Insider Loans: How Restricted is the Banker?

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NOTES

INSIDER LOANS: HOW RESTRICTED IS THE BANKER?

I. Introduction

A vigorous campaign to ensure the safe and efficient operation of the American banking system, initiated by bank regulators and members of Congress, led to the enactment of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRA"). This package of bank reform legislation imposed stricter controls on insider lending transactions which Congress had seen as one of the primary threats to the successful operations of banks. A major obstacle to the effective implementation of these insider lending regulations was the nature of our dual banking system. American banks have the option of becoming federally chartered or state chartered. Although federally chartered banks ("national banks") have the option of becoming members of both the Federal Reserve System and the Federal Deposit Insurance Corporation ("FDIC"), these banks are subject to federal banking laws and regulations by virtue of their charter. State chartered banks, on the other hand, are not subject to any federal banking provisions, unless they become a member of the Federal Reserve System ("member bank"), or insure their deposits with the FDIC.

While prior to FIRA, member banks were subject to limited federal supervision concerning insider loans, state chartered non-member banks even if insured by the FDIC, were not as closely

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3. Id. at 9280-83.
4. Id. at 9283.
5. See N.Y. Banking Law § 96(5) (McKinney 1976).
governed by federal regulation respecting insider loans. The absence of effective statutory restrictions on insider loans precipitated numerous abuses. FIRA was enacted to eliminate abuses that were revealed to Congress in several reports from the FDIC which demonstrated that excessive insider lending was a major cause of bank failures. These abuses involved loans to insiders which were not only excessive in amount but were also granted on substantially more favorable terms than those available to the public. Participation in such unsafe and unsound bank practices was shown to Congress to be significant. The FDIC, for example, determined that almost sixty percent of all bank failures between 1960 and 1975 were principally caused by insider lending abuses. In addition, the reports disclosed that eighty percent of all bank failures between 1970 and 1975 were state chartered institutions, the majority of which were not member banks and thus were not subject to adequate federal regulatory supervision. Thus, to insure the sound operation of the majority of American banks, the FDIC argued that permissive extensions of credit to bank insiders had to be eliminated and replaced by a well delineated system of laws and regulations applicable to member banks and state chartered nonmember banks insured by the FDIC.

9. Id.
10. Id. at 9282.
11. Id. at 9283.
12. Id.
13. Id.
14. Member banks are state chartered banks which join the Federal Reserve System and are thereby governed by the Federal Reserve Board in addition to their individual state regulatory agency. 12 C.F.R. § 215.2(g) (Regulation O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks) (amended Dec. 31, 1979).
15. [1978] U.S. Code Cong. & Ad. News, supra note 2 at 9283. The committee which made this study found that the state laws governing insider lending limits were very different. This prompted Congress to bring all state-insured nonmember banks under some regulatory control with respect to insider lending practices.
17. [1978] U.S. Code Cong. & Ad. News, supra note 2 at 9283. Prior to FIRA, the FDIC had little power to control insider abuses of state chartered insured banks, and unless these banks were members of the Federal Reserve System, no federal agency had the authority to
Prior to the enactment of FIRA, public interest was particularly aroused by the media's coverage of the banking practices of former Office of Management & Budget Director Bert Lance.\textsuperscript{18} The "Lance Affair" in conjunction with publicity of several major bank failures\textsuperscript{19} during the 1970's made the reality of insider abuses widely known.\textsuperscript{20} Some members of the banking community also recognized that insider lending practices had been abusive and expressed concern over the detrimental consequences of such dealings.\textsuperscript{21}

FIRA provides the safeguards necessary to control bank insider abuses by imposing specific lending limitations and mandatory reporting requirements on certain loans to bank directors, executive officers and principal shareholders which apply to member banks and state nonmember insured banks.\textsuperscript{22} The credit restrictions and reporting requirements mandated by FIRA, not only apply to in-house loans, but also to correspondent bank loans to bank executives as well.\textsuperscript{23} In addition, FIRA expands the civil penalties imposed on banks and bank executive officers and directors who violate its provisions, affording the regulators substantially increased supervisory control.\textsuperscript{24} The criminal sanctions previously imposed for such violations remain in effect.\textsuperscript{25}

The courts, the banking community and the general public need
govern their insider lending practices. See also Buchalter & Allen, Bank Insider Abuses: When Does the Ax Fall?, 96 BANKING L.J. 804, 805-06 (1979) [hereinafter cited as Bank Insider Abuses].

18. [1978] U.S. CODE CONG. & AD. NEWS, supra note 2, at 9281. Congress was particularly interested in the correspondent loan and overdraft practices of Mr. Lance, who was the past president of the Calhoun National Bank in Georgia. Mr. Lance has been acquitted of the criminal charges brought against him in relation to these insider practices.

19. Id. at 9280-81. Some major bank failures where excessive insider abuses played a major role were: 1) U.S. National Bank of San Diego, a one billion dollar bank which failed in 1973; 2) Franklin National Bank, a five billion dollar bank which failed in 1974; and 3) Hamilton National Bank of Chattanooga, one of the largest interstate bank holding companies, which failed in 1975.

20. Id. at 9281.

21. Id. at 9279-80. For example, loan officers of several American banks testified that they felt compelled in the absence of any regulation to the contrary, to make loans to bank insiders, even though they knew that the loans were not in the best interest of the bank.


24. Id. § 1818(i)(1) (Supp. II 1978).

to comprehend fully the impact FIRA has on the banking industry in order to closely monitor the insider practices of banks, and prevent insider abuses in the future.  

Section II of this Note will discuss the laws and regulations instituted by FIRA which specifically govern loans to bank insiders, and other federal laws affecting this issue. The effectiveness and practicality of these laws and regulations will be analyzed. Because the banking industry operates under the auspices of a dual regulatory system, section III will discuss the effectiveness of state control over insider lending practices. The New York State Banking Law will be analyzed to determine the impact state law has on insider abuses, and will be compared to the federal regulations concerning insider abuses.

II. Federal Regulation

A. Limitations on Extensions of Credit to Bank Insiders

1. Scope of Legislation

A principal factor contributing to the extensive participation in insider lending abuses was the absence of a statutory definition of "insider" or "extension of credit." Prior to FIRA, many bank insiders were able to secure preferential and excessive extensions of credit because neither the individual nor his monetary advance fell within the ambit of a statutory definition and thereby remained free from regulation. In order to promote a safe and efficient banking system, by eliminating as many insider abuses as possible, a comprehensive definition of insider was essential. Thus, the Federal Reserve Board, pursuant to the power vested in it by FIRA, amended Regulation O which clarifies the scope of the

26. See, e.g., N.Y. Times, Aug. 20, 1980, at A14, col. 1 (where it was revealed that insider influence allegedly enabled directors of the National Bank of Washington to obtain loans for their friends amounting to at least four and one half million dollars).


28. See notes 3-6 supra and accompanying text.


32. The Lance Legacy, supra note 30, at 296.

33. 12 C.F.R. § 215 (amended Dec. 31, 1979). These definitions are applicable to mem-
FIRA provisions governing insider lending practices to include definitive guidelines which eliminate any ambiguity which previously engulfed the terms “insider” and “extension of credit.”

As a general rule, an insider is a member of the upper strata of bank management, namely, directors, executive officers and principal shareholders. Whereas every bank employee may technically fall within the generic definition of an insider, each employee is not a potential threat to the security of a banking institution where extensions of credit are concerned. Generally, lower-level bank employees are not afforded free accessibility to credit. Therefore, Congress and bank regulators are not primarily interested in regulating the borrowing practices of every bank employee. Rather, they are concerned with regulating loans to those insiders who may obtain preferential and excessive credit extensions, for either themselves or their families, friends or business interests, which may threaten the financial security of a bank. The term insider also includes not only those who fall within the general rule, but also includes those who are technically outside the perimeters of bank management, such as a director or principal shareholder of a bank related in interest to the lending bank, or a subsidiary thereof.

The first category of insiders which FIRA regulates is directors. The term director under Regulation O includes not only directors of member banks, but also directors of a bank holding company of which the member bank is a subsidiary and each director of

34. Bank Insider Abuses, supra note 17, at 807.
35. 12 C.F.R. § 215.2(c), .2(d), .2(j) (1980).
37. Bank Insider Abuses, supra note 17, at 807.
38. See note 14 supra.
39. A bank holding company is any company which controls a bank. Control encompasses: the power to vote more than 25% of all voting shares; power over the election of a majority of directors; or influence on major policymaking decisions. 12 U.S.C. § 1841(a)(1) (Supp. II 1978); 12 C.F.R. § 215.2(b)(1)-(2)(b)(1)(iii) (1980).
40. A subsidiary is any company, 25% or more of whose shares are directly or indirectly controlled or owned by a bank holding company, or any company whose election of the board of directors is controlled by the bank holding company, or any company whose policy decisions are influenced by a bank holding company. 12 U.S.C. § 1841(d) (Supp. II 1978).
any other subsidiary of that bank holding company. An advisory director of either a member bank, a bank holding company with a member bank subsidiary or another subsidiary of that bank holding company, is considered a director unless his sole responsibility is to give advice.

Second, pursuant to Regulation O, any individual is considered to be an executive officer if he engages in or has the authority to engage in the major policymaking decisions of the bank. Further, an executive officer includes: the chairman of the board, the president, the secretary, the treasurer, the cashier, and every vice president of a member bank regardless of whether he participates in major policymaking decisions. However, if a resolution of the board or a provision in the bank's bylaws specifically excludes the officer from participating in major policymaking decisions, he is not considered an executive officer. This definition reflects congressional intent to curb all possible insider abuses by expanding the term executive officer to include any individual in a policymaking position, who realistically has the influence to secure preferential and excessive credit extensions.

Third, a principal shareholder is any individual or company which directly or indirectly controls, owns or has the power to vote more than ten percent of any class of voting securities of a mem-

42. Id. The advisory director may not be voted into office by the bank's shareholders and must be prohibited from participating in voting on matters before the board in order to maintain his non-director status under Regulation O. Id.
43. Id. § 215.2(d). Executive officers do not include individuals who have a title, but exercise limited discretion and who do not participate in major policymaking decisions. Id. § 215.2(d) n.1.
44. Id. § 215.2(d).
45. Id. Such factors as whether the officer has an official title, whether it designates him an officer or assistant, or whether he serves with compensation, are not essential in determining that individual's participation in major policymaking decisions. Id.
46. Id. § 215.2(j).
47. Company includes any business entity which is not an insured bank or a corporation whose majority of shares are owned by the United States or any state. Id. § 215.2(a). See 12 U.S.C. § 375b(6)(B) (Supp. 1980).
48. If the member bank is located in a city, town or village with a population of less than thirty thousand, the percentage shall not exceed eighteen percent. 12 C.F.R. § 215.2(j) (1980).
In calculating this ten percent ceiling, any shares held by the immediate family of an individual shareholder are considered to be held by that individual. Although this definition encompasses a major class of insiders, it fails to include shareholders who may not own ten percent of the voting securities of a bank, but who may by virtue of their holdings exercise tremendous influence over major policymaking decisions. If the purpose of FIRA is to curb insider lending abuses, any shareholder in a position to exert significant influence over major policy decisions should be included within the definition of insider regardless of the exact percentage of his holdings. This will ensure that all insiders capable of securing preferential and excessive loans will be governed by federal regulations.

In view of the fact that certain monetary advances to insiders were not regarded as "extensions of credit," but rather were viewed as privileges which inured to those occupying high-level positions in the bank, Regulation O eliminated these practices by including within the familiar meaning of the term "extension of credit" a broad range of monetary transactions. The term "extension of credit" includes not only the making or the renewal of a loan or the granting of a line of credit, but also encompasses any transaction whereby an individual becomes obligated, either directly or indirectly, to pay a bank money. Examples of such transactions include: an overdraft advance, a purchase under a repurchase agreement of securities, the issuance of a standby letter of credit, an increase of an existing indebtedness, and an advance

49. Id.
50. The term "immediate family" includes the individual's spouse, minor children and any of the individual's adult children residing at home. Id. § 215.2(e).
51. Id. § 215.2(j).
52. See note 20 supra.
53. 12 C.F.R. § 215.3(a) (1980).
54. Id. A line of credit under $5,000.00, granted pursuant to an agreement with a bank whereby the bank acquires charge or time credit accounts or makes payments pursuant to a credit card or preauthorized overdraft checking, is not an extension of credit provided it is not made on preferential terms and prior approval is not required. Id. § 215.3(b)(5).
55. Id. § 215.3(a)(8).
56. Id. § 215.3(a)(2). See notes 83-87 infra and accompanying text.
57. 12 C.F.R. § 215.3(a)(1).
58. Id. § 215.3(a)(3).
59. Id. § 215.3(a)(6). This does not include funds if they are "advanced by the bank for its own protection for (i) accrued interest or (ii) taxes, insurance or other expenses which are
of unearned compensation.\textsuperscript{60} Any method by which credit is extended to an insider is governed by these provisions,\textsuperscript{61} thereby bringing the majority of monetary transactions between banks and their insiders within the confines of some regulatory control.

2. \textit{General Restrictions}

The objective in enacting FIRA and issuing Regulation O was substantially to limit the granting of preferential loans to bank insiders.\textsuperscript{62} To achieve this goal, Congress and the Federal Reserve Board imposed specific limitations on credit terms, aggregate lending limits, overdrafts and correspondent loans available to insiders.\textsuperscript{63} A careful analysis of these limitations reveals, however, that officers, directors and principal shareholders, as defined by Regulation O, are not subject to these restraints on an equal basis.\textsuperscript{64}

\textit{(a) Credit Terms}

All member banks and state insured nonmember banks are prohibited from extending credit to an executive officer, principal shareholder or director, unless they do so on substantially the same terms as those prevalent at the time for similar transactions.\textsuperscript{65} In addition, when a bank extends credit to any insider, it must not assume a risk greater than that which the bank would be willing to assume in granting a loan to a disinterested party.\textsuperscript{66} In addition, before a member bank may extend credit to an executive officer, the officer is required to make the following disclosures. First, an executive officer must inform the bank's board of directors that he has been extended credit.\textsuperscript{67} Second, he must file a cur-

\textsuperscript{60} Id. § 215.3(a)(7). An extension of credit, however, does not include any "advance against accrued salary or other accrued compensation, for a period in excess of thirty days or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank." Id. § 215.3(b)(1).

\textsuperscript{61} Id. § 215.3(a)(8).

\textsuperscript{62} See \textit{Bank Insider Abuses}, supra note 17, at 809-10.

\textsuperscript{63} 12 U.S.C. §§ 375a, 375b (Supp. 1980).

\textsuperscript{64} See notes 38-51 supra and accompanying text.


\textsuperscript{66} 12 C.F.R. § 215.4(a) (1980).

rent financial statement with the board of directors. The exemption of directors and principal shareholders of member banks, executive officers of a bank holding company which has the member bank as a subsidiary, and executive officers of any other subsidiary of that bank holding company from these two requirements, is contrary to the purpose of FIRA. If Congress in enacting FIRA had intended to place all insiders on an equal basis with nonbank borrowers, then each insider as defined by Regulation O should be required to report extensions of credit to his board of directors and file a current financial report. These additional requirements would provide a bank with the added information necessary to monitor closely its insider lending practices and prevent potential abuses.

(b) Lending Limits

As a general rule, FIRA and Regulation O prohibit member banks and state-insured nonmember banks from extending credit to any insider in an amount which, when aggregated with all other extensions of credit granted to that individual, exceeds $25,000. In addition, no executive officer or principal shareholder or a related interest thereof may be extended credit if that credit, when aggregated with credit extended previously, exceeds the individual lending limit of ten percent of the bank’s capital stock and unimpaired surplus. This limitation does not apply to directors unless they are also executive officers or principal shareholders.

69. 12 C.F.R. § 215.5(a) n.4 (1980). These requirements are not imposed on nonmember bank executive officers. Id. § 215.5.
71. 12 C.F.R. § 215.4(b)(1) (1980). See also 12 U.S.C. §§ 375b(2), 1828(j)(2) (Supp. II 1978). Prior to issuing credit the sum must be approved of by the entire board of directors and the interested party must refrain from participating in such a decision. Approval is not required for an extension of credit which was approved within fourteen months of the date of the credit extension. 12 C.F.R. § 215.4(b)(1)-4(b)(2) (1980). The term participation includes any indirect action or influence on the decision to extend credit. Id. § 215.4(b)(3).
72. A related interest includes any company, political or campaign committee the individual controls, or the funds or services of which will benefit a person. 12 C.F.R. § 215.2(K) (1980). See also 12 U.S.C. § 375b(2) (Supp. 1980).
73. 12 C.F.R. §§ 215.4(c), .2(f) (1980). See 12 U.S.C. § 84(1) (1976); Id. §§ 375b(1), 1828(j)(2) (Supp. II 1978). This limitation was originally only imposed on national banks.
This exemption only serves to exclude many directors from any statutory controls governing lending limitations. Although extensions of credit to directors which exceed $25,000 must be approved by the board, in the absence of any additional limitations on credit extensions to directors, a director might be able to assert sufficient influence to gain approval of his loan.

FIRA retained the specific monetary limitations on various loans imposed exclusively on executive directors of member banks by prior legislation. These limitations include: $60,000 outstanding at any one time to finance the purchase, construction or repair of an executive officer’s residence; $20,000 outstanding at any one time to finance the education of his children; $10,000 outstanding at any one time for general lending purposes; and $10,000 outstanding at any one time to a partnership in which the executive officer is a partner. In addition, these credit extensions become due and payable at the option of the bank at any time if the executive officer becomes indebted to any other banking institution in excess of the specific monetary limitations. These monetary limitations appear to be overly restrictive, especially in view of today’s high inflation, in that they can hamper executive officers from engaging in accepted and necessary personal banking transactions. On the other hand, directors and principal shareholders may be extended any amount of credit as long as it is approved in advance by the board of directors and not made on preferential terms. The legislative history of FIRA does not indicate the reason for this discrepancy. Whereas board approval may be a sufficient safeguard for loans to directors and principal shareholders, it

sound Banking Practices Are the Target, 94 Banking L.J. 725, 737-38 (1977) [hereinafter cited as Self Dealing and Unsound Banking].
76. Id. § 375a(2). FIRA increased this amount from $30,000 to $60,000.
77. Id. § 375a(3). FIRA increased this amount from $10,000 to $20,000.
78. Id. § 375a(4). FIRA increased this amount from $5,000 to $10,000.
79. Id. § 375a(4)-(5). FIRA increased this amount from $5,000 to $10,000. A partnership loan must be extended from the funds allocated for general extensions of credit. 12 U.S.C. § 375a(4) (Supp. 1980). In addition, if one or more partners are members of the same partnership seeking credit, the full amount of credit extended is considered granted to each officer of the bank who is a partner. Id. § 375a(5).
81. See notes 76-79 supra and accompanying text.
82. See note 71 supra and accompanying text.
does not follow that they should be totally exempt from any monetary limitations on their loans.

(c) Overdrafts

The overdraft has risen to a position of notoriety and special concern to bank regulators in the past decade because of the ease with which an insider could use an overdraft as a means of obtaining credit. To alleviate this problem, FIRA imposes limitations on directors and executive officers who overdraw their accounts. An executive officer's or director's overdraft may only be honored if it is paid pursuant to either: 1) a written agreement pre-authorizing the transfer of funds from another account of the individual to cover the overdraft; or, 2) a written agreement authorizing an interest-bearing credit plan which specifies a method of repayment. Regulation O exempts overdrafts of principal shareholders and any related interests of directors and executive officers from these limitations. This exemption runs contrary to congressional intent to curtail the use of the overdraft as an easy and uncontrolled method of insider credit extensions.

(d) Correspondent Bank Loans

A correspondent loan to an insider is an extension of credit granted by a bank which either maintains a correspondent account with the insider's bank as a depositor or retains funds of the insider's bank as a depository. This relationship has enabled many insiders to obtain preferential and excessive credit extensions from a correspondent bank. Although preferential credit extensions to insiders by correspondent banks was a prevalent practice prior to FIRA, federal law did not restrict these transactions. Congress,

85. 12 C.F.R. § 215.4(d) (1980). Banks in general are permitted to honor overdrafts pursuant to the power vested in them by the Uniform Commercial Code. U.C.C. § 4-401(1) (1978). An inadvertant overdraft by an insider in an amount less than $1,000 which is repaid within three business days, is not considered an extension of credit for the purpose of this legislation. 12 C.F.R. § 215.4(d) (1980).
86. 12 C.F.R. § 215.4(d) n.3 (1980).
90. Id.
cognizant of these abuses included in FIRA provisions prohibiting member banks and state insured nonmember banks which maintain correspondent accounts\textsuperscript{91} with other banks from extending preferential credit to a director, executive officer or principal shareholder of the correspondent bank.\textsuperscript{92} These prohibitions and reporting requirements mandated by FIRA curtail this type of insider abuse which had previously plagued the banking industry.\textsuperscript{93}

### B. Reporting Requirements

In the past, bank regulators found it difficult to effectively supervise insider credit extensions because there was no unified and detailed reporting system through which regulators could learn of all transactions.\textsuperscript{94} A central reporting system for insider credit extensions was lacking even though member banks were required to:

1. file reports of condition annually with the regulatory agencies,\textsuperscript{95}
2. maintain in-house records of insider transactions,\textsuperscript{96} and
3. file reports of extensions of credit to executive officers.\textsuperscript{97} In order to remedy this problem, FIRA and Regulation O instituted three reforms. First, existing disclosure requirements were reinforced.\textsuperscript{98} Second, reporting requirements on in-house loans to principal

\textsuperscript{91} A correspondent account is an account which is maintained by a bank with another bank for the deposit or placement of funds. It does not include time deposits at prevailing market rates or an account maintained in the ordinary course of business solely for the purpose of effecting federal funds transactions at prevailing market rates or making Eurodollar placements at prevailing market rates. 12 C.F.R. § 215.21(c) (1980).

\textsuperscript{92} Id. § 215.20(b). See 12 U.S.C. § 1972(2)(G)(i) (Supp. II 1978). A correspondent bank is defined as any bank "that maintains one or more correspondent accounts from a member bank during a calendar year that in the aggregate exceeds an average daily balance of $100,000 or one half of one percent of such member bank's total deposits . . . whichever amount is smaller." 12 C.F.R. § 215.21(d) (1980). Preferential terms include interest rates. Compare id. § 215.20(b) with 12 U.S.C. § 376 (1976) (prohibits member banks from paying directors higher rates of interest on deposits).

\textsuperscript{93} See Bell & Oliver, Correspondent Bank Loans After the Financial Institutions Regulatory and Interest Rate Control Act of 1978, 34 Bus. Law. 1347, 1347-51 (1979) [hereinafter cited as Correspondent Bank Loans]. See also The Lance Legacy, supra note 30, at 292.

\textsuperscript{94} See Bank Insider Abuses, supra note 17, at 812.

\textsuperscript{95} 12 U.S.C. § 1817(a)(3) (Supp. II 1978). Four reports of condition are filed annually with either the Comptroller of the Currency, Federal Reserve Board, or FDIC stating the amounts of liabilities and assets of the individual bank.

\textsuperscript{96} Id. § 375a.

\textsuperscript{97} Id. § 375a(9).

\textsuperscript{98} Id.
shareholders\textsuperscript{99} were imposed. Third, reports on all correspondent loans to insiders were required.\textsuperscript{100}

Member banks must maintain records identifying loans which they have made to their executive officers and principal shareholders, stating the amounts and terms of such loans.\textsuperscript{101} In view of the fact that loans to related interests of insiders are included in the aggregate amount of credit available to executive officers and principal shareholders,\textsuperscript{102} executive officers and principal shareholders are required to disclose these interests to their bank.\textsuperscript{103} In addition, whenever any executive officer of a member bank exceeds one of the categorical aggregate lending limits\textsuperscript{104} imposed on him, he is required to report this fact to the board of directors.\textsuperscript{105} Requiring a bank rather than the individual to report insider loans in excess of aggregate limits would substantially insure that regulatory agencies will be informed of such activities. Although these reporting requirements enhance the ability of banks and regulatory agencies to supervise insider practices, because they are self-reporting requirements there is a possibility of inaccuracy. Unless an insider discloses his related interests it is difficult, if not impossible, for a bank to be accurately informed of its executive officers' and principal shareholders' related interests.

Under Regulation O, the Comptroller of the Currency, the Federal Reserve Board and the FDIC require that member banks and state insured nonmember banks file a separate report on the aggregate extensions of credit to executive officers and principal shareholders.\textsuperscript{106} This report must list all outstanding extensions of credit to executive officers, principal shareholders, and any of their

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\textsuperscript{100} Id. § 1972(G).

\textsuperscript{101} 12 C.F.R. § 215.10(b)(1)-(3) (1980).


\textsuperscript{103} 12 C.F.R. § 215.7 (1980).

\textsuperscript{104} See notes 75-79 supra and accompanying text.


\textsuperscript{106} 12 C.F.R. § 215.10(b)(2) (1980).

The records of loans to insiders maintained by the individual bank are then filed with the appropriate regulatory agency, thus incorporating them into a central reporting mechanism. Each member must file, with its report of condition, a report enumerating all extensions of credit granted to any of its executive officers.

\textit{Id.} § 215.9, .10.
related interests.\textsuperscript{107} Bank regulators must also be supplied with a list of all principal shareholders and executive officers by name to whom extensions of credit were granted.\textsuperscript{108} This list enables regulators to scrutinize more carefully the practices of an institution by overseeing which insiders have been granted credit and which have not. These reports are to be made available to the public upon request.\textsuperscript{109}

These reports, which must be filed with federal regulatory agencies, serve four functions. First, by requiring member banks to fulfill these reporting requirements, banks will closely monitor their in-house lending practices, and will thereby become more acutely aware of federal regulations governing insider lending. Second, because state insured nonmember banks are also required to file these reports, bank regulators are able to oversee the insider practices of many more banks and, therefore, bank regulators are able to prevent as many abusive insider practices as possible. Third, because these reports are made available to the public, interested customers of member and insured banks will be able to scrutinize insider lending. Fourth, these reporting requirements will supply the regulatory agencies with a factual basis for deciding whether a particular bank is engaging in insider credit extensions which may be harmful to the financial security of the bank.

The Federal Reserve Board focusing on a major source of insider lending abuses also imposed reporting requirements on correspondent bank loans to insiders.\textsuperscript{110} Each officer and principal shareholder of a member bank who becomes indebted to a correspondent bank is required to file annually a report with his bank's board of directors, stating both the aggregate amount of the indebtedness\textsuperscript{111} and the terms upon which the credit was ex-

\textsuperscript{107} Id. § 215.10(b)(2).

\textsuperscript{108} Id. This requirement is applicable to state insured nonmember banks. 12 U.S.C. §§ 1817(K)(1)(A), 1817(K)(1)(B) (Supp. II 1978). See also 12 C.F.R. § 304.4 (1980).

\textsuperscript{109} 12 C.F.R. § 215.10(c) (1980).

\textsuperscript{110} Id. § 215.22. See Correspondent Bank Loans, supra note 93, at 1354-55; Bank Insider Abuses, supra note 17, at 811-12, for a discussion of the need for reporting requirements by insiders on correspondent loans. Insiders include in this instance executive officers and principal shareholders as defined by Regulation O.

\textsuperscript{111} For example, this includes the indebtedness to both the individual and his related interest. 12 C.F.R. § 215.22(b)(2) (1980).
tended.112 These reports are not disclosed to the public, unless otherwise directed by the bank regulators.113 In addition, the Federal Reserve Board mandates that both member banks and state insured nonmember banks must compile reports on all executive directors and principal shareholders who have been granted correspondent loans. These reports must be filed with the appropriate regulatory agency115 and must state which insiders have been granted correspondent bank credit extensions and the aggregate amounts thereof.116

Although directors fall within the confines of regulations governing correspondent loans to insiders,117 directors are not required to comply with the reporting requirements imposed on correspondent loans.118 It has been argued that this discrepancy is justified because directors of member banks owe a high fiduciary duty to their own banks, and thus the need for such reports is unnecessary. However, the opportunity for a director to engage in insider abuses is present. Thus, in order for bank regulators to adequately supervise insider practices, reports on the indebtedness of each insider whether an executive officer, director, or principal shareholder should be filed with the appropriate agency. Anything to the contrary violates the congressional intent in enacting the FIRA provisions controlling correspondent loans to insiders.

C. Civil Penalties and Criminal Sanctions

The civil penalties imposed on member banks and their officers and directors for violation of any of the statutes and regulations governing insider loans are severe.120 FIRA imposes harsh civil

112. Id. § 215.22(b)(3).
113. Id. § 215.22(d).
114. State insured nonmember banks are banks which are members of the FDIC, but not members of the Federal Reserve System.
115. Federal bank regulatory agencies include: 1) the Comptroller of the Currency which supervises national banks; 2) the Federal Reserve Board which supervises state chartered member banks; and 3) the Federal Deposit Insurance Corporation (FDIC) which supervises nonmember insured banks.
116. 12 C.F.R. §§ 215.23(b)(1), .23(b)(2), .349.4(a), .4(b) (1980).
118. 12 C.F.R. §§ 215.23, 349.4 (1980). No mention of directors is made in this section on reports by member banks.
120. Prior to FIRA, if any director or executive officer violated or permitted any person
penalties on any director, executive officer, member bank, or state insured nonmember bank which violates any provision governing extensions of credit to insiders. The Comptroller of the Currency, the Federal Reserve Board and the FDIC have the power to fine a director, an executive officer, a member bank, or a state insured nonmember bank if it has been determined that the individual or bank has violated a provision governing insider lending. Upon such a determination the accused is served with a statement of the charges against him and a penalty is assessed. The individual or bank upon assessment has the right to request an agency hearing to determine the validity of the charges. An agency determination of this nature is a final order which may be reviewed by the United States Court of Appeals. If no hearing is requested the assessment is a final and unappealable order. A determination made at a hearing will only be set aside on review if it is found that the charges were unsupported by substantial evidence. The Comptroller of the Currency, the Federal Reserve

affiliated with the bank to violate any provisions governing extensions of credit to insiders, he was held personally liable to the bank, its shareholders or any other party injured by the violation. This provision remains in effect. 12 U.S.C. § 503 (1976).

121. The penalty can be no greater than $1,000 per day for the continuation of the violation. All penalties are paid to the United States Treasury. Id. § 504(a)-(g) (Supp. II 1978).

122. Only Federal Reserve member banks are governed by these provisions. Id. § 504. See also 12 C.F.R. § 215.11 (1980).

123. The term “violates” includes “any action . . . for or towards causing, bringing about, participating in, counseling, or aiding or abetting a violation.” 12 U.S.C. § 504(a) (Supp. II 1978).


126. Id.


128. 12 U.S.C. §§ 504(d), 1828(j)(3)(D) (Supp. II 1978). Any hearing determination may be reviewed in the United States Court of Appeals for the circuit in which the home office of the member bank is located or in the United States Court of Appeals for the District of Columbia. The petitioner must file a notice of appeal within ten days from the date of the hearing order and send a copy of the notice to the appropriate regulatory agency, which must certify and file in such court the record from the hearing pursuant to 28 U.S.C. § 2112 (1976).


130. Id. §§ 504(c), 1828(j)(3)(D). See also Administrative Procedure Act, 5 U.S.C. § 706
Bank or the FDIC has the authority to take the past history and good faith service of the bank or individuals into account when imposing a penalty.\textsuperscript{131}

In addition to the civil sanctions imposed on violators, the Comptroller of the Currency, the Federal Reserve Bank, and the FDIC are authorized to order a bank, its directors, or executive officers to cease and desist from engaging in activities found to violate federal lending regulations or to constitute unsafe and unsound bank practices.\textsuperscript{132} Prior to the issuance of a cease and desist order, the offending bank is served with a summons stating all the charges against it.\textsuperscript{133} The summons must specify a time and place for an agency hearing to determine the validity of the charges and whether an order should be issued.\textsuperscript{134} Unless the party charged appears at the agency hearing, he is deemed to have consented to the order.\textsuperscript{135} The agency determination at a hearing is a final and appealable order which may be reviewed by the United States Court of Appeals.\textsuperscript{136}

If the regulatory agency believes immediate action must be taken to prevent a bank from continuing to engage in a violation or threatened violation which may cause insolvency or a dissipation of bank funds,\textsuperscript{137} a temporary cease and desist order may be issued.\textsuperscript{138} This order will become effective immediately upon service of notice and will remain in effect until an agency hearing convened to investigate the charges determines otherwise.\textsuperscript{139} Whenever a temporary cease and desist order is issued, the individual or bank

\textsuperscript{131} U.S.C. §§ 504(b), 1828(j)(3)(B) (Supp. II 1978). Factors to be considered include: 1) the financial size of the institution, 2) good faith of the bank or person charged, 3) gravity of the violation and 4) such other matters as justice may require. Id.

\textsuperscript{132} Id. § 1818(b)(1).Unsafe bank practices include violations of the banking laws and regulations. Id.

\textsuperscript{133} Id. The summons shall fix a time and place for an agency hearing to determine whether a cease and desist order should be issued.

\textsuperscript{134} Id. The hearing shall commence within 30 to 60 days after notice is issued or at such time as the agency may determine at the request of a charged party. An individual or bank given notice will be deemed to consent to a cease and desist order, unless such party appears personally or by a duly authorized representative at the hearing. Id.

\textsuperscript{135} Id.

\textsuperscript{136} Id. § 1818(b)(2).

\textsuperscript{137} Id. § 1818(c)(1).

\textsuperscript{138} Id.

\textsuperscript{139} Id.
served has the right to petition the United States Court of Appeals\textsuperscript{140} for an injunction limiting, modifying, or suspending the order until the agency proceedings are completed.\textsuperscript{141}

In addition to cease and desist orders, any officer or director of a member bank or a state-insured nonmember bank may be suspended from office or removed if the appropriate federal agency determines that the individual has engaged in or is participating in any unsafe practices.\textsuperscript{142} For example, these practices include, but are not limited to: 1) breach of fiduciary duty; 2) violation of the banking laws; 3) financial gain at the expense of the bank; or 4) jeopardizing the financial security of the bank.\textsuperscript{143} Prior to removal or suspension the individual is given notice\textsuperscript{144} and is afforded the opportunity to have an agency hearing,\textsuperscript{145} which is subject to judicial review.\textsuperscript{146}

These supervisory powers not only enable bank regulators to scrutinize the practices of all insured banks, but also empower them to take immediate action against those banks, executive officers, or directors who threaten the financial stability of a bank. In part, the mandatory reporting requirements on loans to executive officers and principal shareholders afford the regulatory agencies a factual basis for deciding whether a particular bank is engaging in insider credit extensions which may be harmful to its financial security.

Bank officers and directors may be subject to criminal prosecution if they willfully misapply the monies of their bank.\textsuperscript{147}

\textsuperscript{140} Id. § 1818(c)(2). The person or bank served has the right to petition the United States District Court in the judicial district where the home office of the bank is located or in the United States District Court for the District of Columbia.

\textsuperscript{141} Id.

\textsuperscript{142} Id. § 1818(e)(1)-(2).

\textsuperscript{143} Id.

\textsuperscript{144} Id. § 1818(e)(4). The notice shall set forth the facts which constitute the grounds for removal or suspension and shall fix a date and place at which a hearing will be scheduled. Id.

\textsuperscript{145} Id. A hearing shall be scheduled within 30 to 60 days after issuance of notice, unless an alternate date is fixed by the appropriate agency at the request of the United States Attorney General or director, officer of individual charged. Unless the individual charged appears personally or by a duly authorized representative at the hearing, he is deemed to have consented to the order for removal or suspension. Id.

\textsuperscript{146} Id. § 1818(f). See note 140 supra and accompanying text.

\textsuperscript{147} 18 U.S.C. § 656 (1976) (theft, embezzlement or misapplication by bank officer or employee). A convicted individual shall not be fined more than five thousand dollars, nor
misapplication of bank funds includes both in-house loans to insiders in excess of the statutory limitations\textsuperscript{148} and correspondent preferential loans.\textsuperscript{149} Although proof of intent to defraud the bank is the degree of malice necessary for a successful prosecution,\textsuperscript{150} courts have found the requisite intent in the fact that an officer or director has knowingly violated a provision of the banking law.\textsuperscript{151}

The federal government has been reluctant to prosecute bank insiders who have engaged in lending abuses in the past, unless such abuses threaten the financial security of a bank.\textsuperscript{152} This practice is evidenced by the relatively small number of insider abuses which have been prosecuted in recent years. The failure of prosecutors to vigorously enforce criminal sanctions has undermined the deterrent value of these sanctions. Despite the lack of criminal prosecutions, the fines, cease and desist orders and the suspension or removal powers vested in the Comptroller of the Currency, the Federal Reserve Board, and the FDIC, as now added by FIRA, provide sufficient enforcement authority to sanction those banks and insiders who violate insider lending regulations.\textsuperscript{153}

\section*{III. State Regulation}

Although the majority of state chartered banks are either member banks\textsuperscript{154} or are insured\textsuperscript{155} by the FDIC and, therefore, subject to some federal regulation, most states have enacted specific laws

\begin{itemize}
  \item imprisoned more than five years for such violation unless the amount involved is less than one hundred dollars, in which case the fine shall not exceed one thousand dollars, nor imprisonment exceed one year. \textit{Id.}
  \item 149. \textit{See United States v. Larson}, 581 F.2d 664 (7th Cir. 1978); \textit{United States v. Mann}, 517 F.2d 259 (5th Cir. 1975), \textit{cert. denied}, 423 U.S. 1087 (1976); \textit{United States v. Brookshire}, 514 F.2d 786 (10th Cir. 1975). In Larson, Mann and Brookshire bank insiders were convicted of misapplying bank monies by maintaining a compensating balance of bank funds in a non-interest bearing account at a bank in order to obtain preferential loans.
  \item 152. \textit{See generally Bank Insider Abuses, supra} note 17, at 812.
  \item 153. \textit{Id.} at 814-16.
  \item 154. \textit{See note} 14 \textit{supra} for a definition of member bank.
  \item 155. \textit{See} note 114 \textit{supra} for a definition of insured bank.
\end{itemize}
governing extensions of credit to insiders. For example, the New York State Banking Law\textsuperscript{156} contains a detailed regulatory scheme for controlling insider credit extensions.

As a general rule all officers, directors and trustees of New York chartered banks are required to fulfill their duties in good faith and with that degree of care, prudence and skill which careful men in like positions would exercise.\textsuperscript{157} In performing his duty each director, officer or trustee of a state chartered bank must comply with the restrictions imposed on insider extensions of credit. The nature of the restrictions imposed on insider lending is dependent upon the type of banking institution involved. The three primary banking institutions which operate in New York\textsuperscript{158} include: banks and trust companies,\textsuperscript{159} savings banks,\textsuperscript{160} and savings and loan associations.\textsuperscript{161}

A. Scope of Control

The New York definitions of the terms "insider" and "extension of credit" mirror those contained in Regulation O.\textsuperscript{162} Under New York law the term "insider" includes: 1) any director or trustee of a bank;\textsuperscript{163} 2) any officer or employee of a bank who has the authority or participates in the major policymaking functions of the bank;\textsuperscript{164} 3) the chairman of the board, president, executive vice president, secretary and treasurer of a bank;\textsuperscript{165} and 4) any person who has direct or indirect control over the voting power of ten percent of the stock of the bank, or otherwise controls the management or policies of the bank.\textsuperscript{166} New York laws include the majority of those individuals defined as insiders under federal law.\textsuperscript{167}

\begin{itemize}
\item \textsuperscript{156} N.Y. BANKING LAW §§ 1-9018 (McKinney 1976).
\item \textsuperscript{157} Id. §§ 257(1), 398-b(1). Cf. N.Y. Bus. Corp. LAW § 717 (McKinney 1976).
\item \textsuperscript{158} Credit unions and industrial banks although governed by the New York Banking Law will not be discussed in this Note.
\item \textsuperscript{159} N.Y. BANKING LAW §§ 90-140a (McKinney 1976).
\item \textsuperscript{160} Id. §§ 229-260b.
\item \textsuperscript{161} Id. §§ 375-411.
\item \textsuperscript{162} See notes 38-61 supra and accompanying text.
\item \textsuperscript{163} [1976] 3 N.Y.C.R.R. § 11.1(e)(3).
\item \textsuperscript{164} Id. § 11.1(e)(2). See [1970] 3 N.Y.C.R.R. § 321.1(b) for a definition of executive director.
\item \textsuperscript{165} Id. § 11.1(e)(1).
\item \textsuperscript{166} Id. § 11.1(e)(4).
\item \textsuperscript{167} See notes 38-61 supra and accompanying text.
\end{itemize}
Extensions of credit include any transactions whereby an individual becomes obligated to or renews an obligation to pay any monetary obligation to a bank whether in the form of a note, bill of exchange, draft or any other means of indebtedness. This definition encompasses the same monetary transactions as are included in the federal definition of extension of credit.

B. General Restrictions

In New York extensions of credit to officers, directors or trustees of any of the state's banking institutions are strictly limited by statute. Banks and trust companies are prohibited from extending credit to any of their executive officers or directors, unless the extension of credit is granted after either specific written approval of a majority of the board of directors, or is made pursuant to a resolution of a majority of the board. No extension of credit may be made on preferential terms. Any extension of credit made pursuant to a board resolution must be reported to the Superintendent of Banks. In addition, any extension of credit made to an insider shall be combined with all other outstanding extensions of credit to the insider or a relative or a related interest. This aggregation of credit prevents insiders from obtaining credit extensions in excess of specific monetary limitations.

169. See notes 52-61 supra and accompanying text.
171. Id. See also [1976] 3 N.Y.C.R.R. § 11.3(a)(1)-(4).
172. N.Y. BANKING LAW § 103(8) (McKinney 1976). The board of directors may by resolution permit a bank to extend credit to an officer or individual director stating the maximum amount thereof based upon his financial record, three months prior to such extension. Id.
173. Id. § 130(2).
174. Id. § 103(8).
175. [1976] 3 N.Y.C.R.R. § 11.4. The lending limitations are as follows: 1) $20,000 or one-half of one percent of the net worth of the bank, whichever is less, if the total assets of the bank are $100,000,000 or less; 2) $50,000 or one-half of one percent of the net worth of the bank, whichever is less, if the total assets of the bank are more than $100,000,000 and not more than $500,000,000; 3) $100,000 or one-half of one percent of the net worth of the bank, whichever is less, if the total assets of the bank are more than $500,000,000 and not more than $1,000,000,000; and 4) one-half of one percent of the net worth of the bank if the total assets of the bank are more than $1,000,000,000. Id. § 11.3(a)(1)-(4).
Officers and trustees\textsuperscript{176} of savings banks are prohibited from borrowing money, either directly or indirectly, from their bank.\textsuperscript{177} In addition, each is prohibited from becoming the owner of a piece of real property on which the savings bank holds a mortgage.\textsuperscript{178} Directors and officers of savings and loan associations are also prohibited from borrowing money from their institution for either themselves or their related interests, unless the funds are secured by their shares in the savings and loan association, or secured by real estate owned and used by the director or officer as a residence.\textsuperscript{179}

The limitations imposed on credit extensions to insiders under New York law are very similar to those imposed by federal legislation. First, each mandates that extensions of credit be made on substantially the same terms as those available to the public.\textsuperscript{180} Second, both New York and federal legislation aggregate extensions of credit to the insider with those to his related interests.\textsuperscript{181} Third, both require that loans in excess of certain dollar amounts secure prior approval of the board of directors before issuance.\textsuperscript{182} Although these similarities are important, federal regulation provides a more detailed scheme of control over insider lending practices. This is manifested particularly in the limitations on overdrafts and correspondent loans to insiders\textsuperscript{183} which are unique to federal regulation.

C. Reporting Requirements

All banks are required to maintain detailed records of all insider extensions of credit which demand board approval.\textsuperscript{184} These records must include all relevant facts which supported the board's decision, including, but not limited to: 1) the name of the insider; 2) his relationship to the bank; 3) the date of the loan; 4) the type

\textsuperscript{176} A trustee is a member of a savings banks' board of directors. N.Y. BANKING LAW § 257 (McKinney 1978).
\textsuperscript{177} Id. § 247(d).
\textsuperscript{178} Id.
\textsuperscript{179} Id. § 399(3).
\textsuperscript{180} See notes 65, 173 supra and accompanying text.
\textsuperscript{181} See notes 73, 171 supra and accompanying text.
\textsuperscript{182} See notes 71, 175 supra and accompanying text.
\textsuperscript{183} See notes 83-93 supra and accompanying text.
\textsuperscript{184} [1976] 3 N.Y.C.R.R. § 11.5(a).
of credit extended; and 5) the terms thereof. These records are reviewed by bank examiners of the Superintendent's office.

All boards of directors of banks and trust companies must examine all extensions of credit to insiders. If a director is indebted to his own bank, he must annually file a financial statement with the bank. Executive officers who become indebted to banks other than their employer bank, must report this indebtedness to the board of directors of their employer bank. All banks and trust companies must include in their report of condition to the Superintendent of Banks a detailed explanation of all extensions of credit to executive officers and directors. Failure to file this report results in severe civil penalties. In addition, the Superintendent of Banks has the power to investigate these institutions at least annually, or whenever necessary. This investigative power affords the Superintendent the opportunity to oversee any insider abuses, and to take appropriate remedial measures where necessary.

Although the reporting requirements imposed by the New York Banking Law closely resemble those on the federal level, the New York regulations additionally require banks and trust companies to report to the Superintendent extensions of credit made not only to executive officers, but also extensions of credit made to directors. Whereas Regulation O fails to require the filing of reports respecting loans to directors, Regulation O does require that reports of extensions of credit to principal shareholders be filed. This requirement is not imposed under New York law.
D. Civil and Criminal Sanctions

The civil penalties and criminal sanctions imposed on directors, officers and trustees of state chartered banks for violations of New York law are similar to those imposed under federal law. First, any bank or trust company or one of its executive officers, or directors that permits insider extensions of credit in excess of the statutory limitations, may be required to forfeit up to twice the value of that loan as a penalty. Second, the Superintendent, through a vote of the banking board, has the power to remove any director, officer or trustee from office who he believes has violated one of the banking laws or regulations, or has engaged in unsafe bank practices. Third, after serving notice and conducting a hearing, the Superintendent has the authority to impose a penalty not in excess of $5,000 on any bank institution which is found to have violated a banking law.

Any officer or employee of a banking institution who intentionally overdraws his account and obtains money therefrom is guilty of a misdemeanor. In addition, any director, officer or trustee of a banking institution who attempts to maintain an account with another bank for the sole purpose of obtaining preferential loans for himself is guilty of a misdemeanor. Any director who obtains a loan over and above the statutory limits is also guilty of a misdemeanor in New York.

The New York Banking Law establishes a regulatory framework governing extensions of credit to insiders which is similar to federal regulation. Although the New York laws are not as restrictive as federal regulations, New York requires all state chartered banks to become members of a federal insurance corporation. Thus, all New York nonmember banks are subject to federal regulation to

197. See notes 120-53 supra and accompanying text.
199. Id. § 41 (McKinney 1976). See notes 142-46 supra and accompanying text for a discussion of the applicable federal law.
201. N.Y. BANKING LAW § 662 (McKinney 1976).
203. Id.
204. Id. § 32 (McKinney Supp. 1980).
the extent that they must comply with reporting requirements and are governed by the broad enforcement powers of the FDIC. This additional regulation will help prevent the insider abuses in New York which were prevalent in state nonmember banks prior to FIRA.

IV. Conclusion

Although the majority of bank insiders are honest and prudent individuals who fulfill their duties in good faith, participation in abusive insider lending practices is a reality in the banking industry. Because excessive and unregulated insider loans can severely upset the financial security of a bank and possibly lead to its failure, strict limitations and regulation of insider credit extensions are necessary to insure a safe banking industry.

Although the numerous federal and state statutes and regulations governing insider credit extensions appear at first glance to restrict many facets of insider credit transactions, an analysis of these provisions demonstrates that certain insiders still possess the ability to obtain extensions of credit in what may be excessive amounts and to a large extent in an unregulated manner. Directors, executive officers and principal shareholders are each regulated differently under FIRA and Regulation O. Executive officers of member banks are strictly regulated, whereas directors and principal shareholders are relatively free from restrictions. Because the lending limitations and reporting requirements imposed on extensions of credit to directors, executive officers and principal shareholders are not regulated equally, many of the abuses Congress sought to remedy may be statutorily sanctioned by virtue of these discrepancies. These discrepancies leave open the door to potential insider abuses, although the majority of banks are currently more strictly regulated than during the pre-FIRA era insofar as lending limitations, reporting requirements and civil penalties are concerned. Banks still retain broad discretion in extending credit

205. See notes 114-16 supra and accompanying text.
206. See notes 132-46 supra and accompanying text.
207. See notes 8, 13, 15 supra and accompanying text.
209. See notes 12, 13, 19 supra and accompanying text.
210. See notes 67, 68, 76-80 supra and accompanying text.
211. See notes 71-82 supra and accompanying text.
to certain insiders, particularly principal shareholders and directors. This discretion may continue to foster insider abuses. If the intent in enacting FIRA and the issuance of Regulation O was to bring all potentially harmful insiders within the ambit of strict regulatory control, then the limitations or extensions of credit to all insiders, including executive officers, directors and principle shareholders should promote more parity and fewer exceptions.

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