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*A MISDIAGNOSIS AND AN IMPROPER PROSCRIPTION?
CONCERNS AND CRITICISMS OF PROPOSED S.E.C. RULE 127B*

I. INTRODUCTION

On April 16, 2010, the Securities and Exchange Commission (“SEC”) filed securities fraud charges against Goldman, Sachs & Co. (“GS&Co”) and a GS&Co employee, Fabrice Tourre (“Tourre”), for making material misrepresentations and omissions in connection with a synthetic collateralized debt obligation¹ (“CDO”) GS&Co structured and marketed to investors as the U.S. housing market was beginning to falter.²

The synthetic CDO that GS&Co structured and marketed hinged on the performance of subprime residential mortgage-backed securities³ (“RMBS”).⁴ Allegedly, GS&Co failed to disclose vital information about the CDO to investors, in particular the role that a major hedge fund played in the portfolio selection process and that the same hedge fund had taken a short position⁵ against the CDO.⁶

¹ A CDO is a basket of assets or income streams that are pooled together, split into subordinated repayment rights (“tranches”), rated by a credit rating agency and sold to investors. The assets may consist of cash assets, such as bonds, loans, preferred securities, mortgages, or even tranches of other CDOs. When a CDO is created from a cash asset, it is called a “cash CDO.” Alternatively, a CDO may be created from income streams that result from a pool of credit default swaps, a type of derivative. When a CDO is created from credit default swaps instead of cash assets, it is called a “synthetic CDO.” Neal Deckant, *Criticisms of Collateralized Debt Obligations in the Wake of the Goldman Sachs Scandal*, 30 REV. BANKING & FIN. L. 407, 410 (2010).

² SEC Litigation Release No. 21489, *The SEC Charges Goldman Sachs With Fraud In Connection With The Structuring And Marketing of A Synthetic CDO* (Apr. 16, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21489.htm> (Apr. 16, 2010); See also Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre Complaint, available at <http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf>.

³ The SEC defines “mortgage-backed securities” as debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. See <http://www.sec.gov/answers/mortgagesecurities.htm>; see also SEC Complaint, *supra* at 5 (RMBS are securities backed by residential mortgages. Investors receive payments out of the interest and principal on the underlying mortgages).

⁴ SEC Press Release, *SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages* (Apr. 16, 2010), available at <http://www.sec.gov/news/press/2010/2010-59.htm>.

⁵ The SEC defines a “short position” as one resulting from “short sales.” The SEC defines a “short sale” as the sale of any security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller. See <http://www.sec.gov/answers/shortsale.htm>.

⁶ SEC Press Release, *supra* note 4.

“The product was new and complex but the deception and conflicts are old and simple,” said Robert Khuzami, Director of the Division of Enforcement.⁷ Khuzami also added, “Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio, while telling other investors that the securities were selected by an independent, objective third party.”⁸

The SEC alleged that one of the world’s largest hedge funds, Paulson & Co. (“Paulson”), paid Goldman Sachs to structure a transaction in which Paulson could take short positions against mortgage securities chosen by Paulson based on a belief that the securities would experience credit events.^{9, 10}

According to the SEC’s complaint, the marketing materials for the CDO, known as ABACUS 2007-AC1 (“ABACUS”), all represented that the RMBS portfolio underlying the CDO was selected by ACA Management LLC (“ACA”), a third party with expertise in analyzing credit risk in RMBS.¹¹ The SEC alleged that undisclosed in the marketing materials and unbeknownst to investors, the Paulson hedge fund, which was poised to benefit if the RMBS defaulted, played a significant role in selecting which RMBS should make up the portfolio.¹²

The complaint alleged that after participating in the portfolio selection, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps¹³

⁷ *Id.*

⁸ *Id.*

⁹ A “credit event” is defined as any sudden and tangible (negative) change in a borrower’s credit standing or decline in credit rating. A credit event brings into question the borrower’s ability to repay its debt. It is the defining trigger in a credit derivative contract, or credit default swap. If the borrower experiences a credit event, then the buyer of the contract must pay the seller an agreed-upon sum to cover the loss. *See* <http://www.investopedia.com/terms/credit-event.asp#axzz1ewctQV00>.

¹⁰ SEC Press Release, *supra* note 4.

¹¹ *Id.*

¹² *Id.*

¹³ A “credit default swap” is an over-the-counter derivative contract under which a protection buyer makes periodic premium payments and the protection seller makes a contingent payment if a reference obligation experiences a credit event. SEC Complaint, *supra* note 2, at 5.

(“CDS”) with GS&Co to buy protection on specific layers of the ABACUS capital structure.¹⁴ Given that financial short interest, Paulson had an economic incentive to select RMBS that it expected to experience credit events in the near future.¹⁵ GS&Co did not disclose Paulson’s short position or its role in the collateral selection process in the term sheet, flip book, offering memorandum, or other marketing materials provided to investors.¹⁶

The complaint further alleged that Tourre, a GS&Co Vice President, was principally responsible for ABACUS.¹⁷ Tourre structured the transaction, prepared the marketing materials, and communicated directly with investors.¹⁸ Tourre allegedly knew of Paulson’s undisclosed short interest and role in the collateral selection process.¹⁹ Additionally, he misled ACA into believing that Paulson invested approximately \$200 million in the equity of ABACUS, indicating that Paulson’s interests in the collateral selection process were closely aligned with ACA’s interests.²⁰ However, in reality, their interests were sharply conflicting.²¹

The deal closed on April 26, 2007, and Paulson paid GS&Co approximately \$15 million for structuring and marketing ABACUS.²² By October 2007, 83 percent of the RMBS in the ABACUS portfolio had been downgraded and 17 percent were on negative watch.²³ By January 2008, 99 percent of the portfolio had been downgraded and designated as nearly worthless.²⁴ As

¹⁴ SEC Press Release, *supra* note 4.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ SEC Press Release, *supra* note 4.

²¹ *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

a result, investors in the liabilities of ABACUS lost over \$1 billion.²⁵ Paulson's opposite CDS positions yielded a profit of approximately \$1 billion for Paulson.²⁶

The SEC's complaint charged GS&Co and Tourre with violations of Section 17(a) of the Securities Act of 1933²⁷, Section 10(b) of the Securities Exchange Act of 1934²⁸, and Exchange Act Rule 10b-5²⁹.³⁰ On July 15, 2010, the SEC announced that GS&Co would pay \$550 million and reform its business practices to settle the charges.³¹ GS&Co agreed to settle the SEC's charges without admitting or denying the allegations by consenting to the entry of a final judgment that provides for a permanent injunction from violations of the antifraud provisions of the Securities Act of 1933.³² However, GS&Co did acknowledge that its marketing materials for the ABACUS transaction contained incomplete information.³³

In response to the settlement, SEC Enforcement Director Khuzami commented, "[h]alf a billion dollars is the largest penalty ever assessed against a financial services firm in the history of the SEC ... [t]his settlement is a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing."³⁴

²⁵ *Id.*

²⁶ SEC Litigation Release No. 21489, *supra*, note 2.

²⁷ 15 U.S.C. §77q(a) ("the Securities Act").

²⁸ 15 U.S.C. §78j(b) ("the Exchange Act").

²⁹ 17 C.F.R. §240.10b-5.

³⁰ SEC Press Release, *supra* note 4.

³¹ SEC Press Release, *Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO* (July 15, 2010), available at <http://www.sec.gov/news/press/2010/2010-123.htm> (the settlement requires remedial action by GS&Co in its review and approval of offerings of certain mortgage securities, including the role and responsibilities of internal legal counsel, compliance personnel, and outside counsel in the review of written marketing materials for such offerings. The settlement also requires additional education and training of GS&Co employees in this area of the firm's business).

³² *Id.* (Tourre is litigating the charges against him.)

³³ *Id.* (GS&Co acknowledged that, in particular, it was a mistake for the GS&Co marketing materials to state that the reference portfolio was "selected by" ACA without disclosing that role of Paulson in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors.)

³⁴ *Id.*

Subsequently, the SEC was directed by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010³⁵ (“Dodd-Frank” or “the Act”) to promulgate rules to ensure that securitization participants of asset-backed securities³⁶ (“ABS”) shall not, for a year after the date of the closing of the ABS sale, engage in transactions that would involve or result in any material conflict of interest with respect to investors.³⁷ Just over one year after the GS&Co settlement, on September 19, 2011, the SEC unanimously agreed to propose a new rule, Rule 127B, which closely mirrors the language of Section 621.³⁸

Rule 127B is a product of crisis legislation, as such, it was misconceived and is improperly tailored; the proposal does not address the real failures underlying the financial mechanism in question, and, as proposed, may create unnecessary restrictions on asset-backed securitization markets and will be detrimental to the healthy functioning of the securitization markets. Part II offers an overview of the proposed rule, its origination, and the prohibition and exceptions it sets forth. Part II details the arguments posited by the proposed rule’s supporters and critics. Next, Part III analyzes why the arguments in favor of the rule fail and provides an explanation of the real underlying problems regarding complex securitization transactions, which the proposed rule fails to address. Part IV contends that by incorporating a rule for disclosure to the proposed rule, the potential harmful effects and undue cost of the proposed rule will be minimized. Part V follows with a conclusion.

³⁵ Public Law 111-203, §621, 124 Stat. 1376, 1632 (2010).

³⁶ The SEC defines “asset-backed security” as a security that pays its investors from cash flows from a discrete pool of financial assets such as mortgages. *See* 17 C.F.R. §229.1101(c)(1) (2008); Asset-Backed Securities, Exchange Act Release Nos. 33-8518, 34-50905, 84 SEC Docket 1624 (Dec. 22, 2004).

³⁷ Yin Wilczek, *SEC Proposes Rule to Bar Transactions That Involve Conflicts for ABS Investors*, BUREAU OF NATIONAL AFFAIRS (“BNA”), 43 SRLR 1941 (Sept. 26, 2011).

³⁸ *Id.*

II. PROPOSED S.E.C. RULE 127B

A. The Dodd-Frank Mandate

Section 621 of Dodd-Frank adds new Section 27B to the Securities Act. Section 27B prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an ABS, including a synthetic ABS, from engaging in a transaction that would involve or result in certain material conflicts of interest.³⁹ The prohibition under Section 27B applies to both registered and unregistered offerings of ABS⁴⁰.⁴¹ The prohibition applies during the period ending on the date that is one year after the date of the first closing of the sale of the ABS.⁴² Exceptions from the prohibition are provided for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making.⁴³ Furthermore, Section 27B requires the SEC to issue rules for the purpose of implementing the new Section's prohibition.⁴⁴ To meet this statutory requirement, the SEC proposed Rule 127B under the Securities Act.⁴⁵

“This rule is designed to ensure that those who create and sell asset-backed securities cannot profit by betting against those same securities at the expense of those who buy them,” SEC Chairman Mary Schapiro said in her opening remarks at the September 19, 2011 SEC open meeting.⁴⁶ “At the same time, the rule is not intended to interfere with traditional securitization practices in which loans are originated, packaged into asset-backed securities, and offered to

³⁹ SEC Release No. 34-65355, *Prohibition Against Conflicts of Interest in Certain Securitizations* (Sept. 19, 2011); 76 FR 60320 (Sept. 28, 2011), available at <http://www.sec.gov/rules/proposed/2011/34-65355fr.pdf>.

⁴⁰ ABS can be sold to investors in either a public offering, subject to an effective registration statement filed with the SEC, or a private offering exempt from registration. *Id.* at 60321.

⁴¹ *Id.* at 60320.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Wilczek, *supra* note 37; Speech available at <http://www.sec.gov/news/speech/2011/spch091911mls.htm>.

investors in different structures.”⁴⁷ If the proposed rule had been in place earlier, it would have barred the alleged conduct by GS&Co and very similar conduct by other banks^{48 49}.

B. The S.E.C. Proposal

Proposed Rule 127B closely mirrors the language of Section 621.⁵⁰ Under the proposed rule,

- (a) An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934, which for the purposes of this rule shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
- (b) The following activities shall not be prohibited by paragraph (a): (1) Risk-mitigating hedging activities,⁵¹ or (2) Liquidity commitment,⁵² or (3) Bona fide market-making.⁵³

For the proposed rule to apply, five conditions must be present. The transaction must involve: (1) covered persons, (2) covered products, (3) covered timeframe, (4) covered conflicts, and (5) a “material conflict of interest”.

⁴⁷ *Id.*

⁴⁸ See SEC Litigation Release No. 22008, *J.P. Morgan Securities to Pay \$153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market* (June 21, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr22008.htm>; See also SEC Litigation Release No. 22134, *Citigroup To Pay \$285 Million to Settle SEC Charges For Misleading Investors About CDO Company Profited From Proprietary Short Position Former Citigroup Employee Sued For His Role In Transaction* (Oct. 19, 2011), available at <http://www.sec.gov/litigation/litreleases/2011/lr22134.htm>.

⁴⁹ Wilczek, *supra* note 37.

⁵⁰ *Id.*

⁵¹ Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings. See 76 FR 60320, *supra* note 39, at 60333.

⁵² Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security. See *id.* at 60335.

⁵³ Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security. See *id.* at 60326.

It should be noted that, Rule 127B does not specifically set forth the types of conflicts it covers. However, the SEC proposes that the scope of the conflicts of interest covered by the new rule would be limited to: (1) conflicts of interest between an entity that is a securitization participant with respect to an ABS and an investor in such ABS, (2) conflicts of interest between a securitization participant and an investor that arise as a result of or in connection with the ABS transaction, and (3) conflicts of interest that arise as a result of or in connection with “engage[ing] in any transaction.”⁵⁴ Also, Rule 127B would apply only to “material conflicts of interest”. But, the SEC does not define “material conflict of interest”. The release contains an SEC explanation that it is unwilling to set forth an explicit definition because of the possibility that any such attempt would be both under- and over-inclusive and result in unintended consequences. The SEC does note that certain conflict of interest are inherent in the securitization process, and does not intend to alter or curtail the legitimate functioning of the securitization markets. The SEC proposes to clarify the scope of conflicts of interest that are material through interpretive guidance rather than through a detailed definition in the proposed rule.⁵⁵

⁵⁴ *Id.* at 60328.

⁵⁵ Preliminarily, the SEC believes that engaging in a transaction will involve or result in a material conflict of interest between a securitization participant and investors if:

1. Either (A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (I) adverse performance of the asset pool supporting or referenced by the relevant ABS, (II) loss of principal, monetary default or early amortization event on the ABS, or (III) decline in the market value of the relevant ABS; or (B) a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described in clause (A) above; and
2. there is a “substantial likelihood” that a “reasonable” investor would consider the conflict important to his or her investment decision (including a decision to retain the security or not).

Id. at 60329.

Securities Act Section 27B does not contain a disclosure provision, and as-proposed, neither does Rule 127B.⁵⁶ However, the SEC is seeking comment concerning the role of disclosure in the context of Securities Act Section 27B and the proposed rule.⁵⁷ Section 28 of the Securities Act provides the SEC with authority to adopt conditional and unconditional exemptive rules or regulations “to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”⁵⁸ The SEC is soliciting comment as to whether, in some circumstances, material conflicts of interest that would be prohibited under Section 27B and the proposed rule could be addressed sufficiently through a conditional exemption.⁵⁹ Specifically, provided the SEC were able to make the findings required by Securities Act Section 28, the SEC could require disclosure, as a condition to an exemption, to allow securitization participants to engage in what otherwise would be prohibited behavior under Section 27B and the proposed rule.⁶⁰

C. Support and Criticisms of the Proposal

“In the aftermath of the financial crisis, it became clear that firms were creating financial products, selling those same products to their customers, and then turning around and making bets against those same products they just sold,” said SEC Commissioner Luis Aguilar in his speech at the SEC’s open meeting on September 19, 2011.⁶¹ This practice equates to

selling someone a car with no brakes and then taking out a life insurance policy on the purchaser. In the [ABS] context the sponsors and underwriters of the [ABS] are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail ... [the ABS sponsors and issuers], like the mechanic servicing a car, would know if the vehicle has been designed to fail. And so they must be prevented from securing handsome

⁵⁶ *Id.* at 60343.

⁵⁷ SEC Release, *supra* note 39, at 60343.

⁵⁸ *Id.*; *See* 15 U.S.C. 77z-3.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ Speech by SEC Commissioner Luis Aguilar, *Statement at SEC Open Meeting: Prohibiting Firms from Designing Transactions to Fail* (Sept. 19, 2011), available at <http://www.sec.gov/news/speech/2011/spch091911laa.htm>.

rewards for designing and selling malfunctioning vehicles that undermine the [ABS] markets.⁶²

The proposed rule is an important step forward to prohibit this practice and to protect investors from being persuaded to invest in products designed to fail.⁶³ Section IV of the Proposed Rule raises the possibility of using information barriers and disclosures in lieu of a complete prohibition.⁶⁴ Supporters of the rule would advise against this. Although some supporters may generally be in favor of using information barriers and disclosure to mitigate conflicts of interest, they would suggest that short transactions should be absolutely prohibited, absent an exemption.⁶⁵ In the context of the Proposed Rule, supporters argue that, there must be a presumption that a material conflict of interest situation, where a securitization participant engages in a transaction through which it benefits when the related ABS fails or performs adversely, cannot be justified.⁶⁶

While superficially these positions in support of Rule 127B are persuasive, further analysis, of the transactions covered by the proposed rule and the prohibition set forth by the rule, reveals the potentially harmful and unintended consequences that the rule, as-proposed, may create for the securitization markets.

Discourse exploded in the wake of the SEC v. GS&Co suit.⁶⁷ Critics blamed CDOs for inflating the housing bubble and helping to bring about the recession,⁶⁸ credit rating agencies for

⁶² *Id.* (citing Cong. Rec. S5899 (daily ed. July 15, 2010) (statement by Sen. Levin)).

⁶³ *Id.*

⁶⁴ Chris Barnard, Comment on Prohibition against Conflicts of Interest in Certain Securitizations (Sept. 30, 2011), available at <http://www.sec.gov/comments/s7-38-11/s73811-2.pdf>.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ See Deckant, *supra* note 1.

⁶⁸ See Joel Nocera, *A Wall Street Invention Let the Crisis Mutate*, N.Y. TIMES (Apr. 16, 2010), available at <http://www.nytimes.com/2010/04/17/business/17nocera.html>.

inflating CDO ratings,⁶⁹ and originators and short sellers, like GS&Co and Paulson, for marketing synthetic CDOs that were expected to fail^{70, 71} Despite the large volume of discourse, few commentators discussed CDOs with any degree of technical clarity.⁷² Likewise, a preliminary concern with Dodd-Frank, and the proposed rule mandated under it, is whether Congress itself understood the instruments and transactions with any degree of technical clarity or whether Congress was swayed by other factors before legislating.

Following the recent housing bubble's burst, the subprime mortgage crisis, and the Great Recession, Congress passed the Dodd-Frank Act on July 21, 2010.⁷³ A massive financial overhaul was promised with the signing of Dodd-Frank into law.⁷⁴ One of the initiatives introduced by Dodd-Frank was, as discussed above, to temporarily bar those who package and distribute ABS from engaging in transactions that materially conflict with the interests of investors. However, given that some believe the passing of Dodd-Frank was motivated by populist outrage,⁷⁵ the efficacy of the provisions mandated by the Act must be questioned.

The dangers associated with post-crisis legislation and "bubble laws" have been well documented.⁷⁶ The U.S. Congress is subject to national public opinion and populist

⁶⁹ See Robert Oak, *Credit Ratings Agencies Complicit in Global Financial Casino Gambling Hall Dupe*, ECONOMIST POPULIST (Apr. 23, 2010).

⁷⁰ See Mark Trumbull, *Goldman Sachs vs. SEC: "Vampire Squid" or "Doing God's Work"?*, CHRISTIAN SCIENCE MONITOR (Apr. 21, 2010).

⁷¹ Deckant, *supra* note 1, at 407-08.

⁷² *Id.* at 408; See Aline van Duyn, *More Turmoil Looms in CDO Market*, FINANCIAL TIMES (June 21, 2010) (simply referring to CDOs as "complex," offering few technical details about their structure or function).

⁷³ For an overview of the crisis, see RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* (2009).

⁷⁴ Matthew G. Lamoreaux, *Obama Signs Dodd-Frank Reform Bill*, J. OR ACCOUNTANCY (July 21, 2010), available at <http://www.journalofaccountancy.com/Web/20103125.htm>.

⁷⁵ See Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

⁷⁶ See *id.*; see also Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393 (2006); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Larry E. Ribstein, *Bubble Laws*, 40 HOU. L. REV. 77 (2003); Charles P. Kindleberger, *Manias, Panics and Crashes: A History of Financial Crises* (4th ed. 2000).

sentiments.⁷⁷ During a bubble period, regulators and private gatekeepers tend to let their guard down and there is a boom in fraud as fraudsters see opportunities and investors become more greedy and trusting.⁷⁸ After a bubble bursts, investigators typically turn up evidence of speculative excess and even widespread fraud.⁷⁹ Then, investors burnt by losses from the bursting of the bubble and outraged by evidence of misconduct create populist pressure for new regulation.⁸⁰ “It is in the post-bubble environment, when scandals and economic reversals occur and when corporate transactions grab the attention of the American public and the U.S. Congress, that Congress often acts.”⁸¹

Due to the upswing in populist anger and accompanying intense public pressure for action following the bursting of bubbles, post-bubble periods offer “windows of opportunity to well-positioned policy entrepreneurs to market their preferred, ready-made solutions when there is little time for reflective deliberation.”⁸² Bubble laws tend to be adopted in a hurry and the pressure to act quickly benefits policy entrepreneurs who have pre-packaged purported solutions that can be readily adapted into legislative form.⁸³ Therefore, legislating in the immediate aftermath of a public scandal or crisis, as were the circumstances surrounding Dodd-Frank, is a formula for poor public policymaking; urgency prevents careful and balanced consideration of the issues, and instead facilitates “a window for action by the better-positioned, not the better informed, policy entrepreneurs.”⁸⁴

⁷⁷ Bainbridge, *supra* note 76, at 1785.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*; see also Alice Bartoo, Comment on Prohibition against Conflicts of Interest in Certain Securitizations (Oct. 11, 2011) (requesting the SEC “[p]lease implement ... all the regulations of the Dodd-Frank [A]ct. ... I would like to see some strength of leadership at correcting as many of [these] terrible, greedy and risky actions as possible.”), available at <http://www.sec.gov/comments/s7-38-11/s73811-4.htm>.

⁸¹ *Id.* at 1786 (internal quotations and citations omitted).

⁸² *Id.* (quoting Romano, *supra* note 77, at 1590).

⁸³ Bainbridge, *supra* note 76, at 1786.

⁸⁴ Romano, *supra* note 77, at 1602.

Experts have independently demonstrated that this pattern of boom-bust-regulation is a reoccurring phenomenon in American law.⁸⁵ The Sarbanes-Oxley Act of 2002 (“SOX”) and Dodd-Frank are just the latest iterations of this process.⁸⁶ Indeed, in describing the current situation, one commentator wrote,

The Obama administration thinks it has discovered the perfect formula to cram legislation through in a hurry: Demonize some prominent firm within an industry you plan to redesign, and then pass a law that has nothing to do with the accusation against the demonized firm. They did this with health insurance and now they’re trying it with finance. ... Today, the new demon *de jour* is Goldman Sachs, a handy scapegoat to promote hasty financial rejiggering schemes. ... The SEC’s dubious civil suit against Goldman is a wasteful diversion at best. It has nothing to do with the Obama administration’s suicidal impulse to impose more tough regulations and taxes on banks to encourage them to lend more.⁸⁷

In this case, Section 621 under Dodd-Frank was poorly conceived and there is a disconnect between means and ends. A further analysis of ABS transactions suggests that the provision was seriously misconceived because it is unlikely to cure the central problems of the securitization markets or otherwise protect and benefit investors as Congress intended.

III. WHY THE PROPOSED RULE DOES NOT SOLVE THE REAL PROBLEM

Though conflicts of interest between those who structured ABS and their investors played a role in the CDO meltdown, the conflicts were much less important in the market failure than the assets underlying the instruments and transactions involved. The center of the problem for securitization markets was the widespread distribution of securities that were so complex that, due to a lack of transparency, they could not be valued accurately, which opened the door to fraud and abuse. The proscription in proposed Rule 127B fails to address these issues.

⁸⁵ See Ribstein, *supra* note 77, at 83-94; Romano, *supra* note 77, at 1590-94.

⁸⁶ Bainbridge, *supra* note 76, at 1786.

⁸⁷ Alan Reynolds, *SEC vs. Goldman Sachs: Legislation by Demonization* (Apr. 21, 2010), available at <http://www.cato-at-liberty.org/sec-vs-goldman-sachs-legislation-by-demonology/>.

A. Complexity and the Credit Rating Agencies

Although much attention has been given to the conflicts of interest, such as was involved in the ABACUS case, which can arise in the structured products market, of greater concern is that structured products are complex and as one commentator noted, “the more complex, the less understandable.”⁸⁸ Some products are composed of a complex set of risk elements that are very difficult for investors to compile on their own.⁸⁹ Others provide investors exposure to types of risks or markets that they could not invest in directly.⁹⁰ The correct price of even simple structured products is difficult for many investors to determine on their own.⁹¹ To price structured products, investors need to have an understanding of the relationship among the various elements of a structure in order to accurately gauge the valuation impact of having those elements packaged together into a single product.⁹² Aside from pricing difficulties, investors often fail to fully appreciate the risk of loss they take when purchasing structured products.⁹³ While an investor may generally understand the nature of the risk embedded in the product, the complexity of the structure may make it difficult to determine with any degree of precision how market movements will impact the product’s value.⁹⁴ Thus, the foundational concern regarding structured products is the potential inability of investors to properly price, or fully assess the embedded risks of, structured products.⁹⁵

⁸⁸ See Suzanne H. Shatto, Comment on Prohibition against Conflicts of Interest in Certain Securitizations (Oct. 8, 2011), available at <http://www.sec.gov/comments/s7-38-11/s73811-3.htm>.

⁸⁹ Bennett, *supra* note 109, at 814-15.

⁹⁰ *Id.* at 815.

⁹¹ *Id.*

⁹² *Id.* at 816.

⁹³ *Id.*

⁹⁴ *Id.* (“This difficulty is exacerbated by the fact that many products are structured to include a leverage factor that multiplies the impact of any movement in the value of the underlying asset or index. For example, each one-percentage point movement in the underlying index may produce a two or three percentage point change in the product’s value. Leveraged products thereby increase the opportunity for gains, but also the likelihood that the investor will suffer significant losses.”).

⁹⁵ Bennett, *supra* note 109, at 816.

The heart of the problem is that, due to the complexity of the products, unregulated ratings for ABS became proxies for the full disclosure required by securities law.⁹⁶ When ABS were repackaged into complex CDOs or used indirectly to create derivative obligations such as CDSs, participants in transactions and institutions holding the securities relied on the high ratings given to component ABS rather than looking at the assets underlying them.⁹⁷ The disclosures concerning these instruments failed to warn of weaknesses in the assets on which they rested.⁹⁸

Over time, the CDO market's quality controls expanded beyond the scope of federal securities regulation which permitted irresponsible and fraudulent practices concerning financial instruments underlying ABS and their derivatives.⁹⁹ Ratings by private rating agencies largely displaced the structured disclosure requirements of securities law as the primary basis for investors' purchase of the securities.¹⁰⁰ That rating system, full of rampant conflicts of interest as a product of the rating agencies getting paid by the issuers of the securities they rated, failed to detect the increasing risk in the debt instruments used as the collateral for the CDO system.¹⁰¹

Originally, credit rating agencies¹⁰² ("CRAs") rated corporations, or their ability to repay particular debt securities, and earned revenues from investor subscriptions.¹⁰³ In the 1970s, the CRAs changed their business model to base their revenues on fees from issuers of securities that

⁹⁶ Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1361 (2009).

⁹⁷ *Id.* at 1362.

⁹⁸ *Id.*

⁹⁹ *Id.* at 1363.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² The three most important agencies for purposes of the CDO market are Moody's, Standard & Poor's ("S&P"), and Fitch. As of 2002, Moody's and S&P together had almost 80% of the global market share for rating securities; Fitch had 14%, and the remainder was scattered among smaller newcomers. See *Challenging Times for Credit Ratings Monopoly*, IRISH TIMES (Dec. 13, 2002), available at <http://www.irishtimes.com/newspaper/finance/2002/1213/1039700348175.html>.

¹⁰³ *Id.*; see Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 49-50 (2004).

they rated;¹⁰⁴ this created a conflict of interest because it gave the CRAs a powerful incentive to give their customers favorable ratings.¹⁰⁵ In 1975, the SEC approved the use of ratings by Nationally Recognized Statistical Rating Organizations (“NRSROs”) to judge the quality of securities that broker-dealers could use to satisfy their capital requirements.¹⁰⁶ Subsequently, the SEC expanded the use of ratings to other areas as well.¹⁰⁷ Additionally, federal and state regulators, in establishing standards for institutions such as banks and insurance companies, began requiring that securities be top-rated to be counted toward minimal capital requirements.¹⁰⁸ As a result of ratings becoming more widely used, ABS that were rated in the top rating categories were considered equivalent to securities issued or guaranteed by government-sponsored enterprises, even though the ABS lacked an express or implied federal guaranty.¹⁰⁹

The creation of CDOs increased the complexity of certain ABS.¹¹⁰ The layers between debt instruments providing the underlying cash flow for the instruments and the final instruments sold on the markets destroyed the transparency that the securities laws were designed to create, and made the unregulated rating system a substitute for due diligence in determining quality.¹¹¹ To rate ABS, CRAs began with a “loan tape” which described the characteristics of the included obligations.¹¹² CRAs were not, however, required to use due diligence to assure the validity of

¹⁰⁴ See Hill, *supra* note 137, at 50 (“The change in business model coincided with another change that made the agencies more important actors in the issuance of [ABSs]: government bodies, ironically led by the SEC, began to use the agencies’ ratings to measure the quality of the securities held by regulated entities.”).

¹⁰⁵ Mendales, *supra* note 132, at 1373.

¹⁰⁶ *Id.* at 1374.

¹⁰⁷ *Id.* (Such as regulations under the 1940 Act, under which taxable money market funds may not hold more than five percent of their assets in securities rated below the top tier ratings of at least two rating agencies.)

¹⁰⁸ *Id.* at 1375.

¹⁰⁹ *Id.*

¹¹⁰ Mendales, *supra* note 132, at 1381.

¹¹¹ *Id.*

¹¹² *Id.*

the information on the loan tape.¹¹³ Then, in order to rate each particular tranche of a particular issue, CRAs applied their statistical models to the characteristics of each pool of obligations.¹¹⁴ Unlike ratings for typical corporate debt securities, investors could not easily double-check the balance sheet, income statement, and SEC filings designed to maximize transparency of an offering.¹¹⁵ To the contrary, the rating for a tranche of any CDO has been equated to a kind of “black box,” which is not easily subject to analysis by purchasers.¹¹⁶ Even sophisticated investment professionals have found that CDOs consisting of multiple types of obligations are impossible to value and have nothing to rely upon but the rating system.¹¹⁷

As ABS and their derivatives became more complex, transparency declined, and the market became even more dependent on the rating system, with little concern for its accuracy.¹¹⁸ For example, “[f]or a synthetic CDO based on derivative obligations resting on a pool of AAA-rated [ABS], a purchaser was not in a good position to backtrack to determine whether the AAA ratings reflected consistent up-to-date statistical models applied correctly to underlying pools of well-documented obligations with known characteristics.”¹¹⁹ However, the CRAs did not perform due diligence to ensure adequate documentation for each mortgage in a pool, nor did they determine whether mortgages represented higher risks than would be permitted under

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ Mendales, *supra* note 132, at 1381.

¹¹⁷ Louise Story, *A Question of Value: What's an Asset Worth? It's Not Always Easy to Tell*, N.Y. TIMES, June 20, 2008, at C1 (reporting that investment professionals were unable to value CDOs).

¹¹⁸ *Id.* at 1376.

¹¹⁹ Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., at 41 (Apr. 27, 2008) (A single offering may include tranches rated AAA (S&P's top investment-grade rating), tranches with lower but still investment-grade ratings, and tranches rated below investment grade. Because top-rated tranches enjoy the right to collections from all obligations in a pool before lower-rated tranches may receive anything, they may receive ratings indicating stronger payment ability than most – or even all – of the individual sources of cash flow in a pool. A mortgage-backed security may thus receive a top rating even though all the mortgages backing it are subprime).

Ginnie Mae standards,¹²⁰ or whether the mortgages had qualitatively different characteristics making default almost certain.¹²¹ Furthermore, due to a duopoly in rating ABS and their derivatives, Moody's and S&P were under no competitive pressure to update their statistical models to reflect changing conditions.¹²²

By not performing due diligence on the pools they were rating, the CRAs failed to recognize significant qualitative changes in the loans underlying the securities they rated; they also failed to change their statistical models based on the increasing complexity of ABS and changes in the housing market.¹²³ In the recent housing bubble, what were called "subprime" loans did not fit the historic model of documented loans to mortgagors with a suspect credit history.¹²⁴ The subprime loans included loans to mortgagors with no equity and loans that were completely undocumented.¹²⁵ Therefore, the loans were prone to fraud by mortgagors who overstated their incomes and by bloated appraisals of mortgaged property, or they were time bombs due to reset at rates above the mortgagor's ability to pay.¹²⁶ These were not simply loans with a higher probability of default, they were loans with a near certainty of default.¹²⁷ In fact, the inadequacy of the rating system models was clear based on information available before the housing market crash.¹²⁸ Top ratings, which are supposed to indicate a strong capacity to pay principal and interest, were inconsistent across different types of debt securities.¹²⁹ Under Moody's system, 2.2% of corporate bonds rated Baa (the lowest investment-grade rating)

¹²⁰ Ginnie Mae rules preclude it from guaranteeing pools of loans including characteristics such as significantly higher interest rates than those currently being paid on Ginnie Mae securities, or with refinancing built into the structure of the loans. Mendales, *supra* note 132, at note 129.

¹²¹ *Id.* at 1377.

¹²² *Id.*

¹²³ *Id.* at 1379-80.

¹²⁴ *Id.* at 1396.

¹²⁵ *Id.*

¹²⁶ Mendales, *supra* note 132, at 1396.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

defaulted for each five-year period from 1983-2005.¹³⁰ For CDOs with the same rating, the average five-year default rate from 1993 to 2005 was 24%.¹³¹ For municipal bonds with the same rating, the five-year default rate was only 0.097%.¹³²

Prior to the meltdown, the CRAs were not required to disclose underlying information to which they applied their statistical models to rate a given ABS or CDO.¹³³ However, since the meltdown, the SEC has proposed new rules and amendments intended to increase transparency and improve the integrity of credit ratings.¹³⁴ The proposed rules would implement certain provisions of Dodd-Frank and enhance the SEC's existing rules governing credit ratings and NRSROs.¹³⁵ Under the SEC's proposal, NRSROs would be required to: report on internal controls; protect against conflicts of interests; establish professional standards for credit analysts; publicly provide – along with the publication of the credit rating – disclosure about the credit rating and the methodology used to determine it; and enhance their public disclosures about the performance of their credit ratings.¹³⁶ The SEC's proposal also requires disclosure concerning third-party due diligence reports for ABS.¹³⁷

It remains to be seen whether these measures will fully correct these foundational problems surrounding the CRAs due to the complexity of ABS.

¹³⁰ Richard Tomlinson & David Evans, *The Ratings Charade*, BLOOMBERG (July 2007), available at <http://www.bloomberg.com/news/marketsmag/ratings.html>.

¹³¹ *Id.*

¹³² *Id.*

¹³³ Mendales, *supra* note 132, at 1382 (Interestingly, in 2007, well after the subprime default crisis had begun, Moody's announced that it was changing the model that it had adopted in 2002 to rate securities on subprime mortgages. Therefore, when the rating system failed, beginning with subprime mortgage defaults in 2006, not only private investors but even financial institutions around the world found it impossible to value the CDOs they held).

¹³⁴ SEC Press Release, *SEC Proposes Rules to Increase Transparency and Improve Integrity of Credit Ratings* (May 18, 2011), available at <http://www.sec.gov/news/press/2011/2011-113.htm>.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.*

B. Dangers Associated with the Proposal's Proscription

There is a danger that, concerning Dodd-Frank's Section 621, and now SEC Rule 127B, legislators adopted proposals of policy entrepreneurs without a careful consideration of the costs and consequences associated with the policy prescriptions. Unfortunately, because policy entrepreneurs tend to be critics of markets and corporations, bubble laws often do, and in this case may, "impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success."¹³⁸ The proposed prohibition of certain securitization transactions and structures could unduly stifle the free flow of capital, constrain market participants in managing their risks, frustrate capital formation, and cut investors off from investment opportunities.¹³⁹ Some commentators are worried that proposed Rule 127B's prohibition may prove to be over-inclusive, banning more than is called for – the proposal may characterize a "material conflict of interest" too expansively and the proposal may implement the statutory exceptions for hedging activities, liquidity commitments, and market making too narrowly.¹⁴⁰ These concerns should be heeded. If not properly tailored, proposed Rule 127B and the prohibition it sets forth may prove to unduly restrain a beneficial financial mechanism.

If the government proscribed or banned transactions for which information asymmetry exceeded a certain level, one of the most immediate potential consequences would be the elimination of many, if not most, structured transactions.¹⁴¹ Structured transactions are widely

¹³⁸ Bainbridge, *supra* note 76, at 1787 (quoting Ribstein, *supra* note 77, at 83).

¹³⁹ See Speech by SEC Commissioner Troy Paredes, *Statement at Open Meeting to Propose Rule Amendments to Prohibit Conflicts of Interest in Certain Securitizations* (Sept. 19, 2011), available at <http://www.sec.gov/news/speech/2011/spch091911tap.htm>.

¹⁴⁰ *Id.*

¹⁴¹ Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 21 (2004).

used and accepted.¹⁴² Often structured transactions are efficient means of obtaining funding for their participants while also achieving various accounting, tax and regulatory benefits.¹⁴³ They reflect the innovation for which the US capital markets are known, have many legitimate uses, and comprise a significant part of the US capital markets.¹⁴⁴ These types of transactions are efficient because they serve to transfer investment risks to those who have the most expertise, or the most willingness to invest, in the risks.¹⁴⁵ Indeed, securitization transactions are normally viewed as socially desirable.¹⁴⁶ Even despite the subprime mortgage crisis, there is evidence that securitization has still created overall value in the financial markets.¹⁴⁷

Another reason that the government should not proscribe transactions as a means of controlling information asymmetry is that any such bans may create “regulatory arbitrage incentives” in which parties would aspire to structure transactions in ways that appear to meet regulatory requirements.¹⁴⁸ The consequences of such actions would be undesirable: the regulatory proscription would be bypassed and the transaction costs would rise due to added expenses of lawyers and other advisors hired to help structure the transaction.¹⁴⁹ For these

¹⁴² In re Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002) (First Interim Report of Neal Batson, Court-Appointed Examiner), at 22 (noting, for example, that “total outstanding mortgage-backed and asset-backed securities in the United States alone exceed \$6 trillion”), available at <http://www.enron.com/corp/por/pdfs/InterimReport1ofExaminer.pdf>.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ Schwarcz, *supra* note 142, at 21 (“There is usually a panoply of risks associated with any given originator. In a securitization, for example, the originator separates particular financial assets from those risks by selling or otherwise transferring those assets to a “bankruptcy-remote” SPE. Investors in the SPE can, therefore, base their investment decisions solely on the risks associated with the transferred assets. Moreover, even those limited risks can be borne by providers of credit enhancement or investors in subordinated securities, parties who are in the business of precisely assessing and absorbing such risks. As a result, the universe of investors interested in investing in those assets greatly expands”).

¹⁴⁶ Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1118 (2008).

¹⁴⁷ *Id.*; see Xudong An, Yongheng Deng & Stuart A. Gabriel, *Value Creation Through Securitization: Evidence from the CMBS Market* (Feb. 18, 2008) (SSRN working paper no. 1095645).

¹⁴⁸ Schwarcz, *supra* note 142, at 22.

¹⁴⁹ *Id.*

reasons, the proscription of structured transactions may be unwise and may yield undesired results.

Some commentators question why banks were even allowed to create and sell products like the synthetic CDO at the center of the GS&Co ABACUS case.¹⁵⁰ And, in the same vein, they wonder what purpose a synthetic CDO, which contains no actual mortgage bonds, serves for the capital markets, and for society.¹⁵¹ Additionally, critics argue that since buyers and sellers of CDSs often have no stake in the underlying instrument, such swaps function like an insurance policy.¹⁵² One party collects a fee for promising to, essentially, insure a bond; the other party makes the premium payments, and gets a big payoff if the bond goes bad.¹⁵³ The problem, some say, is that swaps are open to anyone, including parties with nothing to insure.¹⁵⁴ Therefore, allowing speculators to bet on entities in which they have no stake is similar to “letting your neighbor take out an insurance policy on your life.”¹⁵⁵ In the end, critics argue, the CDOs involved in the GS&Co trades, “were simply a side bet – like those in a casino – that allowed speculators to increase society’s mortgage wager without financing a single house.”¹⁵⁶ However, contrary to these views, structured products remain an important investment tool for both retail and institutional investors.¹⁵⁷

A more detailed description of securitization is essential to better understand the benefits that the above mentioned instruments provide to financial markets. The SEC describes securitization as: a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as

¹⁵⁰ See Andrew Ross Sorkin, *When Deals on Wall Street Resemble a Casino Wager*, N.Y. TIMES (Apr. 20, 2010).

¹⁵¹ *Id.*

¹⁵² See Roger Lowenstein, *Gambling With the Economy*, N.Y. TIMES (Apr. 20, 2010).

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ See Sorkin, *supra* note 91.

securities.¹⁵⁸ This financing technique makes it easier for lenders to exchange payment streams coming from loans, or other pooled assets, for cash allowing them to make additional loans or credit available to a wide range of borrowers and companies seeking financing.¹⁵⁹ As a result of securitization, the credit and other risks associated with the pooled assets are transferred away from the sponsor's balance sheet to investors in the ABS.¹⁶⁰

Over the years, the securitization process significantly evolved.¹⁶¹ There are now synthetic ABS in which investors in securities issued by special purpose entities¹⁶² ("SPE") acquire credit exposure to a portfolio of fixed income assets without the SPE owning these assets.¹⁶³ The investors gain this exposure because the SPE has entered into derivatives transactions, such as CDSs that reference particular assets.¹⁶⁴ The counterparty to the CDS may be the sponsor who originated or selected the underlying portfolio.¹⁶⁵ The SPE, as seller of protection under the CDS, is in effect long the credit exposure on those assets as if it had purchased them.¹⁶⁶

¹⁵⁸ Asset-Backed Securities, SEC Release No. 33-9117 (Apr. 7, 2010), 75 FR 23328, 23329 (May 3, 2010) (Some of the types of assets that are financed today through securitization include residential and commercial mortgages, agricultural equipment leases, automobile loans and leases, student loans and credit card receivables).

¹⁵⁹ *Id.*

¹⁶⁰ See SEC Release, *supra* note 39, at 60321 (one type of ABS is a CDO).

¹⁶¹ *Id.*

¹⁶² See *id.* (a financial institution or other entity, commonly known as a sponsor, first originates or acquires a pool of financial assets. The sponsor then sells the financial assets, directly or through an affiliate, to a special purpose entity. The SPE issues the securities supported or "backed" by the financial assets. These securities are then sold to investors).

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ SEC Release, *supra* note 39, at 60321 (To illustrate, a bank that maintains fixed income assets on its balance sheet may protect itself against default of those assets by purchasing a CDS from the SPE that references the same or similar types of assets. In other cases, a person may desire to purchase CDS protection even though such person does not own the reference assets underlying the CDS sold by the SPE. In both of these cases, the SPE, as seller of the CDS protection, takes on the risk of default on the reference assets underlying the CDS (and the consequent obligation to make a payment to the CDS counterparty as a result of such default) in exchange for ongoing payments from the purchaser of the CDS protection. Additionally, in both scenarios any payments the SPE is required to make under the CDS will be funded from amounts received by the SPE from the investors in the ABS issued by the SPE. Hence, the proceeds of the SPE's issuance of securities typically are not used to purchase loans, receivables or other investment assets, but instead are typically used to purchase highly creditworthy collateral to support (1) the

In both the non-synthetic ABS and the synthetic ABS, the SPE and the investors in the SPE have an ongoing long exposure to each instrument in a reference pool of assets – assets held directly by the SPE, in the case of a non-synthetic transaction, or assets referenced in a CDS under which the SPE has sold protection to a counterparty, in the case of a synthetic transaction.¹⁶⁷ However, the transactions differ in that the synthetic transaction inherently involves a party – the counterparty to the CDS – that has purchased CDS protection on the same reference pool of assets and thus has an ongoing short exposure to those assets.¹⁶⁸ This purchaser of CDS protection may be a securitization participant – such as the bank sponsoring the synthetic ABS.¹⁶⁹ In these transactions, and considering the CDS in isolation, the securitization participant would be taking an investment position that is directionally opposite to that taken by the investors in the synthetic ABS, as is generally the case in any transaction through which a buyer is able to acquire and a seller is able to dispose of a particular financial exposure in pursuit of their respective investment objectives.¹⁷⁰ If the referenced assets default, the securitization participant receives a payment from the SPE pursuant to the CDS and the investors in the SPE ultimately suffer a loss on their investment.¹⁷¹ If the referenced assets do not default, the investors would have benefited from payments from the CDS counterparty while the SPE would not have any payment obligations to the CDS counterparty.¹⁷²

With respect to a particular structured product, the fact that a dealer responsible for the structuring of the product and an investor were on opposite sides of the embedded derivative

SPE's contingent obligation to pay the purchaser of the CDS in the event of one or more defaults with respect to the reference assets underlying the CDS (the synthetic reference pool of assets), and (2) to the extent not used for payments to the CDS purchaser, the SPE's obligations to investors in the SPE's issued securities. The SPE makes payments to investors based on cash flows and proceeds from the CDS and the collateral pool).

¹⁶⁷ *Id.* at 60322.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² SEC Release, *supra* note 39, at 60322.

was, for most of the history of the structured products market, seen as a natural economic fact, not a conflict of interest.¹⁷³ Structured product professionals believe that it is natural for a bank to create a CDO by shorting the underlying reference portfolio, and standard that it would offset part of that short position with a client.¹⁷⁴ A CDO cannot exist without parties willing to short the reference portfolio because, as mentioned above, their payments fund the payments made to the investors.¹⁷⁵ Investors can only take a long position in a synthetic CDO if someone else is willing to go short.¹⁷⁶ It is a common and almost essential element of creating a structured product for a dealer to take the opposite position from the investors in a structured product.¹⁷⁷ However, the fact that the dealer may profit to the same extent as the investors' loss if the investors lose on a transaction creates the appearance of a conflict.¹⁷⁸ No matter how distasteful this may seem, in and of itself, this outcome is not impermissible and is simply a fundamental reality regarding structured products.

Synthetic CDOs facilitate the management of risk and the flow of capital.¹⁷⁹ Meanwhile, banks that have lent money to questionable borrowers use CDSs as a hedge – if the loans go bad, the bank makes up for the loss by collecting on the CDS.¹⁸⁰ As mentioned above, a major source of criticism is that financial institutions took risky “bets” in synthetic CDOs. That is, instead of using derivatives to hedge, institutions took positions in synthetic CDOs with the intention of

¹⁷³ Michael Bennett, *Complexity and Its Discontents: Recurring Legal Concerns with Structured Products*, 7 N.Y.U. J. L. & BUS. 811, 829 (2011).

¹⁷⁴ *Id.* at 830.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* (“This is a non-scandal. ... Synthetic CDOs cannot exist unless somebody is betting that they will lose value. In such a zero-sum contest, big investors who went long knew perfectly well that other investors had to be taking the other side of the bet”)

¹⁷⁷ *Id.* at 831.

¹⁷⁸ *Id.*

¹⁷⁹ Sorkin, *supra* note 91.

¹⁸⁰ Lowenstein, *supra* note 93.

earning long-term growth.¹⁸¹ While some firms made money, many others lost vast sums when their derivative bets went wrong.¹⁸² However, derivatives are not intended to be a growth-enhancing investment.¹⁸³

Unlike investments in assets, derivatives are contracts that involve “parties” and “counterparties,” and one party’s gain is another party’s loss.¹⁸⁴ Theoretically, with a large enough pool of CDSs, the amount the short position pays to the long position exactly equals the sum total of credit defaults that the long position pays to the short position.¹⁸⁵ The objective in designing a CDS is to ensure that at the outset the net present value of all exchanges of the payments to be made by both sides will equal zero.¹⁸⁶ When used properly, derivatives allow companies to hedge cash flow risk, allowing it to continue its investments.¹⁸⁷ If derivatives are used to hedge risk, they can help bring regularity and certainty to a company’s cash flow, which may be used for investment and growth.¹⁸⁸ The core problem with the GS&Co ABACUS CDO, and other structured finance transactions, was that “investors relied on flawed assessments of risk.”¹⁸⁹

¹⁸¹ Nocera, *supra* note 69.

¹⁸² Deckant, *supra* note 1, at 426; *see also* Sebastian Mallaby, *In SEC vs. Goldman, who’s really at fault?*, Washington Post (Apr. 21, 2010) (“[t]his is a non-scandal. The securities in question, so-called synthetic CDOs, cannot exist unless somebody is betting that they will lose value. In such a zero-sum contest, big investors who went long knew perfectly well that other investors had to be taking the other side of the bet. [GS&Co] lost \$90 million by betting [ABACUS] would go up; [Paulson] went short.”).

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ *See* Kenneth A. Froot, David S. Scharfstein & Jeremy C. Stein, *A Framework for Risk Management*, HARV. BUS. REV. (1994).

¹⁸⁸ *See id.* (the role of risk management is to ensure that a company has the cash available to make value-enhancing investments).

¹⁸⁹ Sorkin, *supra* note 91 (quoting Sean Egan, managing director of Egan-Jones Ratings).

IV. THE CASE FOR INCLUDING A “ROLE FOR DISCLOSURE”

Proposed Rule 127B does not include a role for disclosure. A major concern is that when a transaction or structure is banned under the proposed rule, investors may be forced to pass on investment opportunities that they might otherwise welcome if given the opportunity to make an informed choice.¹⁹⁰ One way to prevent sacrificing investor choice in the context of the proposed rule could be to allow for disclosure to remedy what the rule would otherwise treat as a prohibited material conflict of interest.¹⁹¹ Such a response would fit into the traditional scheme of federal securities law which favors disclosure, allowing investors to make their own investment decisions as they wish with the benefit of the information provided for them.¹⁹² The federal securities laws depend on disclosure, not institutional constraints, following Justice Brandeis’s observation that “sunlight is said to be the best of disinfectants,” rather than judging the merit of registered securities.¹⁹³ If, given a choice, an investor were to decide to transact in the face of a properly identified and adequately disclosed conflict of interest, Rule 127B should not block the investor from the investor’s preferred investment.¹⁹⁴ Government decision making, as effectuated through a ban on certain transactions and structures should not displace informed investor decision making.¹⁹⁵

ABS, other than those expressly exempted from registration under the securities laws, are subject to the full disclosure requirements for securities issued for sale to the general public.¹⁹⁶ Although it is possible to privately place such securities and side-step the full disclosure required by the securities laws, a key purpose of securitization is, as elaborated above, turning illiquid

¹⁹⁰ Paredes, *supra* note 140.

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ Mendales, *supra* note 132, at 1363.

¹⁹⁴ Paredes, *supra* note 140.

¹⁹⁵ *Id.*

¹⁹⁶ *See generally* Regulation S-K, 17 C.F.R. §229 (2008).

assets into readily tradable instruments, and privately placed securities are not freely tradable.¹⁹⁷ Therefore, securitization participants generally provide disclosures to investors in ABS, which should include adequate disclosure as to material conflicts of interest between investors and the securitization participant.¹⁹⁸ However, as argued above, these conflicts of interests, although having an appearance of impropriety, are not the causes of the foundational issues regarding securitization, ABS, and CDOs.

Section 28 of the Securities Act provides the SEC with the authority to adopt conditional or unconditional exemptive rules and regulations “to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”¹⁹⁹ Discussed at length above, ABS and their derivatives are useful; they provide liquidity for housing-based lending and for other types of securitized debt, and can be used effectively as hedging strategies.²⁰⁰ Thus, an effective response must preserve the advantages of the system while addressing the underlying flaws that led to the crisis.²⁰¹ Being that the new rules and regulations, proposed under Dodd-Frank, concerning the CRAs seek to redress the informational inadequacies surrounding ABS, it appears that in most circumstances, material conflicts of interest that would be prohibited under proposed Rule 127B can be adequately addressed through a conditional exemption.²⁰² Therefore, the SEC should require disclosure, as a condition to an exemption, to allow securitization participants to engage in what otherwise would be prohibited behavior under the proposed rule.²⁰³

¹⁹⁷ Mendales, *supra* note 132, at 1382.

¹⁹⁸ SEC Release, *supra* note 39, at 60343.

¹⁹⁹ 15 U.S.C. 77z-3.

²⁰⁰ Mendales, *supra* note 132, at 1406.

²⁰¹ *Id.*

²⁰² SEC Release, *supra* note 39, at 60343.

²⁰³ *Id.*

Another approach would be to tolerate insufficient disclosure. Under this approach, disclosure would remain the sole remedy for any informational asymmetry between an originator and investors.²⁰⁴ Supporters of this approach believe that in an efficient market, stock prices virtually instantaneously reflect all publicly available information relevant to the value of the traded securities; thus, not all investors need to understand any given disclosure.²⁰⁵ However, complexity undermines the assumptions of this approach. With complexity, few, if any, investors will actually understand even detailed disclosures regarding complex instruments in order to act instantaneously and achieve an efficient market.²⁰⁶

Perhaps supplemental protections, in addition to, not in place of, disclosure can be used to minimize the asymmetric information problem.²⁰⁷ For instance, fraud in connection with the sale of mortgages or other nonsecuritized debt obligations has historically been subject to state law.²⁰⁸ Being that these sales are now largely made for the purpose of securitization, fraud in such transactions should be subject to uniform federal regulation.²⁰⁹ If this were so, any material misrepresentation regarding a CDO or the collateral underlying it would give rise to civil actions, by the SEC and also by private investors who purchase a CDO in reliance on the misrepresentation.²¹⁰ Criminal prosecutions may also be appropriate in egregious cases.²¹¹ Furthermore, any sale of a debt instrument with knowledge that it would be securitized, accompanied by any material misrepresentation concerning the instrument sold, should be a violation of the antifraud provisions of the federal securities laws.²¹² Such remedy would seem

²⁰⁴ Schwarcz, *supra* note 142, at 17.

²⁰⁵ *Id.* at 18.

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 23-24.

²⁰⁸ Mendales, *supra* note 132, at 1407.

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

to fit the GS&Co ABACUS circumstances well, which, “for all the trumpeting in the press about an impenetrable sophisticated transaction, in the end boils down to a claim of a garden variety fraud: Goldman misstated the true nature of Paulson’s involvement, thereby misleading those who bet the value of the securities would rise.”²¹³

V. Conclusion

Proposed SEC Rule 127B must be implemented carefully for fear of hampering the securitization markets. As a product of crisis legislation, the proposal was misconceived and, as proposed, is improperly tailored. The proposal does not address the real failures underlying the financial mechanism in question, namely, complexity of modern ABS and synthetic CDOs and the failure of the CRAs to perform adequate due diligence to ensure that their ratings were accurate. In light of new rules and regulations under Dodd-Frank aimed at redressing the integrity and accuracy deficiencies regarding the credit rating system, the prohibition under Rule 127B is sure to create unnecessary restrictions on asset-backed securitization markets and will be detrimental to the healthy functioning of the securitization markets. Investors would be better protected and served by the incorporation of a role for disclosure to the proposed rule which would minimize the potential harmful effects and undue cost of the proposed rule’s prohibition.

²¹³ Norman A. Olch, *SEC v. Goldman Sachs: Read the Complaint*, FULL COURT PASS (Apr. 20, 2010), available at <http://www.fullcourtpass.com/2010/04/sec-v-goldman-sachs-read-complaint.html>.

