, which must be paid back to the financial institutions with interest.\(^13\) The results of these deals are merely loans to the original corporation disguised as commodities transactions.\(^14\) Through several prepay s, Citigroup and J.P. Morgan lent Enron $6.4 billion dollars.\(^15\) These transactions enabled Enron to report non-existent earnings and conceal the discrepancy between actual and reported earnings from financial analysts and investors.\(^16\)

Citigroup and Enron also entered into special purposes entities (SPEs)\(^17\) transactions in which Enron converted cash

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9. Id.
11. Id.
12. Id.
13. Id.
14. Id.
17. Special Purposes Entities (SPEs) operate as a trust for a company. See THE CORPORATE LIBRARY, at http://www.thecorporatelibrary.com/spotlight/accounting/SPEs.html (last visited Feb. 7, 2004). The company creates the SPE and sells it an asset to fund a new project or product. Id. That asset is also removed from the company’s balance sheet. Id. Some companies, including Enron, use these entities purposely to keep debt off the balance sheet. Id.
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received from financing activities to cash from operations. 18

Citigroup financed the off-balance sheet SPEs for Enron. 19 These
SPEs, such as Project Nahanni, purchased short-term government
securities which were then quickly sold with "the proceeds [being]
booked as cash flow from operations." 20 Although Citigroup and
J.P. Morgan's transactions with Enron were arguably legal, the
transactions deceived investors and forced the financial institutions
to settle with bank regulators and the Securities and Exchange
Commission (SEC). 21

This Note addresses two main issues related to Citigroup's
and J.P. Morgan's settlement with regulators. Part II of this Note
will discuss the particular details of the settlements. 22 Part III of
this Note will discuss the implications of the settlements for these
particular financial institutions as well as for the financial services
industry. 23 Part IV of this Note will discuss the possible negative
effects arising from the settlements. 24

II. DETAILS OF THE SETTLEMENTS

Although Citigroup and J.P. Morgan were both heavily
involved in the Enron scandal, they received different punishments
from the SEC. 25 Under these settlements, Citigroup and J.P.
Morgan will pay fines of $101 million and $135 million,
respectively. 26 In determining the settlements with the financial
institutions, the SEC took into account how each company
"[cooperated] with the [SEC's] investigation, as well as its timely

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18. Global Power Report, supra note 16; see also In the Matter of Citigroup, Inc.,
7 Fed. Sec. L. Rep (CCH) ¶ 75,482, at 63,160 to 63,173 (July 28, 2003), available at
[hereinafter Citigroup Enforcement Action].
20. Id.
21. See Floyd Norris, A Warning Shot to Banks on Role in Others' Fraud, N.Y.
22. See infra notes 25-44 and accompanying text.
23. See infra notes 45-134 and accompanying text.
24. See infra notes 135-158 and accompanying text.
efforts to resolve the matter.\textsuperscript{27} Citigroup paid less in fines than J.P. Morgan because Citigroup officials were more cooperative with the SEC investigations.\textsuperscript{28}

Citigroup accepted a "cease and desist" order issued by the SEC in an administrative proceeding, while J.P. Morgan accepted a civil injunction prohibiting it from committing future violations of Section 10(b) of the Securities and Exchange Act of 1934 and Exchange Act Rule 10b-5.\textsuperscript{29} Under a "cease and desist" order, there is no automatic contempt of court penalty for violating the order.\textsuperscript{30} However, if Citigroup refuses to comply with the order, then the administrative law judge has the discretion to impose additional civil penalties.\textsuperscript{31} According to an SEC official, the J.P. Morgan injunction was meant to "send a signal" to other organizations that are not cooperative with SEC investigations.\textsuperscript{32} If J.P. Morgan engages in more Enron-like transactions, it will have violated a court order and have committed a criminal infraction.\textsuperscript{33} The SEC warned it would be willing to file criminal charges if such an infraction occurs.\textsuperscript{34} The injunction against J.P. Morgan was similar to the SEC's injunction against Arthur Anderson.\textsuperscript{35} Arthur Anderson violated that injunction in its dealings with Enron, commencing the criminal case that led to the dissolution of the well-respected accounting firm.\textsuperscript{36}

In addition to their settlement with the SEC, J.P. Morgan and Citigroup will each pay a combined total of $25 million to the

\textsuperscript{27} Id.
\textsuperscript{28} Norris, supra note 21.
\textsuperscript{31} See id.
\textsuperscript{32} Robert Julavits, Chase, Citi Style Differences Reflected in Enron Settlements, AM. BANKER, July 29, 2003, at 1.
\textsuperscript{33} Id.
\textsuperscript{34} Id.
\textsuperscript{35} Id.
\textsuperscript{36} Id.
state and city of New York to avoid criminal prosecution.\textsuperscript{37} Robert M. Morgenthau, of the Manhattan district attorney's office, decided not to pursue criminal charges and instead settled with J.P. Morgan and Citigroup.\textsuperscript{38} Mr. Morgenthau believed it would have been difficult to prove intentional fraud on a particular individual and that the financial institutions would already suffer tremendously as Enron's biggest creditors.\textsuperscript{39} Additionally, under this settlement Citigroup was ordered to revamp its internal controls to ensure greater disclosure of structured finance transactions, such as prepay and SPEs.\textsuperscript{40} Both financial institutions also agreed with state and federal banking regulators to overhaul their risk management practices, including credit exposure.\textsuperscript{41}

Citigroup and J.P. Morgan have also reached agreements with the Federal Reserve Board.\textsuperscript{42} Under these agreements, although there were no monetary penalties, the financial institutions agreed to submit a revised set of standards for complex deals such as SPEs.\textsuperscript{43} Citigroup and J.P. Morgan also agreed to strengthen their internal risk management procedures.\textsuperscript{44}

\textsuperscript{37} Global Power Report, \textit{supra} note 16.
\textsuperscript{38} \textit{Id}.
\textsuperscript{39} White & Behr, \textit{supra} note 8.
\textsuperscript{40} See Citigroup Enforcement Action, \textit{supra} note 18; see also J.P. Morgan Enforcement Action, \textit{supra} note 29.
\textsuperscript{41} Global Power Report, \textit{supra} note 16.
\textsuperscript{43} See J.P. Morgan Federal Reserve Agreement, \textit{supra} note 42; see also Citigroup Federal Reserve Agreement, \textit{supra} note 42. Citigroup and J.P. Morgan revised standards provide for greater review by top management over complex transactions. Eichenwald & Atlas, \textit{supra} note 10.
\textsuperscript{44} See Citigroup: Enron settlements with the SEC, Federal Reserve, OCC, and Manhattan DA, THE ASIAN BANKER J., July 31, 2003 (on file with NCBI) [hereinafter Asian Banker]; see J.P. Morgan Federal Reserve Agreement, \textit{supra} note 42; see Citigroup Federal Reserve Agreement, \textit{supra} note 42.
III. IMPLICATION OF THE SETTLEMENTS

A. Effect of the Settlements on Citigroup and J.P. Morgan

These settlements will affect Citigroup and J.P. Morgan in various areas of their overall business structures. The most significant impact is monetary because under these settlement agreements the two financial institutions combined will pay over $300 million to the SEC and the Manhattan District Attorney's Office. Although, neither Citigroup nor J.P. Morgan conceded guilt under their respective settlement agreements, the mere fact of such a large settlement with bank regulators may be viewed as an admission of guilt and could strengthen the shareholder suits relating to Enron.

Some commentators believe that an unexpected consequence of the penalties imposed by the SEC is that the penalties may be advantageous to Citigroup and J.P. Morgan if class action suits are brought against them. Pursuant to the Fair Fund provision of Section 308(a) of the Sarbanes-Oxley Act enacted in 2002, settlement money paid to the SEC can be credited against any final settlement of a class action suit. The fines will settle all charges with the SEC and provide some protection

45. See Norris, supra note 21.
46. See White & Behr, supra note 8.
47. See id; see also Citigroup Enforcement Action, supra note 18; see also J.P. Morgan Enforcement Action, supra note 29.
49. 15 U.S.C. § 7246 (2003). Section 308 of the Sarbanes Oxley Act entitled “Fair Funds for Investors” allows the SEC in particular cases to distribute civil money penalties to the harmed investor. Stephen M. Culter, Testimony Concerning Returning Funds to Defrauded Investor (Feb. 2, 2003), available at http://www.sec.gov/news/testimony/022603tssmc.htm (last visited Feb. 2, 2004). Prior to the act, when the SEC received monetary penalties it was required to transfer the funds to the Department of Treasury. Id.
51. Global Power Report, supra note 16; see Citigroup Enforcement Action, supra note 18; see J.P. Morgan Enforcement Action, supra note 29.
against future private class action suits. Thus, the fines the financial institutions paid under the settlement are possibly less of a deterrent because the amounts may offset any future judgments.

However, other commentators believe the settlements may make Citigroup and J.P. Morgan more vulnerable to private shareholder litigation arising from their transactions with Enron. More specifically, the cost of settling lawsuits with Enron’s shareholders will likely increase; the settlements with the SEC may provide Enron’s investors with a basis for directly suing the financial institutions.

Even though Citigroup and J.P. Morgan did not admit to guilt in their settlements, other Enron creditors will use these settlements to their advantage in attempting to recover their losses related to Enron directly from the financial institutions. One attorney who represents some of Enron’s shareholders stated that, “[o]n a psychological basis I think it’s going to motivate the shareholders to hold out for more.” The banks are not paying this amount of money for charity purposes.” Similarly, the settlements may give credibility to Enron’s shareholders’ claims in their anticipated shareholder class action lawsuit.

The settlements will also affect Citigroup and J.P. Morgan as creditors in Enron’s bankruptcy proceedings. Citigroup and

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53. Emily Thornton & Mike France, For Enron’s Bankers, a “Get out of Jail Free” Card, BUS. Wk., Aug. 11, 2003, at 29. Under the Sarbanes-Oxley Act, the fines that were paid to the SEC will also be allocated to reimburse investors who lost money in the Enron fraud. See Citigroup Enforcement Action, supra note 18.


55. Id.; Ong, supra note 4.

56. See Glater, supra note 54. Enron’s creditors will likely bring private suits against Citigroup and J.P. Morgan in an attempt to recover their losses related to Enron, especially given the low possibility of recovering all they are owed from Enron. Id.

57. Id.

58. White & Behr, supra note 8 (quoting Henry T.C. Hu, Professor at Columbia Law School).

59. See White & Behr, supra note 8.

60. Norris, supra note 21.
J.P. Morgan are the two largest creditors in the Enron bankruptcy proceedings.\textsuperscript{61} Neal Batson, Enron's bankruptcy examiner, recently released a statement asserting that "there is sufficient evidence of inequitable conduct by six financial institutions, including Citigroup and J.P. Morgan," that would not allow them to recover their claims on an equal basis in relation to other creditors in Enron's bankruptcy proceedings.\textsuperscript{62} Since Citigroup and J.P. Morgan were involved in Enron's financial deception, other Enron creditors can make a valid argument that under the doctrine of equitable subordination\textsuperscript{63} it would not be equitable to allow Citigroup and J.P. Morgan to recover the same amount as the other creditors who acted in good faith.\textsuperscript{64} Under this doctrine, the financial institutions' claims of approximately $4.2 billion would be subordinated to the claims of other creditors.\textsuperscript{65} However, in order for equitable subordination to be applicable to Citigroup's and J.P. Morgan's particular situation, Enron's creditors would have to prove that Citigroup and J.P. Morgan breached a fiduciary duty or were engaged in fraudulent activities; the creditors may decide that the litigation costs would outweigh any recovery.\textsuperscript{66}

Other companies that may have claims against Citigroup or J.P. Morgan could be encouraged to file suit because the settlements show that the financial institutions are already willing to settle cases regarding their participation in the Enron scandal.\textsuperscript{67} For example, The Vanguard Group recently sued Citigroup claiming that Citigroup sold it Enron bonds worth $70 million, even though Citigroup knew at the time that Enron was in

\textsuperscript{61} Onge, \textit{supra} note 4.


\textsuperscript{63} 11 U.S.C. § 105 (2003). The doctrine of equitable subordination is based on principles of equity that assumes it would not be fair to allow the Citigroup and J.P. Morgan to recover as much as the other creditors who were not involved in the downfall of the corporation. Glater, \textit{supra} note 54.

\textsuperscript{64} See Glater, \textit{supra} note 54.

\textsuperscript{65} See White & Behr, \textit{supra} note 8.

\textsuperscript{66} See Glater, \textit{supra} note 54.

\textsuperscript{67} See generally id.
financial trouble.\textsuperscript{68} Citigroup and J.P. Morgan have also recently been sued by other lenders of Enron.\textsuperscript{69} These suits, filed by private companies that invest in bank loans, alleged that Citigroup and J.P. Morgan were encouraging other investors to rely on Enron’s financial statements while aware of the documents’ misleading nature.\textsuperscript{70} These lawsuits came less than one month after Citigroup and J.P. Morgan settled with bank regulators.\textsuperscript{71} Citigroup and J.P. Morgan have also been sued by Enron itself.\textsuperscript{72} After the settlements with bank regulators, Enron’s new management, on behalf of the company, sued the financial institutions for their involvement in financing transactions that led to the bankruptcy of Enron.\textsuperscript{73}

In addition, the financial institutions have established reserves for future litigation related to their involvement in the Enron scandal.\textsuperscript{74} J.P. Morgan has reserved $700 million for matters related to Enron, while Citigroup has reserved $1.3 billion related to Enron and Dynegy matters.\textsuperscript{75} Citigroup’s reserves will be reflected on their financial statements as a one-time charge against earnings.\textsuperscript{76}

The settlements with the SEC and bank regulators not only cost Citigroup and J.P. Morgan monetarily, but it also damaged their reputations.\textsuperscript{77} Because of the settlements, the financial

\textsuperscript{68} Jathon Sapsford & Aaron Lucchetti, Vanguard Sues Citigroup Over Enron-Bond Deals, WALL ST. J., Apr. 14, 2003, at C5.


\textsuperscript{70} \textit{Id.} DK Acquisition Partners and Springfield Associates have filed suit against Citigroup and J.P. Morgan claiming these companies encouraged investors to rely on Enron’s financial statements when they knew the documents were misleading. \textit{Id.}

\textsuperscript{71} \textit{Id.}


\textsuperscript{73} Kristen Hays, Enron Sues Investment Banks, Brokerages, Associated Press, Sept. 25, 2003. Bankruptcy laws require Enron to attempt to recover as much as possible for its creditors. \textit{Id.}

\textsuperscript{74} Glater, \textit{supra} note 54.

\textsuperscript{75} \textit{Id.} Citigroup also set up prepay transactions with Dynegy under which they provided the company with $300 million in disguised loans. \textit{Id.}

\textsuperscript{76} \textit{Id.}

\textsuperscript{77} Robert Julavits, Citi Gives $2m to Habitat for Humanity, AM. BANKER, July 30, 2003, at 20.
institutions have spent additional resources in an attempt to restore their respective images in the financial community.\textsuperscript{78} A day after the settlement with the SEC, Citigroup donated $2 million to Habitat for Humanity as a symbol of the company "being a good corporate citizen" that has improved its ethical behavior.\textsuperscript{79}

As a result of the settlements, the financial institutions will expend financial and human capital to redesign their internal controls.\textsuperscript{80} Under Citigroup's and J.P. Morgan's settlements with the Federal Reserve Board, each have agreed to increase risk management controls and provide the regulatory agencies with a new set of standards where senior executives will review complex transactions, such as transactions involving SPEs.\textsuperscript{81} Internal controls will be augmented in three key areas: 1) credit risk management, 2) legal and reputational risk management, and 3) approval and progress reports.\textsuperscript{82} The financial institutions will spend many man-hours modifying and updating their risk management systems.\textsuperscript{83} J.P. Morgan also has to file revised standards with the New York State Banking Department which will require additional time and effort.\textsuperscript{84}

The settlements have changed the way the two financial institutions conduct their overall businesses. For example, Citigroup has implemented a new internal control where it will only provide structured financing to customers that fully disclose the financial impact of the transaction to its investors.\textsuperscript{85} Citigroup

\textsuperscript{78} Id.

\textsuperscript{79} Id. (Interviewing Robert B. Willumstad who is chairman and chief executive officer of Citi's Global Consumer Group).

\textsuperscript{80} See generally Eichenwald & Atlas, supra note 10; see Citigroup Enforcement Action, supra note 18; see J.P. Morgan Enforcement Action, supra note 29.

\textsuperscript{81} Eichenwald & Atlas, supra note 10; see also J.P. Morgan Federal Reserve Agreement, supra note 42; see also Citigroup Federal Reserve Agreement, supra note 42.

\textsuperscript{82} J.P. Morgan Federal Reserve Agreement, supra note 42; Citigroup Federal Reserve Agreement, supra note 42.

\textsuperscript{83} See generally Eichenwald & Atlas, supra note 10.

\textsuperscript{84} See Julavits, supra note 32, at 1; see J.P. Morgan Enforcement Action, supra note 29.

\textsuperscript{85} Hintze, supra note 69.
and J.P. Morgan have also agreed not to perform transactions where the required accounting is likely to deceive investors.\(^8\)

Although Citigroup and J.P. Morgan have settled with the SEC and the bank regulators, these settlements do not clear the individual bankers at these financial institutions from liability related to transactions with Enron.\(^8\) The Department of Justice is still investigating criminal liability related to the Enron scandal.\(^8\) The SEC retained the option of filing civil charges against Enron's financial partners, including individual bankers at Citigroup and J.P. Morgan, which may amount to additional penalties and banishment from the financial services industry.\(^8\)

B. Impact of the Settlements on the Financial Services Industry

The Citigroup and J.P. Morgan settlements with the SEC and bank regulators will have a significant impact on the entire financial services industry.\(^9\) The behavioral and internal changes that Citigroup and J.P. Morgan have made as a part of these settlements will likely serve as a guide to the rest of the financial industry.\(^9\) The settlements signal that financial institutions can be held liable for the financial effects of transactions with their clients.\(^9\) Thus, if the transaction is legal, but the financial institution has knowledge that the transaction will deceive investors, then the financial institution can be held liable.\(^9\) Stephen Cutler, the SEC's director of enforcement, says "[f]inancial institutions may not look the other way when their clients use them to manipulate financial results."\(^9\)

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88. See generally Norris, supra note 21.
89. Id.
90. Id.
91. Id.
92. White & Behr, supra note 8.
94. Id.
Senator Carl Levin (D-MI) views the SEC settlements with Citigroup and J.P. Morgan as “[a] clear message that U.S. bankers, brokers, accountants and lawyers have an obligation to analyze and understand the consequences of their actions, and they will be held accountable for deceptive transactions.”

Other financial institutions should regard the settlements as a reminder “that you can’t turn a blind eye to the consequences of your actions. If you know or have reason to know that you are helping a company mislead its investors, you are in violation of the federal securities laws.” Executives at financial institutions will need to ensure a greater understanding of complex transactions with their clients.

Which transactions will serve as “red flags” to bank regulators is a question that has been raised, but not completely answered, by the settlements. Bank regulators have stated simply that financial institutions will be held liable for transactions that deceive investors. Citigroup and J.P. Morgan used SPEs and prepay transactions that allowed Enron to misrepresent its earnings. From the settlements, other financial institutions are aware that a transaction involving prepay or SPEs is prohibited if it deceives investors, but how far this will be extended is not clear. For example, derivative transactions generally generate financial or tax results different from a normal economic transaction. Does this mean that financial institutions will be held responsible for all such transactions? The Citigroup and J.P. Morgan settlements provide a good starting point by giving some examples of the transactions that financial institutions can be

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95. Id.
96. Perrotta, supra note 86, at 4.
97. See generally Norris, supra note 21.
98. See id.
100. See generally id.
102. Id. For example, some derivatives are designed to enable banks to receive the economic benefits of owning stock in a particular company even though it is not allowed to buy such shares. If financial institutions were required to tell regulators the purpose of these transactions, then it may depress the derivative market. Id.
103. See id.
held accountable for, but it is still unclear exactly which transactions are prohibited.\textsuperscript{104}

These settlements show an enforcement trend of bank regulators holding financial institutions responsible for the impact of transactions they finance.\textsuperscript{105} Even though bank regulators do not have jurisdiction to prosecute the violation of criminal laws, they can and will increase their criminal referrals to offices that can criminally prosecute, such as the Manhattan district attorney's office.\textsuperscript{106} With the rising trend in prosecuting corporate officials, these criminal referrals will receive more attention, especially given the ambiguity of the new corporate governance laws.\textsuperscript{107} To avoid prosecution, financial institutions will need to ensure that they stay in compliance with the new internal controls regulations imposed by the Federal Reserve Board and remain abreast of new risk management requirements in the industry.\textsuperscript{108}

Due to the role of SPEs in Enron's collapse, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities (Fin. 46), to clarify the accounting for SPEs.\textsuperscript{109} Fin. 46 will require the financial institutions to consolidate SPEs onto their balance sheets.\textsuperscript{110} However, Fin. 46 has the potential to make trust-preferred securities appear as ordinary debt, which would disqualify them

\begin{footnotes}
\item[104] Id.
\item[105] See Thomas P. Vartanian, New Banking Laws Starting to Transform Enforcement, \textit{AM. BANKER}, Sept. 26, 2003, at 11; see generally White & Behr, supra note 8.
\item[106] Id.
\item[107] See id.
\item[108] See id. Manhattan district attorney Robert Morgenthau in a letter to Alan Greenspan, Chairman of the Federal Reserve Board, pleaded for a ban on all transactions where U.S. financial institutions conduct business with "notoriously uncooperative secrecy jurisdictions" such as the Cayman Islands. Perrotta, supra note 86, at 4. Although this suggestion is far-reaching, financial institutions must be aware that there may be some heighten inquiries by bank regulators into U.S. banks that perform multiple transactions with such countries. Id.
\item[110] Moyer, supra note 109, at 1.
\end{footnotes}
from Tier 1 capital status. Currently, federal regulators are waiting to see if Fin. 46 applies to trust-preferred securities or whether they require deconsolidation. If Fin. 46 does apply to trust-preferred securities, then it would lower some financial institutions capital ratios significantly, forcing them to increase assets or decrease liabilities.

Citigroup and J.P. Morgan may have been relieved from criminal prosecution due to their immense size and complexity. Robert M. Morgenthau, of the Manhattan district attorney’s office, has stated that when dealing with organizations the size of Citigroup and JP Morgan, it will be difficult to pinpoint a single responsible party. If this is an accurate assessment, then officials at smaller financial institutions need to recognize that criminal liability may be imposed on them due to regulators’ ability to trace transactions to a single individual.

Bank regulators have allowed Citigroup and J.P. Morgan to become enormous financial institutions as a result of regulatory and congressional actions, such as the repeal of the Glass-Steagall Act, which has allowed them to offer many different services. In allowing this growth, regulators have fostered an environment where they are unable to hold individuals in these larger financial institutions personally responsible for their actions. While these settlements may send a message to officials at smaller financial institutions that they may be held criminally liable for inappropriate transactions, these same settlements may send a different message to officials at larger institutions.

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111. Id. Trust preferred securities are treated as debt for tax purposes, but still counted as Tier 1 capital – a key financial ratio that measures a banks capital stability. Matt Andrejczak, Banks Trust Preferred Securities as a Financing Tool, WASH. BUS. J., March 19, 1998.
112. Davenport, supra note 109, at 1.
113. Moyer, supra note 109, at 20. “Capital status” is a key measure of financial strength. Tier 1 status, which is primarily equity, helps to determine financial institutions capital ratios. Id.
115. Id.
116. See id.
117. Id.
118. See id.
119. Silverman, supra note 114.
large financial institutions may believe they will not be held personally responsible for their actions because it will be too difficult to trace transactions back to them.\footnote{120}

Many commentators also believe that Citigroup and J.P. Morgan officials may have been saved from criminal liability because they are the largest creditors of Enron and will incur heavy losses from Enron’s collapse.\footnote{121} Therefore, other financial institutions that are involved in transactions that deceive investors, but are not creditors of a failing company, may be more likely to be held criminally responsible for their actions.\footnote{122}

Susan Schmidt Bies, a member of the Board of Governors of the Federal Reserve System, stated in a speech before the Conference of State Bank Supervisors that financial institutions that have had problems in the past two years lacked the necessary internal controls because management has been more concerned with financial results.\footnote{123} The lack of proper internal controls was a key factor in the Enron debacle.\footnote{124} As a result of this problem, Citigroup and J.P. Morgan have agreed to revamp their internal controls under their respective agreements with the Federal Reserve Board.\footnote{125} As such, management at other financial institutions should be more involved in designing and implementing internal controls to mitigate risks.\footnote{126} To ensure successful internal control audits, Governor Bies suggests that the audits be focused on the higher risk areas and reviewed regularly.\footnote{127}

\footnote{120. See id.}
\footnote{121. See Global Power Report, \textit{supra} note 16.}
\footnote{122. \textit{Id.}}
\footnote{125. See J.P. Morgan Federal Reserve Agreement, \textit{supra} note 42; see Citigroup Federal Reserve Agreement, \textit{supra} note 42.}
\footnote{126. See Bies, \textit{supra} note 123.}
\footnote{127. \textit{Id.}}
Under the settlements with the SEC, J.P. Morgan will pay more in monetary fines than Citigroup.\textsuperscript{128} During the SEC's investigations, Citigroup cooperated with the investigations, while J.P. Morgan continued to maintain for months that it had done nothing wrong.\textsuperscript{129} The discrepancy in the type of settlements and severity of fines between Citigroup and J.P. Morgan indicate that financial institutions should fully cooperate with SEC investigations in order to avoid more severe punishment.\textsuperscript{130}

Lastly, the settlements provide notice to other financial institutions that if they use deceptive transactions, such as those used by Citigroup and J.P. Morgan (i.e. SPEs and "prepays"), they will encounter major legal problems.\textsuperscript{131} "All financial institutions need to take a broad view of their responsibilities to assess the economic substance and consequences of the transactions they enter into."\textsuperscript{132} In a letter to Robert M. Morgenthau, the Manhattan district attorney, vice-chairman of J.P. Morgan Marc J. Shapiro wrote, "[o]ur view historically ... was that our clients and their accountants were responsible for the clients' proper accounting and disclosure of the transactions."\textsuperscript{133} Now, his bank will "hold [itself] to a higher standard" and become more involved in understanding and structuring financial transactions.\textsuperscript{134}

\section*{IV. Possible Negative Effects Arising From the Settlements}

Although they do not create binding precedent, the SEC settlements with Citigroup and J.P. Morgan demonstrate to the rest of the financial services industry that as public companies, financial institutions must be careful not to mislead shareholders in addition to complying with all relevant banking laws.\textsuperscript{135} The recent

\begin{itemize}
\item \textsuperscript{128} See White & Behr, supra note 8.
\item \textsuperscript{129} Id.
\item \textsuperscript{130} Julavits, supra note 32, at 1.
\item \textsuperscript{131} See Norris, supra note 21.
\item \textsuperscript{132} Paul Waldie, \textit{U.S. Banks will pay to settle Enron Claims}, GLOBE AND MAIL, July 29, 2003, at B1 (quoting Robert M. Morgenthau).
\item \textsuperscript{133} Norris, supra note 21.
\item \textsuperscript{134} Id.
\item \textsuperscript{135} Id.; see also Editorial, \textit{Enron's Friends in Need}, N.Y. TIMES, July 31, 2003, at A24.
\end{itemize}
SEC settlements sent a message to the financial services industry that the SEC has been revitalized. These recent settlements display the SEC’s commitment to restore investor confidence in the marketplace.

The settlements, however, may have a negative impact on the financial services industry as a result of financial institutions inferring that they can avoid criminal prosecution by merely paying a fine. Manhattan district attorney Robert M. Morgenthau stopped pursuing the criminal charges against Citigroup and J.P. Morgan — instead opting for a $50 million fine. Morgenthau claims that the district attorney’s office would not have been able to prove that “any individual acted with the intent to commit fraud.” Thus, the settlement was to punish the financial institutions and obtain money for the victims in the Enron scandal.

The SEC settlements with Citigroup and J.P. Morgan may also support the view that these risky transactions are a cost of doing business. Citigroup and J.P. Morgan earned significant revenues from these transactions. Financial institutions may balance the risk of paying penalties versus the benefit of receiving revenue for these structured finance transactions. Although the civil penalties amounted to $300 million, this is less than 2% of the annual profits of these financial institutions and far less than the fees they earned from their dealings with Enron. With the recent fines imposed on Citigroup and J.P. Morgan representing approximately one week’s profit to the banks, these settlements may have sent the message that if financial institutions pay a hefty fine they can avoid criminal prosecution. Therefore, the SEC
may have signaled to corporate executives that they will not be personally liable for their actions.\textsuperscript{147}

This past July marked the one-year anniversary of President Bush’s corporate fraud task force which has been involved in punishing corporate officers and restoring investors’ confidence in the market.\textsuperscript{148} In a warning to corporate executives who are involved in deceiving investors, President Bush stated, “[y]ou will be exposed and you will be punished. No boardroom in America is above or beyond the law.”\textsuperscript{149} However, a week later the SEC settled with Citigroup and J.P. Morgan and allowed their corporate executives to pay civil penalties and avoid criminal prosecution.\textsuperscript{150} Citigroup and J.P. Morgan executives helped Enron deceive investors, yet the executives who participated in the deception will not face criminal penalties.\textsuperscript{151} Investors might lose confidence in the market if companies are allowed to pay fines to settle their deceptive transactions.\textsuperscript{152}

The SEC settled with Citigroup and J.P. Morgan to ensure that investors who lost money in the Enron scandal received something back on their investment, despite the negative effects of the settlement.\textsuperscript{153} Some commentators believe the SEC settled to protect J.P. Morgan and Citigroup from Arthur Anderson’s fate.\textsuperscript{154} “Investigators knew what happened when the government moved against Enron’s auditors at Anderson: the accounting firm blew up. Who wanted to take the chance that a big bank might fall into a similar death spiral?”\textsuperscript{155} The SEC may have realized that if it continued to investigate Citigroup or J.P. Morgan, the financial institutions may have had a similar outcome to Arthur Anderson,

\textsuperscript{147} Editorial, \textit{supra} note 138, at 18.
\textsuperscript{148} \textit{Id}.
\textsuperscript{149} \textit{Id}.
\textsuperscript{150} \textit{Id}.
\textsuperscript{151} \textit{Id}.
\textsuperscript{152} \textit{See} Editorial, \textit{supra} note 138, at 18. One of the SEC’s duties is to ensure that investors are confident that they are making a sound investment decision based on complete and accurate data. U.S. Securities and Exchange Commission: The SEC: Who We Are, What We Do, \textit{at} http://www.sec.gov/about/whatwedo.shtml (last visited Feb. 7, 2004).
\textsuperscript{153} Global Power Report, \textit{supra} note 16.
\textsuperscript{154} Silverman, \textit{supra} note 114.
\textsuperscript{155} \textit{Id}. 
a result that would have been drastic to the economy.156 Robert M. Morgenthau, Manhattan district attorney, is quoted as saying, "[y]ou have to be concerned with the impact on the financial markets with whatever you do."157 Our economy is currently recovering from a recession and may not have been able to withstand the downfall of a financial giant such as a J.P. Morgan, who manages a derivative book worth more than $30,600 billion.158

V. CONCLUSION

The Citigroup and J.P. Morgan settlements provide an insight into an evolving trend of corporate governance in today’s marketplace.159 The move toward holding a company’s officials responsible for their actions may not be fully exhibited in these settlements, but nonetheless these settlements are a step in the right direction.160 Other financial institutions can learn a number of lessons from the Citigroup and J.P. Morgan’s experiences with regulators.161

First, financial institutions should implement new internal control policies to ensure that they do not permit the type of transactions that caused the Enron scandal.162 The behavioral changes promised by Citigroup and J.P. Morgan should serve as a model for other financial institutions.163 Both companies agreed to change their compliance monitoring, risk management, and business practices related to complex structured finance transactions.164 Both financial institutions have also agreed to change their internal controls and apply closer scrutiny to how their clients account for transactions in which they are involved.165

156. Id.
157. Id.
158. Id.
159. See Francis, supra note 1, at 2-3.
161. See White & Behr, supra note 8.
162. Id; see also Eichenwald & Atlas, supra note 10.
163. Id.
164. See Julavits, supra note 32, at 1.
165. Perrotta, supra note 86, at 4.
Second, financial institutions should keep abreast of the changing compliance requirements of bank regulators and regularly review internal audits to ensure they are focused on the high risk areas of the company.

Third, financial institutions should gain a better understanding of their clients' transactions and ensure that they are not helping their clients deceive investors. The SEC's settlements with Citigroup and J.P. Morgan raise important issues concerning the ability and duty of financial institutions to evaluate what effect complex structured finance transactions will have on their clients. These settlements suggest that if a financial institution is involved in such a transaction, it should gain a complete understanding of the transaction, disclose how the transaction creates risk for the financial institution, and determine the appropriateness of participating in the transaction.

Other financial institutions can learn from Citigroup's and J.P. Morgan's settlements because the two giants are not the only financial institutions to participate in risky, complex, structured finance transactions with their clients. Other financial institutions need to be careful because, as Senator Carl Levin stated, "[t]he July 2003 settlements with Citigroup and J.P. Morgan are only the latest in what will likely be a long series of enforcement actions arising from the financial scandals of the last two years."

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166. See Bies, supra note 123.
167. Id.
169. Vartanian, supra note 105, at 11.
170. Id.
171. Global Power Report, supra note 16.
172. Senator Carol Levin is the Chairman of the Senate Permanent Subcommittee on Investigations. Id.
173. Id.