TOWARD A MORE PERFECT SUBSTITUTE: HOW PRESSURE ON THE ISSUERS OF PRIVATE-LABEL MORTGAGE-BACKED SECURITIES CAN IMPROVE THE ACCURACY OF RATINGS

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From 2000 to 2007, individuals, institutions, and pension funds rushed to invest in private-label mortgage-backed securities (MBSs). They were attracted by reasonable returns and what they perceived to be very little risk. They were encouraged by agency ratings – incorporated into the offering documents – that rated each MBS as investment grade, often AAA.

With the beginning of the 2008 financial crisis, these same investors watched as their investments were downgraded to junk status, receiving ratings of CCC or worse. They sought redress against the issuers under section 11 of the Securities Act of 1933, which allows a harmed investor to recover damages where a registration statement contains an untrue statement of a material fact. Unfortunately – one after another – their lawsuits were dismissed on the grounds that a rating is not a material fact. Such reasoning defies reality. Ratings were the primary indicator of risk that investors considered when deciding whether they should invest in MBSs.

This Article proposes a novel solution. Where a harmed investor brings a cause of action pursuant to section 11 of the Securities Act of 1933 against a private-label MBS issuer, based upon an allegation that the registration statement contained an inaccurate rating, the burden should shift to the issuer to establish (1) that the loss model used was state of the art, and (2) all inputs were correct and up to date. If the issuer fails to meet this burden, then the plaintiff will have established a material misstatement, satisfying the most troublesome element of a section 11 claim.

In addition to allowing harmed investors an avenue for recovery, this Article’s proposal will also lead to better disclosure. Once private-label MBS issuers are liable for inaccurate ratings contained within MBS offering documents, they will choose rating agencies with a reputation for accuracy (not rating agencies with the reputation for giving the highest rating). This reputational pressure will lead to an improvement in loss models and inputs. Finally, the advantage of this proposal is that it allows investors an avenue to recovery, but with minimal government intervention, at least as compared to the new Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which freezes out private-label MBS issuers in favor of agency issuers like Fannie Mae and Freddie Mac.
INTRODUCTION

Mortgage-backed securities (MBSs)\(^1\) are fixed-income securities, where “payment on the securities is derived directly from collections on mortgage loans.”\(^2\) Investors in MBSs include banks, nonbank financial institutions, individuals, and pension funds.\(^3\) Investing is a risky business. In a perfect world, investors understand the risks associated with the security in which they

\(^1\) This Article focuses on the securitization of mortgages into MBSs, also called residential mortgage-backed securities (RMBSs). For a detailed discussion of the formation of an MBS, see infra Part I. For now, a brief explanation of MBSs will suffice:

The creation of MBS begins with a financial institution such as a bank or credit union extending a mortgage loan to a borrower. The lender will then “pool” groups of loans with similar characteristics to create securities themselves, or sell the loans to issuers of mortgage-backed securities [that] handle the aggregation of loans and pooling. The loans are sold to a trust, which will be the issuer of the MBS. Once securitized, the MBS can be sold to investors, or retained as investments.


are investing. For an MBS, those risks include, among others, the risk that borrowers might default on the underlying mortgages, the risk of recovery (or lack of recovery) in the event of default, and the risk that the tranche structure\(^4\) may not adequately protect investors.\(^5\)

Investors, however, live in an imperfect world. Consider just one of the aforementioned risks: default of the underlying mortgage. Even if the offering documents did provide prospective investors with all the data necessary to gauge the risk of default – such as a FICO score of the borrower,\(^6\) loan-to-value ratio, debt-to-income ratio, interest rate, the adjustability of the interest rate, and geographic location – it is doubtful that most investors could appreciate how the data compound for one borrower, let alone how the data compound across the thousands of mortgages that make up the MBS.\(^7\) In short, investors in MBSs had, and continue to have, an information problem.\(^8\) The information they had was imperfect, as was their ability to integrate that information.\(^9\) This sort of information problem leads to underestimating risk and overestimating value.\(^10\)

Professor Steven Schwarcz, a prolific author in the area of MBS disclosure, asserts that “complexity of the mortgage-backed securities made it difficult for investors to fully appreciate the risks they were incurring, tempting them to rely on such imperfect substitutes as rating-agency ratings and the results of

\(^{4}\) See infra Part I.C (discussing private-label issuers’ use of a tranche structure to confine risk to the lowest class of an offering). “Tranche is French for slice, or ‘a division or portion of a pool or whole,’” and “[i]n the private-label MBS context, tranche refers to an ‘issue of bonds derived from a pooling of like obligations.’” Horton, supra note 1, at 835 (quoting MERRIAM-WEBSTER’S DICTIONARY OF LAW 500 (1996)).

\(^{5}\) Steven McNamara, Informational Failures in Structured Finance and Dodd-Frank’s “Improvements to the Regulation of Credit Rating Agencies,” 17 FORDHAM J. CORP. & FIN. L. 665, 689-90 (2012) (observing that rating agencies’ rating models evaluated CDOs for default probabilities, recovery probabilities, and how these predicated losses would affect individual tranches).

\(^{6}\) “The FICO ratings system, created by the Fair Isaac Corporation, gives individual consumers credit scores that are meant to predict whether they will pay their debt obligations as expected by lenders.” David Reiss, Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market, 33 FLA. ST. U. L. REV. 985, 995 n.53 (2006).

\(^{7}\) Adam J. Levitin et al., The Dodd-Frank Act and Housing Finance: Can It Restore Private Risk Capital to the Securitization Market?, 29 YALE J. ON REG. 155, 165-66 (2012) (detailing the information provided by the prospectus and prospectus supplement, and asserting that investors cannot tell the relationship between the pieces of information).

\(^{8}\) Id. at 159 (arguing that MBS investors suffered from an information problem).

\(^{9}\) Id.

\(^{10}\) Adam J. Levitin & Susan M. Wachter, Explaining the Housing Bubble, 100 GEO. L.J. 1177, 1181 (2012) (“[Investors] underpriced for risk and thus oversupplied mortgage credit . . .”).
mathematical models.” If one accepts Professor Schwarcz’s explanation that ratings were imperfect substitutes for completely accurate information and the ability to integrate that information, then one solution is to improve the ratings – that is to say, move toward a more perfect substitute.

But how can ratings become more perfect, more accurate? The answer is relatively simple: place reputational pressure on the rating agencies to be accurate. That reputational pressure ideally should come from the issuer. That requires shifting the issuer’s concern away from a rating agency’s reputation for providing a high rating and toward the rating agency’s reputation for accuracy. Forcing such a shift will be difficult. Prior to the 2008 financial crisis, issuers were motivated by profit. Picking a rating agency that provided a high rating led to profit, because investors were encouraged to purchase the issuer’s MBSs. Furthermore, there was very little downside to incorporating an inaccurate rating into the registration statement, because the rating assigned by a rating agency was not the kind of material misstatement that gives rise to issuer liability, even where the rating was wildly overoptimistic. Absent


13 See infra Part III.A.

14 A material misstatement is a necessary element of an action brought pursuant to section 11 of the Securities Act. See TSC Indus. v. Northway, 426 U.S. 438, 449 (1976) (deciding that whether a fact is a material misstatement depends on whether “a reasonable shareholder would consider it important in deciding how to vote”).

15 See infra Part IV.C.
conduct approaching fraud, there was, and is, no issuer liability for incorporation of inaccurate ratings into the registration statement.

This Article proposes a simple burden-shifting procedure under section 11 of the Securities Act: where a plaintiff brings a cause of action pursuant to section 11 of the Securities Act against the issuer, alleging that an MBS (or similarly complex fixed-income security) registration statement incorporated an inaccurate rating, the burden should shift to the issuer to establish (1) that the loss model used by the rating agency was state of the art, and (2) all inputs used by the rating agency were correct and up to date. If the issuer fails to meet this burden, then the rating will be deemed a material misstatement within the registration statement, satisfying what is often the most troublesome element of a section 11 claim. While the foregoing burden-shifting formula is a relatively minor change to the operation of section 11, it will facilitate major improvements in disclosure, because the threat of litigation and liability is the major force driving accurate disclosure. If an issuer is responsible for the inaccuracy of a rating within its registration statement — such as AAA when it should be BBB+, or even CCC — then a rational issuer will minimize the risk of liability by hiring a rating agency with a strong reputation for accuracy. That will in turn incentivize the rating agency to provide accurate ratings.

The structure of this Article is as follows. Part I explains how mortgage finance grew in complexity over the past eighty years, culminating with the invention of agency MBSs and then private-label MBSs. Part II examines how the complexity in mortgage finance made it difficult for private-label MBS issuers to communicate risk to prospective investors, and how ratings eased that burden (that is to say, issuers relied on rating agencies to provide succinct

16 See Genesee Cnty. Emps. Ret. Sys. v. Thornburg Mortg. Sec. Trust 2006-3, 825 F. Supp. 2d 1082, 1193-95, 1203 (D.N.M. 2011) (denying the issuer’s motion to dismiss because there was evidence that the issuer actively participated in engineering false ratings).

17 Id. Likewise, there was no liability for a rating agency that created the inaccurate rating that was incorporated into the registration statement, and despite Dodd-Frank’s efforts, this will likely continue. See infra Part IV.B.


19 See infra Part V.

20 See infra Part IV.B.

21 Daniel J. Morrissey, Shareholder Litigation After the Meltdown, 114 W. Va. L. REV. 531, 546 (2012) (discussing the importance of shareholder remedies in overcoming the issues raised by MBSs); Michael L. Seigel, Bringing Coherence to Mens Rea Analysis for Securities-Related Offenses, 2006 WIS. L. REV. 1563, 1583 (commenting on civil enforcement, as well as the criminal alternative).

22 See infra Part V.D.

23 See infra Part V.D.
snapshots of risk: AAA, BBB+, and continuing down to CCC for extremely speculative investments). The rating became a proxy, a heuristic, for accurate information and the ability to integrate that information.24 Part III discusses how the loss models, and the inputs, failed. Implicit in this discussion is the proposition that the loss models and inputs need not fail; while they will never be absolutely perfect, they can be better, more accurate, and more perfect. The assertion that loss models can be more perfect is the most controversial part of this Article. Some scholars argue that it is impracticable, or maybe even impossible, for rating agencies to accurately rate structured financial instruments like MBSs because they are just too complex.25

Part III, however, argues that flaws in the rating process are identifiable and fixable.26 Rating agencies can be encouraged to use state-of-the-art models. Rating agencies can be encouraged to verify their loan-level data and regularly update macroeconomic trend data. Thus this Article is more than a critique. It presents a concrete solution implementable by courts: use section 11 and a simple burden-shifting procedure to shift the issuer’s focus to the rating agency’s reputation for accuracy.

Part IV discusses the current state of issuer liability (or lack of liability) under section 11 when the issuer incorporates inaccurate ratings into their registration statement. Specifically, when an MBS registration statement contained an inaccurate rating, it was very hard for an injured investor to show a material misstatement. In response to that problem, Part V contains a detailed explanation of this Article’s burden-shifting model. This model is a novel proposal that will make it easier for a harmed investor to sue the issuer when the registration statement contains a rating that “gets it wrong.” That, in turn, will put pressure on the issuer to hire a rating agency with a reputation for “getting it right.”

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25 Joshua Coval et al., The Economics of Structured Finance, 23 J. ECON. PERSP. 3, 20 (2009) (“[The] rating agencies did not fully appreciate the fragility of their estimates nor the possible effects of modest errors in assumptions about default correlations and probabilities in their credit ratings.”); Lois R. Lupica, The Consumer Debt Crisis and the Reinforcement of Class Position, 40 LOY. U. CHI. L.J. 557, 597 (2009) (“[R]ating agencies . . . failed to recognize some securitization’s . . . failings . . . .”); Schwarz, Regulating Complexity, supra note 11, at 223 (stating that not even the rating agencies fully understood MBSs).

26 See infra Part III. For another article arguing that the errors are identifiable and fixable, albeit through greater regulation, see Jason W. Parsont, NRSRO Nullification: Why Ratings Reform May Be in Peril, 77 BROOK. L. REV. 1015, 1020 (2012). Parsont lists several causes of inaccuracy, including failure of rating agencies to adhere to procedures and methods, failure to validate underlying information provided by mortgage originators, and cutting corners. Id. at 1024-28. All of these causes are fixable.
Finally, Part VI discusses, and attempts to rebut, some possible criticisms of this Article’s proposed burden-shifting model. One objection is that the rating agency, not the issuer, should face liability for inaccurate ratings; after all, it is the rating agency—not the issuer—that drafted the ratings. There are practical reasons for this Article’s focus on the issuer: the issuer cannot take advantage of the First Amendment defense that rating agencies have used to some success. Further, there are compelling policy reasons for holding the issuer—not the rating agency—liable for inaccurate ratings contained in the registration statement. First, the structure of section 11 evidences a legislative intent to hold the issuer primarily responsible for the registration statement it files; section 11 requires that the issuer face strict liability, while others involved in the offering process benefit from various defenses, including a due diligence defense. Further, the issuer is better able to economically shoulder civil liability than the rating agency. Civil liability would likely drive the rating agency from the offering process, unnecessarily removing its potential to play a constructive role in alleviating information asymmetries,27 and “narrow[ing] the information gap.”28

A second possible objection to this Article’s proposal is that Dodd-Frank already puts in place protections to prevent another housing bubble.29 Dodd-Frank’s requirement that private-label issuers provide more information, however, ignores the fact that much of the problem is traceable to information overload, not lack of information.30 Further, Dodd-Frank’s skin-in-the-game requirement will result in the marginalization of private-label MBS issuers, to the benefit of government-sponsored entities (GSEs), including Fannie Mae and Freddie Mac.31 A complete government takeover of housing finance by marginalizing private-label issuers will create its own set of problems, including a lack of competition, lack of transparency, and greater susceptibility to political pressure.32

27 See Jonathan R. Macey, The Regulator Effect in Financial Regulation, 98 CORNELL L. REV. 591, 598 (2013) (“[C]redit ratings from credit rating agencies were meant to ameliorate the contracting problem that results from the fact that contracting parties possess radically asymmetric information about the assets over which they are contracting.” (footnote omitted)); Steven L. Schwarz & Lucy Chang, The Custom-to-Failure Cycle, 62 DUKE L.J. 767, 772 (2012) (“Credit ratings are simplifying metrics for addressing information asymmetry between borrowers and lenders.”); Caleb Deats, Note, Talk That Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies from Regulation?, 110 COLUM. L. REV. 1818, 1824 (2010) (“[R]atings help issuers and investors overcome informational asymmetries.”).


30 See infra Part II.B.

31 See infra Part VI.B.

32 Thomas H. Stanton, The Failure of Fannie Mae and Freddie Mac and the Future of
I. MORTGAGE-BACKED SECURITIES: A HISTORICAL VIEW

President Franklin Roosevelt, in his address to the United States Savings and Loan League in 1942 stated, “[A] nation of home owners, of people who own a real share in their own land, is unconquerable.” President Ronald Reagan stated, “I firmly believe that the opportunity to own a home is part of the American dream,” and went on to quote Walt Whitman: “the final culmination of this vast and varied republic will be the production and perennial establishment of millions of comfortable city homesteads . . . healthy and independent, single separate ownership, fee simple, life in them complete but cheap, within reach of all.” A decade later, George H.W. Bush stated, “I believe that those on welfare, what they really want is a piece of the American dream: homeownership, a good job, opportunities for their children, and strong, loving families.” And thereafter, Bill Clinton stated that home ownership is “an essential part of the American dream we’re working hard to restore.”

When one considers the foregoing collection of presidential quotes, it becomes clear that the history of mortgage finance in the United States was shaped in large part by decades of pro-homeownership sentiment in Washington. There is, however, much more to the story. Sentiment alone—even with the power of the presidential bully pulpit—could not inflate an unsustainable housing bubble. The federal government implements policy through legislation, and the implementation of housing policy was no different: (1) the National Housing Act of 1934 (NHA) created the Federal Housing Administration (FHA) to insure mortgages and guarantee that banks would receive their mortgage payments; (2) the NHA was amended in 1938 to create Fannie Mae to purchase FHA-insured loans and provide banks with capital to make still more loans; (3) the Housing and Urban Development Act


33 Horton, supra note 1, at 843 (footnotes omitted) (alteration in original).

34 Id. at 843-44 (“[O]ne of the goals of every president since Franklin Delano Roosevelt has been to increase homeownership . . . . The only variation from administration to administration is the plan for reaching the goal.”).

35 National Housing Act, Pub. L. No. 73-479, 48 Stat. 1246 (1934) (“To encourage improvement in housing standards and conditions, to provide a system of mutual mortgage insurance, and for other purposes.”).

36 Peter M. Carrozzo, A New Deal for the American Mortgage: The Home Owners’ Loan Corporation, the National Housing Act and the Birth of the National Mortgage Market, 17 U. MIAMI BUS. L. REV. 1, 43 n.317, 44 (2008) (citing National Housing Act, ch. 847, sec. 2-13, § 201-514, 52 Stat. 8, 8-26 (1938)).
of 1968 transformed Fannie Mae from a government agency to a publicly traded corporation and allowed the FHA-insured mortgages it purchases on the secondary market to be bundled and sold as agency MBSs, infusing still more cash into the mortgage market; and (4) the Secondary Mortgage Market Enhancement Act of 1984 paved the way for private-label issuers to compete in the MBS market, infusing still more cash into the mortgage market. Not surprisingly, banks strongly supported this evolution, because each successive piece of legislation made it easier for the banks to maintain liquidity to originate more mortgages, which meant that the banks could make more money.

Along the foregoing legislative timeline, banks evolved from the “originate-and-hold” model for financing mortgages, to the “originate-and-sell” model, and then again to the “originate-and-securitize” model. Each advance increased the complexity of the process. Increased complexity increased information problems. Under the originate-and-sell model,
information was lost or distorted when the mortgage was sold from bank to investor. Under the originate-and-securitize model, information was lost or distorted when the mortgage was sold from bank to issuer and then again when the resulting securities were sold to the investor. Further, in the final step, the information problem compounded, because the risks associated with each of the thousands of mortgages combined during the formation of the MBS.

A. The Originate-and-Sell Model

The Stock Market Crash of 1929 and the Great Depression drastically reduced property values, weakening the housing market. The crash caused property values to decline by fifty percent. Due to the short term of home loans (five to ten years), and the prominence of adjustable rates and balloon payments, borrowers were dependent on their banks to refinance their loans. Unfortunately, “knowing their positions were insecure, [banks] refused to refinance loans that came due; as a result, borrowers defaulted, having neither the cash nor the home equity necessary to pay the loans back.” The result was a wave of foreclosures (about 250,000 per year between 1931 and 1935) that threw the United States deeper into depression. Congress reacted by creating the Federal Housing Administration (FHA) and the Federal National Mortgage Security Corporation (FNMA), which took the place of private mortgage companies. The FHA and FNMA permitted the purchase and securitization of mortgages that had previously been considered high risk.

securitization has long noted the informational asymmetries that exist between the originator and the investors regarding the securitized assets.

44 Levitin & Wachter, supra note 10, at 1230.
45 Bar-Gill, supra note 43, at 1081; Levitin & Wachter, supra note 10, at 1230.
46 Bar-Gill, supra note 43, at 1081 (stating that securitization creates numerous problems, including difficulty in assessing risk); Levitin & Wachter, supra note 10, at 1230.
48 Green & Wachter, supra note 47, at 94. Professor Robert J. Shiller at Yale created a Price Index often used by those researching the history of mortgage finance. See Robert J. Shiller, Online Data Robert Shiller, Yale Univ., http://www.econ.yale.edu/~shiller/data.htm (download Excel file that tracks “historical housing market data . . . showing home prices since 1890”) (last visited Oct. 16, 2013). Professor Shiller’s index, however, is adjusted for inflation, while Green and Wachter appear to be citing the nominal change in value. Therefore, while the two estimates for property value decline – Green and Wachter’s fifty percent and Shiller’s seven percent – appear in conflict at first blush, they are not. Also, in 2013, Professor Shiller won the Nobel Prize in economics for his work in asset pricing. See Brenda Cronin, Nobel Honors Asset Pricing, WALL ST. J., Oct. 15, 2013, at A2.
49 Green & Wachter, supra note 47, at 94.
50 Id.
51 Id.
Association (Fannie Mae). FHA insured the payments on mortgages, calming the nerves of banks and slowing the rate of foreclosure. Fannie Mae began to remove the toxic loans from the banks’ books by purchasing them.

Interestingly, with the end of the Great Depression, and thus the end of Fannie Mae’s ostensible purpose, Fannie Mae did not wind up. Fannie Mae continued buying mortgages that banks originated. Indeed, it expanded its work. Fannie Mae is currently the primary GSE tasked with creating a secondary market for mortgage debt by purchasing mortgages.

The continuation of Fannie Mae solidified the originate-and-sell model and allowed banks to overcome the liquidity restraint inherent in the prior originate-and-hold model. As the name implies, under the originate-and-sell

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52 Technically, Fannie Mae was the successor to the Home Owner’s Loan Corporation (HOLC). The HOLC, having performed its task, was disbanded in 1936. “In its place . . . Fannie Mae . . . was invented as a government agency in 1938 for the purpose of abetting a secondary market in FHA mortgages.” Id. at 95-96.

53 Id. at 95 (stating that the mortgage insurance provided by FHA was necessary for investors to “purchase mortgages with confidence”).

54 Id. (“The Home Owner’s Loan Corporation (HOLC) raised funds using government-backed bonds, used the funds to purchase defaulted mortgages from financial institutions and then reinstated the mortgages.”).

55 Id. at 95-98 (detailing the history of Fannie Mae, Freddie Mac, and Ginnie Mae after the Great Depression).

56 Id. (explaining that, when Fannie Mae was privatized, it was “able to buy and sell non-government-backed mortgages”).

57 Michael H. Schill, Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets, 64 S. Cal. L. Rev. 1261, 1267-71 (1991) (describing Fannie Mae’s activities and relevance after the Great Depression). Fannie Mae was created to purchase FHA-insured home loans from banks and hold them for its own account. Green & Wachter, supra note 47, at 95. Because the mortgages were guaranteed by FHA, they were a safe investment for the government; FHA would step in and make the payments if the borrower defaulted. Id. at 95, 111.

58 This Article often uses the terms GSE and Fannie Mae interchangeably. However, the reader should be aware that there are other GSEs that facilitate the secondary mortgage market, including Freddie Mac and Ginnie Mae. Green & Wachter, supra note 47, at 95-98 (explaining that in 1968, Fannie Mae split into two pieces – Ginnie Mae and the “new” Fannie Mae – and in 1970, Congress created Freddie Mac). For a quantitative comparison of originations, see Statistics, SEC. INDUS. & FIN. MKTS. ASS’N, http://www.sifma.org/research/statistics.aspx (under “structured finance” header, follow “US Agency Mortgage-Backed Securities Issuance and Outstanding”) (last updated Aug. 8, 2013).

59 Green & Wachter, supra note 47, at 99. Beyond serving as a buyer of mortgages, Fannie Mae expanded the secondary market by creating standardized underwriting policies, mortgage contracts, and loan documents that lenders used. Schill, supra note 57, at 1268. Prior to Fannie Mae, “[o]riginating lenders had found that individual mortgage loans were difficult to sell” because “the underwriting policies of lending institutions varied tremendously as did the mortgage contracts and loan documents that they used.” Id.

60 During the 1920s, banks followed the originate-and-hold model for home loans.
model, banks sold the loans they originated to Fannie Mae. By immediately selling each loan on the secondary market, a bank could replenish its capital, make another loan, and repeat ad infinitum. While the bank loses its right to interest payments on the underlying mortgage, the bank earns a profit by marking up the loan (often referred to as a servicing fee). The following hypothetical assists with comparing the originate-and-hold model with the originate-and-sell model:

[Under the originate-and-hold model] a bank would use deposits from Aaron, Bruce, Cynthia, and Dave (A, B, C, and D, respectively) to provide a mortgage to Zed as follows: A, B, C, and D each deposit $10,000. The bank now has $40,000. The bank receives a request from Zed (Z) for a mortgage, and given Z’s outstanding credit record, the bank agrees. The bank provides Z with a $40,000 mortgage at eight percent (8%) per annum over thirty years. Over the course of the loan, the bank is repaid the principal and earns $65,662.10 in interest.

The problem under the originate and hold model was that the deposits limited the amount of mortgages that could be originated by the bank. Other contenders – Zachary, Zar, Zen, and Zuzu (Z1, Z2, Z3, and Z4).

Immergluck, supra note 41, at 451-52, 465. Like the name implies, banks kept the rights to the home loans they originated in their own portfolio. Id. at 465 n.74. The downside of the model was that the number of home loans that a bank could make was limited by deposits, “since most were depository institutions – e.g., banks and credit unions.” Tess Wilkinson-Ryan, Breaching the Mortgage Contract: The Behavioral Economics of Strategic Default, 64 Vand. L. Rev. 1547, 1572 (2011). Put simply, if a bank had $100,000 in deposits, it was limited to originating $100,000 in home loans. Horton, supra note 1, at 842-43. Likewise, the bank’s ability to realize a profit was limited. If the bank paid three percent to its depositors, and charged six percent for a home loan, the bank made a profit of $3000, as illustrated: (100,000 * 0.6) – (100,000 * 0.3) = 3000. Id. The forgoing formula was so well accepted that it gave rise to the following yarn: “[Bankers] operat[e] according to a 3-6-3 rule: bankers gathered deposits at 3 percent, lent them at 6 percent, and were on the golf course by 3 o’clock in the afternoon.” John R. Walter, The 3-6-3 Rule: An Urban Myth?, 92 Fed. Res. Bank Richmond Econ. Q. 51, 51 (2006).

61 A. M. Burkhart, Real Estate Practice in the Twenty-First Century, 72 Mo. L. Rev. 1031, 1034 (2007).

62 See Dickerson, supra note 61, at 205-06 (stating that mortgage originators quickly sold the loans they originated).

63 United States v. James, 592 F.3d 1109, 1117 (10th Cir. 2010) (“When a mortgage is resold, a successor lender pays the amount of the original mortgage plus a markup equal to the original lender’s profit.”); see C.F. Sirmans & John D. Benjamin, Pricing Fixed Rate Mortgages: Some Empirical Evidence, 4 J. Fin. Serv. Res. 191, 199 (1990) (“The implied mark-up over the secondary market yield reflects the servicing fees, the commitment fee required by the secondary market, and the liquidity and default guarantees of the government-sponsored secondary market.”).
respectively) – each of whom had less stellar credit, were out of luck . . . .

[Under the originate-and-sell model], lenders have the option to [sell] the
mortgages that they originated . . . which provides the bank with more
liquidity (cash on hand) to facilitate the origination of still more
mortgages. Thus, in the example above, the bank could use the deposits
of A, B, C, and D to offer mortgages to Z, as well as Z1, Z2, Z3, Z4 . . .
the only limit is demand.\(^64\)

B. The Originate-and-Securitize Model

While a huge step in the evolutionary process, the originate-and-sell model
had limits. The amount of capital held by Fannie Mae limited the number of
loans that could be purchased (much like under the originate-and-hold model,
where the amount of loans that a bank could originate was limited by the
amount of capital held by the bank).\(^65\) To truly fuel the mortgage market a
broader base of capital was needed.\(^66\) Thus, “to provide a greater degree of
liquidity to the mortgage investment market and an additional means of
financing its operations,” in 1968 Fannie Mae was given the power “to issue
and sell securities based upon the mortgages [it purchased].”\(^67\) As one author
succinctly explained, “[w]hen [Fannie Mae] needed more capital to buy loans
from the primary market it would bundle the loans and sell mortgagor-
payment-rights to investors. This securitization process by Fannie . . . [became]
known as mortgage-backed securitization.”\(^68\)

By securitizing the mortgages and selling them to the public, Fannie Mae
gained access to the largest source of liquidity possible, the capital markets.\(^69\)

\(^64\) Horton, supra note 1, at 842 (footnotes omitted) (citing The Housing Decline: The
Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Fin., 109th
Cong. (2007) (statement of Michael Decker, Senior Managing Director, Research and
Public Policy, Securities Industry and Financial Markets Association)).

\(^65\) See supra note 59 and accompanying text.

\(^66\) See 12 U.S.C. § 1716(4) (2012) (declaring as one of the subchapter’s purposes to
“promote access to mortgage credit throughout the Nation . . . by increasing the liquidity of
mortgage investments and improving the distribution of investment capital available for
residential mortgage financing”).


\(^68\) Jacob Werrett, Note, Achieving Meaningful Mortgage Reform, 42 CONN. L. REV. 319,
325 (2009); see Richard W. Bartke, Fannie Mae and the Secondary Mortgage Market, 66
NW. U. L. REV. 1, 68 n.295 (1971) (discussing Fannie Mae raising money on the capital
markets by issuing MBSs); Burkhart, supra note 61, at 1034 (“To raise capital for these
purchases, the secondary market purchasers sell ownership shares in the pools of mortgages
they acquire or sell bonds that are secured by the mortgages . . . .”).

\(^69\) See Immergluck, supra note 41, at 467 (commenting on the importance of unrestricted
access to the capital markets); James Carlson, Note, To Assign, or Not to Assign: Rethinking
Assignee Liability as a Solution to the Subprime Mortgage Crisis, 2008 COLUM. BUS. L.
REV. 1021, 1023 (“Securitization allowed mortgage originators to shift lending risk to the
larger economy . . . .”).
Fannie Mae issued its first agency MBS in 1981, and was issuing over one trillion dollars annually by 2003. For much of that time, Fannie Mae functioned as a virtual monopoly, operating with the implicit backing (and guarantee) of the federal government.

C. Deregulation and the Rise of Private-Label MBSs

Change came with the deregulation of the 1980s. To spur homeownership, President Reagan encouraged private competition in the secondary mortgage market. He supported legislation that would encourage the small collection of private firms offering private-label MBSs. These efforts included the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), which exempted private-label MBSs from state blue sky laws, allowed national banks to invest in private-label MBSs, and allowed for shelf-registration of private-label MBSs, as well as the Real Estate Mortgage Investment Conduit (REMIC) provisions of the 1986 Tax Reform Act (TRA), which allowed private-label MBS issuers to avoid double taxation. The passage of the SMMEA and the TRA set the stage for an initial phase of growth in private-label MBS issuances from 1986 to 1988, and then a later phase of accelerated growth from 1996 to 2007 among private-label issuers, such as Countrywide, Wells Fargo, Lehman

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70 Statistics, supra note 58.
71 Darrell Issa, Unaffordable Housing and Political Kickbacks Rocked the American Economy, 33 Harv. J.L. & Pub. Pol’y 407, 408 (2010) (“Fannie Mae and Freddie Mac nearly achieved monopoly results thanks to numerous competitive advantages guaranteed through their unique relationship with the federal government.”).
72 Horton, supra note 1, at 846-47 (detailing the Reagan Revolution).
73 Id. at 847 (describing President Reagan’s plan to “determine which loans can be better handled by the private sector”).
74 See id. at 847-48 (observing a Senate report arguing “[i]t was time for the private sector to ‘assume a more significant role’ in funding mortgages”). This “small collection of private firms” included Bank of America, which issued the first MBS in 1977. See ABA Section of Taxation Comm. on Fin. Transactions Subcomm. on Asset Securitization, Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets, 46 Tax L. Rev. 299, 303-04, 304 n.11 (1991).
75 Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 106(c), 98 Stat. 1689, 1692 (“Any... mortgage related securities... shall be exempt from any law of any State with respect to or requiring registration...”).
76 Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 671, § 860A, 100 Stat. 2085, 2309 (“Except as otherwise provided in this part, a REMIC shall not be subject to taxation under this chapter...”).
77 With the passage of the SMMEA, by 1988, “the market for all mortgage securities, including privately sponsored securities, ha[d] reached that of municipal and corporate bonds.” Edward L. Pittman, Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 497 (1989).
Brothers, Bear Stearns, Washington Mutual, J.P. Morgan, Merrill Lynch, Morgan Stanley, and Deutsche Bank.\textsuperscript{78}

The actual private-label securitization process involves the originator, the investment bank that purchases the loan and the issuing trust, as follows:

The process for creating a RMBS\textsuperscript{79} begins when an arranger, generally an investment bank, packages mortgage loans – generally thousands of separate loans – into a pool, and transfers them to a trust that will issue securities collateralized by the pool. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the borrowers. The trust finances the purchase of the loan pool through the issuance of RMBS to investors. The monthly interest and principal payments from the loan pool are used to make monthly interest and principal payments to the investors in the RMBS.\textsuperscript{80}

The advent of private-label MBSs allowed for the growth of unconventional mortgage loans.\textsuperscript{81} Fannie Mae was confined to issuing securities backed by FHA mortgages, also called conventional mortgages.\textsuperscript{82} A conventional mortgage must conform with certain requirements; it “must not exceed maximums for three categories, including: (1) payment-to-income ratio . . . ; (2) loan-to-value ratio . . . ; and (3) loan amount . . . .”\textsuperscript{83} As one court observed: “By virtue of the GSEs operating in only a portion of the secondary mortgage market – that of conforming loans – there remained a need for a sophisticated secondary market for nonconforming loans that did not meet the GSEs’ strict underwriting criteria.”\textsuperscript{84} Private companies adapted to this need and began to


\textsuperscript{79} RMBSs are synonymous with private-label MBSs.

\textsuperscript{80} OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, supra note 1, at 6.

\textsuperscript{81} Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 17 (2008) (“[A] niche evolved for private companies to issue their own MBS featuring pools of loans that could not qualify for the GSEs’ MBS pools.”).

\textsuperscript{82} Id. (“Fannie Mae and Freddie Mac . . . issue securities comprised primarily of conventional mortgages.”).

\textsuperscript{83} Id.

\textsuperscript{84} Id. Interestingly, in the years leading up to the 2008 financial crisis, Fannie Mae tried to enter the market it had previously been prohibited from entering:

Fannie Mae faced the danger that the market would pass us by . . . . We were afraid that lenders would be selling products we weren’t buying and Congress would feel like we weren’t fulfilling our mission. The market was changing, and it’s our job to buy loans, so we had to change as well.

Duhigg, supra note 32, at A1 (quoting former Fannie Mae CEO Daniel Mudd). Freddie Mac faced the same pressure:

The subprime market was developed largely by private label participants, as were most non-traditional mortgage products. Freddie Mac entered the non-traditional slice of the market because, as the private lending sector shifted toward those types of loans,
“issue their own MBS featuring pools of loans that could not qualify for the GSEs’ MBS pools.”85 The growth in issuances, starting in the mid-1980s and accelerating in 1996, was accompanied by growth in complexity at the mortgage level and at the securitization level.86 At the mortgage level, fixed rates gave way to adjustable rates or “teaser rates,” which would adjust upward upon the happening of a trigger.87 At the securitization level, complexity was added when cash flows were sliced and diced into tranches, with the senior tranches receiving priority (over the cash flow) to ostensibly justify their AAA rating.88 The tranche structure (sometimes referred to as a “waterfall”) allowed the cash flow to pour to the next tranche after the senior tranche was full.89 Waterfall provisions, as explained by Professor Kathryn Judge, “set forth the rights of each of the different tranches” with the overall idea of “creat[ing] a hierarchical structure in which losses on the underlying loans are allocated first to the subordinate tranches.”90 Thus, the cash flow can suffer a certain level of loss (that is, from mortgage defaults) without compromising the rating of the senior tranche.91 The general consensus was that only a “thin cushion” of subordinate tranches would protect the senior tranches, “producing a great quantity of high-quality securities.”92 For example, consider a typical MBS offering, IndyMac Residential Mortgage Backed Certificates, Series 2006-L2.93 The two subordinate tranches in that offering made up only 1.3% of the

Freddie needed to participate in order to carry out its public mission of promoting affordability, liquidity and stability in housing finance. In addition, if it had not done so, it could not have remained competitive or even relevant in the residential mortgage market we were designed to serve. Stanton, supra note 32, at 229-30, 234-35 (quoting former Freddie Mac CEO Richard Syron).

85 Anchor, 81 Fed. Cl. at 17 (citing KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES: DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 1-2 to 1-3 (2001)). The other side of this coin is that the GSEs’ dominance crowded the private-label MBSs into risky subprime, alt-A, and jumbo loans. Horton, supra note 1, at 859-63 (“[I]f private-label issuers wanted to realize the profits that came with securitization, they were forced to use risky non-conforming mortgages.” Id. at 860-61).

86 Anchor, 81 Fed. Cl. at 17-18.

87 Judge, supra note 1, at 681.

88 Id. at 673.

89 Id.

90 Id.

91 Id.


93 IndyMac Residential Mortg.-Backed Trust Series 2006-L2, Prospectus (Form 424B5) (June 15, 2006) [hereinafter IndyMac Prospectus], available at http://www.sec.gov/Archives/edgar/data/1364578/000088237706002099/d522044_424b5.htm. The securities were issued by IndyMac MBS, Inc., a wholly owned subsidiary of IndyMac Bank, FSB. The latter entity originated or acquired the loans to be securitized. In re IndyMac Mortg-Backed
deal structure, and received a Baa3 and Ba2 rating, respectively. The remaining 98.3% of the deal structure received a AAA rating.

From 2000 to 2005, private-label issuers grew to possess almost as much market share as the GSEs. In 2005, private-label MBS issuances totaled $726 billion, while agency issuances totaled $983 billion. A comparison of their growth is set forth in Chart 1 below:

Chart 1. MBS Issuances (Billions of Dollars).

Mortgages became easy to obtain. The number of buyers (demand) skyrocketed. Home values increased by eighty percent when securitizations increased from $496.7 billion in 1996 to over $2 trillion in 2006.


94 IndyMac Prospectus, supra note 93, at 5.
95 Id.
96 Statistics, supra note 58.
97 Id.
98 Chart 1 is based on data from the Securities Industry and Financial Markets Association (SIFMA). See Statistics, supra note 58. The data for 2013 is based on the first ten months of that year.
99 Pittman, supra note 77, at 538-39 (“Since the adoption of SMMEA in 1984, the market for mortgage securities has grown significantly. . . . In 1988, for example, $71 billion in private mortgage securities were originated, compared with only $10 billion in 1984, the year SMMEA was adopted.” (citations omitted)).
100 A home worth $106,700 in the last quarter of 1996 was worth $192,200 by the last quarter of 2006. See Shiller, supra note 48.
101 Statistics, supra note 58.
Home prices, however, could not increase forever. In 2006, the median sales price for existing one-family homes plateaued at $221,900 and then in 2007 began to fall.\textsuperscript{102} By 2009, home prices had fallen thirty-two percent.\textsuperscript{103} Once a homeowner’s equity was gone (that is, his home was underwater), he could no longer refinance his mortgage to escape the expiration of the initial “teaser” interest rate.\textsuperscript{104} Beginning in 2007, when their interest rates increased, homeowners began to default on their mortgage payments.\textsuperscript{105} The loss in cash flow caused some private-label MBSs to default in payments to investors.\textsuperscript{106} It was at that moment that investors in private-label MBSs – perhaps for the first time – began to realize the risks associated with their investments,\textsuperscript{107} including the chances that the underlying mortgagees may default, the risk of recovery (or lack of recovery) in the event of default, and the risk that the tranche structure may not adequately protect them.\textsuperscript{108}

\begin{flushright}

\textsuperscript{103} Shiller, \textit{supra} note 48 (showing that a home worth $192,200 in the last quarter of 2006 was worth $130,900 in the last quarter of 2009).

\textsuperscript{104} Schwarcz, \textit{supra} note 2, at 1317 (“When home prices stopped appreciating and began collapsing, those borrowers were unable to refinance. Furthermore, many subprime mortgage loans had adjustable rates which increased after an initial ‘teaser’ period.”).

\textsuperscript{105} Id. (“As a result [of increasing interest rates and collapsing home prices], many risky borrowers began defaulting, causing some of the highly rated MBS, CDO, and ABS CDO securities—whose payment depended on collections from the underlying financial assets—to default or to have their credit ratings downgraded.” (footnote omitted)).

\textsuperscript{106} Id. MBSs that were structured to absorb default rates of 1.3\%, IndyMac Prospectus, \textit{supra} note 93, at 5, were experiencing defaults of 5\% or more, see \textit{infra} note 202 and accompanying text.

\textsuperscript{107} Due to the stranglehold of the GSEs over the conforming markets, private-label issuers securitized mortgages for subprime, alt-A, and jumbo originators. Horton, \textit{supra} note 1, at 859-63 (discussing the process by which private-label issuers securitize mortgages for these originators). These loans were riskier than conforming mortgages. Id. Further, risky mortgage lending was consistently encouraged by the federal government and fed by an investing class that believed that housing prices, and thus the value of MBSs, could only increase. Id. at 865 (quoting Jonathan R. Macey & Geoffrey P. Miller, \textit{The Community Reinvestment Act: An Economic Analysis}, 79 Va. L. Rev. 291, 320 (1993) (“[R]egulators award extra [Community Reinvestment Act] points to institutions that utilize ‘more flexible’ lending criteria when making [Community Reinvestment Act] loans. . . . [I]t is difficult to imagine what ‘more flexible’ could mean, if not risky . . . .”). When the risk finally manifested itself and borrowers stopped making payments on subprime, alt-A, and jumbo mortgages, the MBSs dependent on those cash flows plummeted in value. Id.

\textsuperscript{108} McNamara, \textit{supra} note 5, at 682 (discussing investor difficulties in evaluating risks and their assumption “that the supersenior tranches their institutions retained would in any event be safe as they sat at the very top of the tranched capital structures”).
The economic turmoil rippled outward, reaching even prime borrowers. They were the traditional bulwark against a total housing collapse “because of their ability to draw upon their equity to refinance.” They were, however, “unable to refinance during the bubble because falling home prices wiped out their equity.” Once the traditional bulwark gave way, “the spiral downward accelerated.” The end result is the current economic crisis.

While the outcome is obvious to us now, it was not then. As more fully explained in Part II, below, the disclosure mechanisms embodied in the Securities Act of 1933 failed to inform prospective investors of the risks of investing in MBSs, or if they did inform investors of the risks, those risks were so many and their interconnectivity so complex that investors often relied upon ratings from agencies like Fitch, Moody’s, and S&P to vouch for the quality of the MBSs. We now know that such ratings were faulty.

In Parts II, III, and IV, this Article describes what went wrong with the disclosure model as it applied to private-label MBSs, and more specifically, the ratings contained in such disclosures. In Part V, this Article proposes a solution, a way to make ratings a more perfect substitute for accurate information and the ability to integrate that information using section 11 of the Securities Act and a simple burden-shifting procedure.

II. HOW MBS COMPLEXITY OVERLOADED THE DISCLOSURE MODEL

A. The Disclosure Model in General

Louis D. Brandeis wrote in his 1914 book, Other People’s Money, “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.” In pushing for passage of the Securities Act of 1933,

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109 Horton, supra note 1, at 831 (citing Mark Zandi, Financial Shock 169 (2009)).
110 Id. (citing Zandi, supra note 109, at 169-70).
111 Id.
112 Id.
113 Id. Interestingly, this was a repeat of the events that occurred from 1931 to 1935, when banks refused to refinance mortgages. See Green & Wachter, supra note 47, at 94 (discussing how banks refused to modify adjustable-rate mortgages during the Great Depression).
115 Lynch, supra note 114, at 264 (commenting on credit rating agencies’ use of “seriously flawed” risk assessment models).
116 Louis D. Brandeis, Other People’s Money and How the Bankers Use It 92 (1913). Felix Frankfurter -- who assembled and led the drafting team that wrote the Securities Act of 1933 -- was heavily influenced by Louis D. Brandeis. See Amy Deen Westbrook, What’s in Your Portfolio? U.S. Investors Are Unknowingly Financing State
Franklin Roosevelt regularly mentioned *Other People’s Money* when emphasizing the importance of disclosure.\(^{117}\) The quote also reflects the belief at the time that businesses had taken advantage of major informational advantages in order to sell overvalued securities to investors:

> Investment bankers, brokers, dealers, corporate directors, and accountants had systematically overreached and cheated the American public out of their hard earned money during the 1920s – causing the Great Depression. Fully half of all securities floated during this period were worthless, “and [those] cold figures spell[ed] tragedy in the lives of thousands of individuals who [had] invested their life savings, accumulated after years of effort, in [those] worthless securities.”\(^{118}\)

Thus, it should come as no surprise that the Securities Act of 1933 incorporates a disclosure model “allow[ing] issuers to sell very risky or even unsound securities, provided they gave buyers enough information to make an informed investment decision.”\(^{119}\) The Securities Act provided that such information be provided in a registration statement,\(^{120}\) an often long document.\(^{121}\) Registration statements set out, among other things, the names of

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\(^{117}\) Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1072 (1995) (“In support of their arguments for a mandatory disclosure scheme, for example, President Roosevelt and congressional supporters of the Securities Act frequently quoted Louis Brandeis’s 1914 book, *Other People’s Money*.”).


\(^{121}\) For example, Google’s Initial Public Offering Registration Statement was over 160 pages, excluding exhibits, and more recently, Twitter’s Initial Public Offering Registration Statement was over 200 pages, excluding exhibits. Google Inc., Registration Statement (Form S-1) (Apr. 29, 2004), available at http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm; Twitter, Inc., Registration Statement (Form S-1) (Oct. 3, 2013), available at http://www.sec.gov/Archives/edgar/data/1418091/000119312513390321/d564001ds1.htm.
the directors, information about the business, risk factors, how the proceeds will be used, and financial information.\footnote{122}{Section 7 of the Securities Act states that the registration statement “shall contain the information, and be accompanied by the documents, specified in Schedule A” and “such other information, and be accompanied by such other documents, as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.” Securities Act of 1933 § 7, 15 U.S.C. § 77g; see 17 C.F.R. §§ 229.501-.512 (2013) (listing information that should be contained in registration statement).}

Further, pursuant to the Securities Act of 1933, an issuer or underwriter cannot even offer a security to a prospective investor without a prospectus, a shortened version of the registration statement.\footnote{123}{Securities Act of 1933 § 5(b) to (c), 15 U.S.C. § 77e(b) to (c) (requiring that an offer be accompanied by a prospectus); Securities Act of 1933 § 10(a)(1), 15 U.S.C. § 77j(a)(1) (“[A] prospectus relating to a security . . . shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of schedule A . . . .”).} By requiring a prospectus that warns of the risks associated with a given security, SEC ensures that all prospective investors have all “facts essential to a fair judgment upon the security offered.”\footnote{124}{Williams, supra note 116, at 1222 (quoting Felix Frankfurter, The Federal Securities Act: II, FORTUNE, Aug. 1933, at 53, 55).} The Securities Act prohibits any other communications that might contradict the prospectus or that might “arouse[e] and stimulat[e] investor and dealer interest” before the prospective investor can digest the information contained in the prospectus.\footnote{125}{In re Carl M. Loeb, Rhodes & Co., SEC Release No. 34-5870, 38 S.E.C. 843, 851 (1959) (holding that press releases publicizing an offering which are designed to stimulate interest in the offering violates section 5(c) of the Securities Act of 1933).} 

\subsection*{B. The Disclosure Model Applied to Private-Label MBSs}

Like any other security, MBSs must be registered pursuant to the Securities Act of 1933.\footnote{126}{Wendy Gerwick Couture, Price Fraud, 63 BAYLOR L. REV. 1, 21 n.106 (2011) (quoting TASK FORCE ON MORTG.-BACKED SEC. DISCLOSURE, STAFF REPORT: ENHANCING DISCLOSURE IN THE MORTGAGE-BACKED SECURITIES MARKETS 24 (2003), available at http://www.treasury.gov/resource-center/fin-mkts/Documents/disclosure.pdf).} The registration process can take a month or more,\footnote{127}{Andrew Seth Bogen, Note, The Impact of the SEC's Shelf Registration Rule on Underwriters' Due-Diligence Investigations, 51 GEO. WASH. L. REV. 767, 770 (1983) (“[A] corporation could often be delayed several months in making a securities offering because of time-consuming registration procedures.”).} and the issuer “has[s] to file with the SEC a separate registration statement for each new offering.”\footnote{128}{Horton, supra note 1, at 857 (citing Bogen, supra note 127, at 767).} This was problematic for issuers of MBSs, because “MBS[s] are extremely sensitive to interest rate fluctuations” and “issuers must be able to
take advantage of certain ‘windows of opportunity’ that will allow them to price and sell their securities at a favorable return.”

Rule 415’s shelf registration largely alleviates the timing problem. Rule 415 “permits an issuer’s filing of a single registration statement [i.e., a shelf registration] to satisfy reporting requirements for several offerings if the issuer periodically supplements that statement with certain new information.” Once the shelf registration is filed, the issuer can make numerous MBS offerings “off the shelf.” With each new MBS offering, in addition to a prospectus based on the shelf-registration statement, the investor is provided “a prospectus supplement disclosing the specific terms of the offering, including its structure and the characteristics underlying mortgages.”

The shelf-registration process – with its core prospectus and prospectus supplements – complicates the question of what documents are considered part of the registration statement for purposes of an action under section 11. As the Second Circuit explained in NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.:

The shelf registration process enables qualified issuers to offer [MBS] on a continuous basis by first filing a shelf registration statement and then subsequently filing separate prospectus supplements for each offering. The shelf registration statement includes a “base” or “core” prospectus that typically contains general information, including the types of securities to be offered and a description of the risk factors of the offering. It will generally not include transaction-specific details – such as pricing information, or information regarding the specific assets to be included in the vehicle from which the securities are issued – which is contained instead in the prospectus supplements.

By regulation, each new issuance requires amending the shelf registration statement, thereby creating a “new registration statement” for each issuance, that is “deemed effective only as to the securities specified therein as proposed to be offered.” “Amendments” to the shelf registration statement include the prospectus supplements unique to each offering. Thus, each of the 17 Offerings that NECA seeks to challenge is registered pursuant to a separate registration statement consisting of the

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129 Pittman, supra note 77, at 532.

130 Horton, supra note 1, at 856. Rule 415, which governs shelf registration, provides: Securities may be registered for an offering to be made on a continuous or delayed basis in the future, Provided, That: The registration statement pertains only to: . . . (vii) Mortgage related securities, including such securities as mortgage backed debt and mortgage participation or pass through certificates.

131 Horton, supra note 1, at 857 (quoting Bogen, supra note 127, at 767).

132 Pittman, supra note 77, at 533.

133 Id.
same Shelf Registration Statement and a unique Prospectus Supplement.\textsuperscript{134}

The Second Circuit concluded that the registration statement referred to in section 11 is different for each offering – even if every offering’s registration statement includes the same shelf registration statement.\textsuperscript{135}

The registration statement should accurately disclose information to investors.\textsuperscript{136} Mortgage securitization is, however, a multistep process in which each step becomes increasingly complex and increasingly prone to information problems.\textsuperscript{137} It should come as no surprise that “homeowners know more about their risks than mortgage originators, who in turn have information advantages over other mortgage securitization intermediaries and MBS investors.”\textsuperscript{138}

Within the registration statement are the risk factors associated with the MBS.\textsuperscript{139} Risk factors will vary by offering, but include those that serve as an indicator of the risk of default of the underlying mortgages, including interest rates, loan-to-value (LTV) ratios, and the creditworthiness of underlying borrowers.\textsuperscript{140} MBS registration statements did provide the investor with information, but it was a \textit{flood} of information.\textsuperscript{141} It is that flood that causes the problem, as explained by Professors Levitin, Pavlov, and Wachter:

\begin{itemize}
\item[\textsuperscript{134}] NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co., 693 F.3d 145, 150-51 (2d Cir. 2012) (citations omitted).
\item[\textsuperscript{135}] See id. at 157.
\item[\textsuperscript{136}] Levitin et al., \textit{supra} note 7, at 165.
\item[\textsuperscript{137}] \textit{Id.} (“MBS investors receive limited information about the mortgages backing an MBS issuance, and the quality of that information is dubious.”).
\item[\textsuperscript{138}] \textit{Id.}
\item[\textsuperscript{139}] SEC regulations require that the registration statement meet the following requirements: Where appropriate, provide under the caption “Risk Factors” a discussion of the most significant factors that make the offering speculative or risky. This discussion must be concise and organized logically. Do not present risks that could apply to any issuer or any offering. Explain how the risk affects the issuer or the securities being offered. \textit{17} C.F.R. \textsection 229.503(c) (2013).
\item[\textsuperscript{140}] The supplemental prospectus for the IndyMac Residential Mortgage Backed Trust Series 2006-L2 disclosed raw data, such as the value of the underlying asset (appraisal information), LTV ratios, and payment-to-income ratios. IndyMac Prospectus, \textit{supra} note 93. Other examples include geographic location of the mortgaged homes, the credit rating of the borrowers, the loan terms (rate, balloon payments, etc.), and LTV ratios. \textit{Id.}
\item[\textsuperscript{141}] According to Foote, Gerardi, and Willen:
Simply put, the market for mortgage investments was awash in information.
To start with, prospectuses for pools of loans provided detailed information on the underlying loans at the time they were originated. This information included the distributions of the key credit-quality variables, such LTV ratios, documentation status, and borrower credit scores. More importantly, they provided conditional distributions showing, for example, the share of borrowers with FICO scores between 600 and 619 or the share of borrowers with LTV ratios between 95 and 99 percent. In many cases, issuers provided loan-level details in what was known as a “free writing prospectus.”
\end{itemize}
An MBS investor will have access to the prospectus and, more importantly, the prospectus supplement. These documents tell investors about the weighted averages of a variety of loan, borrower, property characteristics, and underwriting characteristics – LTV, FICO, state, loan size, amortization, loan term, loan type, for example. It might also give some distributional breakdown, by quintiles. What is impossible for investors to tell, however, in most cases, is the relationship between these terms.

Consider two securitizations, each of two loans. One has a loan with a high LTV ratio and a low FICO and another loan with a low LTV ratio and a high FICO. The other has a loan with a high FICO and a high LTV ratio and a loan with a low FICO and a low LTV ratio. The average FICO and LTV for both securitization pools may be the same, but it cannot be assumed that the pools present equal risks. Absent the ability to correlate loan characteristics, weighted averages are of limited use.142

III. THE RISE (AND FALL) OF RATINGS AS A REMEDY FOR INFORMATION PROBLEMS

A. The Importance of Ratings

Faced with the complex interplay of discrete facts, investors realized they could not engage in “‘do-it-yourself’ financial analysis of opaque debt instruments.”143 By using “opaque,” this Article does not refer to lack of information, but to the fact that the many distinct pieces of information combined in ways that confounded the reader of the prospectus. Investors began to rely on the ratings to break through the opacity. Ratings integrate “both public disclosures and nonpublic information on issuers and reduce risks to discrete categories for the market to process.”144 Thus, today’s registration statements (or at least those statements pre-2008) prominently include the rating given by rating agencies, ranging from AAA for investment grade to CCC for extremely speculative, which is included to help investors understand the risks associated with the investment.145 Below is a reproduction of the


142 Levitin et al., supra note 7, at 165-66.

143 McNamara, supra note 5, at 681 n.54 (quoting John C. Coffee, Jr., Ratings Reform: The Good, the Bad, and the Ugly 4 (The Ctr. for Law & Econ. Studies, Columbia Univ. Sch. of Law, Columbia Law & Econ. Working Paper No. 359, 2010)).

144 Manns, supra note 114, at 1035.

ratings provided in the prospectus supplement for IndyMac MBSs, Series 2006-L2.

Chart 2. Ratings for IndyMac MBSs, Series 2006-L2.146

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<th>Class</th>
<th>Initial Class Certificate</th>
<th>Principal Balance</th>
<th>Expected Final Scheduled Distribution Date</th>
<th>Initial Rating (Moody’s)</th>
<th>Initial Rating (S&amp;P)</th>
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<tbody>
<tr>
<td>Offered Certificates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A-1</td>
<td>$126,935,000</td>
<td>May 2008</td>
<td>Aaa</td>
<td>AAA</td>
<td></td>
</tr>
<tr>
<td>A-2</td>
<td>$67,521,000</td>
<td>May 2011</td>
<td>Aaa</td>
<td>AAA</td>
<td></td>
</tr>
<tr>
<td>A-3</td>
<td>$28,235,000</td>
<td>May 2011</td>
<td>Aaa</td>
<td>AAA</td>
<td></td>
</tr>
<tr>
<td>M</td>
<td>$1,016,000</td>
<td>May 2011</td>
<td>Baa3</td>
<td>NR</td>
<td></td>
</tr>
<tr>
<td>Nonoffered Certificates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Class B</td>
<td>$2,031,000</td>
<td>N/A</td>
<td>Ba2</td>
<td>NR</td>
<td></td>
</tr>
<tr>
<td>Class C</td>
<td>. . .</td>
<td>N/A</td>
<td>NR</td>
<td>NR</td>
<td></td>
</tr>
<tr>
<td>Class R</td>
<td>N/A</td>
<td>N/A</td>
<td>NR</td>
<td>NR</td>
<td></td>
</tr>
</tbody>
</table>

Classes A-1, A-2, and A-3 received a Aaa rating, signifying investment grade. Class M received a Baa3 rating, barely investment grade. Class B received a Ba2, or noninvestment grade, rating. The chart below explains the relationship of the various ratings to each other.

Chart 3. Credit Rating Scale.147

<table>
<thead>
<tr>
<th>Credit Quality</th>
<th>Moody’s</th>
<th>S&amp;P</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Grade</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highest Credit Quality</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>High Credit Quality</td>
<td>Aa1 to Aa3</td>
<td>AA+ to AA-</td>
<td>AA</td>
</tr>
<tr>
<td>Strong Payment Capacity</td>
<td>A1 to A3</td>
<td>A+ to A-</td>
<td>A</td>
</tr>
<tr>
<td>Adequate Payment Capacity</td>
<td>Baa1 to Baa3</td>
<td>BBB+ to BBB-</td>
<td>BBB</td>
</tr>
<tr>
<td>Speculative Grade</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Possibility of Credit Risk</td>
<td>Ba1 to Ba3</td>
<td>BB+ to BB-</td>
<td>BB</td>
</tr>
<tr>
<td>Significant Credit Risk</td>
<td>B1 to B3</td>
<td>B+ to B-</td>
<td>B</td>
</tr>
<tr>
<td>High Credit Risk</td>
<td>Caa1 to Caa3</td>
<td>CCC+ to CCC-</td>
<td>CCC</td>
</tr>
<tr>
<td>Default Is Likely/Imminent</td>
<td>Ca</td>
<td>CC, C</td>
<td>CC, C</td>
</tr>
<tr>
<td>In Default</td>
<td>C</td>
<td>SD, D</td>
<td>D</td>
</tr>
</tbody>
</table>

Manns, supra note 114, at 1013-14 (discussing ratings agencies as proxies for risk).

146 Chart 2 draws from information included in the IndyMac Prospectus. See IndyMac Prospectus, supra note 93, at 7.

In discussing how rating agencies failed, we often lose sight of the important role they can play in alleviating information discrepancies if they are correct (and that is a big if). In the seventeenth and eighteenth centuries, colonial importers extended credit to merchants. Even where information about the merchant could be obtained – for example, through letters of credit – “the process was tediously slow.” As a result, importers often misjudged the creditworthiness of their customers. Payments were often late if they came at all.

At some point, these importers began to rely on others to judge the creditworthiness of their customers. Firms sprang up that could take advantage of “economies of scale associated with gathering and disseminating credit information in a systematic, organized way.” These firms were called mercantile credit rating agencies. They “assessed the ability of merchants to pay their financial obligations and sold these assessments to businesses who would then use this information to help them decide whether or not to lend or provide other financing to a particular merchant and, if so, under what terms.”

The first modern rating agency – what eventually became Moody’s – was created in 1909 in New York City to rate railroad, utility, and industrial bonds. When it came to rating industrial bonds, rating agencies – including

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150 *Id.*

151 *Id.* (“[L]etters of reference were faked or forged . . . .”).

152 *Id.*

153 *Id.*

154 *Id.*


156 *Id.* at 23 (footnote omitted).

157 Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK N.Y. Q. REV., Summer-Fall 1994, at 1, 2; Lynch, *supra* note 114, at 237 (“In 1909, John Moody formed the first company focused specifically on assessing the ability of businesses to pay amounts due on the bonds they issued.”); Elizabeth Devine, *Note, The Collapse of an Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FORDHAM J. CORP. & FIN. L. 177, 179 (2011) (“Rating agencies have been around for about a century, beginning in 1909 when John Moody set about synthesizing all types of credit information into a single rating, publishing a manual called ‘Moody’s Analyses of Railroad Investments.’”).
Moody’s – developed a reputation for accuracy.\textsuperscript{158} In a 2002 study of ratings given to industrial firms, Professors Baker and Mansi found that a vast majority of institutional investors believe published ratings of industrial bonds accurately reflected their issuers’ creditworthiness.\textsuperscript{159} While 82.3\% of institutional investors believed that the ratings were accurate or overstated risk, only 17.7\% of institutional investors believed that the ratings understated risk.\textsuperscript{160}

Of course, rating a bond issued by an industrial firm (for example, Caterpillar) is different than rating a bond issued by a financial institution (for example, Countrywide). The rating agencies, however, developed a reputation for accurately rating MBSs as well.\textsuperscript{161} In fact, the early concern was that rating agencies may have been too conservative in determining whether the investors in MBSs will get paid.\textsuperscript{162} There was a concern that rating agencies would assign a AA rating to an MBS when the actual risk of loss would be better reflected by a AAA rating, stifling the burgeoning securitization industry, which was “by far the most rapidly growing segment of the U.S. credit markets.”\textsuperscript{163} In short, prior to the financial crisis, rating agencies were seen as accurate – or even too conservative – raters of MBSs.\textsuperscript{164}

Even more importantly, rating agencies served a second purpose. Investors lacked accurate information or the ability to integrate that information. MBSs, more than any other type of security, created information problems. Rating agencies were seen as a way to alleviate those problems:

Even if most outside investors cannot value accurately the securitized assets, rating agencies may be able to act as intermediaries that rate asset-backed securities and thus mitigate the informational asymmetries

\textsuperscript{158} Cantor & Packer, supra note 157, at 9 (finding in a study that excludes asset-backed bonds that, historically, “the agencies do a reasonable job of assessing relative credit risks”).

\textsuperscript{159} H. Kent Baker & Sattar A. Mansi, Assessing Credit Agencies by Bond Issuers and Institutional Investors, 29 J. BUS. FIN. & ACCT. 1367, 1391-92 & tbl.11 (2002) (“[A] majority of issuers (69.6\%) and investors (63.5\%) believe that bond ratings accurately reflect their issuers’ creditworthiness, but they differ about whether bond ratings overstate or understate risk.”).

\textsuperscript{160} Id. at 1392 tbl.11 (showing that 63.5\% of investors believe bond ratings accurately reflect issuer’s creditworthiness, 18.8\% believe the ratings overstate risk, and 17.7\% believe that ratings understate risk).

\textsuperscript{161} In the late 1980s, Moody’s began rating MBSs. Cantor & Packer, supra note 157, at 19 (“In the mid-1980s, Standard and Poor’s was the undisputed leader in MBS and ABS ratings. In the late 1980s, Moody’s caught up considerably . . . .”).


\textsuperscript{163} Lynn M. LoPucki, The Death of Liability, 106 YALE L.J. 1, 24 (1996).

\textsuperscript{164} Schwarcz, supra note 162, at 18 (discussing a conservative bias against innovation at rating agencies).
between insiders and outsiders. Bond-rating agencies may not provide the most accurate classification – that is, the classification may not be based on the full set of information held by insiders – but such classification does help convey information to outside investors.\(^{165}\)

The rating agencies were so trusted to “narrow the information gap”\(^{166}\) that SEC actively promoted the use of ratings in the disclosure process.\(^{167}\) Specifically, “[i]n 1981, the SEC announced a new policy intended to encourage the disclosure of security ratings in registration statements.”\(^{168}\) As part of that policy, “SEC promulgated Rule 436(g), which provides that ratings are not to be considered part of the registration statement ‘prepared or certified by a person within the meaning of sections 7 and 11 of the [1933] Act.’”\(^{169}\) The intent of the rule was to “exclude any [rating agency] whose security rating is disclosed in a registration statement from civil liability under Section 11.”\(^{170}\)

This was accompanied by a growing use of ratings in statutes and regulations.\(^{171}\) The SMMEA “required state regulators to treat [private-label MBSs] that receive high credit ratings as the equivalent of U.S. government obligations . . . effectively requir[ing] states to permit insurers to invest in high-rated mortgage-backed securities.”\(^{172}\) Thus, state insurance regulations that allowed insurance companies to invest twenty-five percent of investments in government bonds were expanded to allow twenty-five percent of investments in investment-grade RMBSs.\(^{173}\) This opened up a large new market for private-label MBSs – if the MBSs received an investment-grade rating.


\(^{166}\) Anand, supra note 28, at 438.

\(^{167}\) In re Lehman Bros. Mortg.-Backed Sec. Litig., 650 F.3d 167, 183 n.11 (2d Cir. 2011) (identifying an SEC policy to promote inclusion of credit agency ratings in registration statements).

\(^{168}\) Id.

\(^{169}\) Id. (quoting 17 C.F.R. § 230.436(g)(1) (2013)).


\(^{171}\) John Patrick Hunt, *Rating Dependent Regulation of Insurance*, 17 CONN. INS. L.J. 101, 119 (2010) (discussing state laws for insurer investments, in which regulations “frequently include ratings-based criteria for permitted investments”). But see John C. Coffee, Jr., *Systematic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 838 (2011) (“[T]he legal need for institutions to receive investment grade ratings from ratings agencies as a precondition to debt purchases has been largely curtailed by the Dodd-Frank Act, which deleted most federal statutory references requiring such ratings.”).

\(^{172}\) Hunt, supra note 171, at 121 (footnote omitted).

\(^{173}\) Id. at 122; Pittman, supra note 77, at 519 n.103.
At the federal level, the Federal Deposit Insurance Corporation (FDIC) ensured that commercial banks were allowed to invest in investment-grade MBSs. Likewise, savings and loans – the mortgage-focused cousin of the commercial bank – could invest in MBSs that were investment grade. Beyond the insurance companies, commercial banks, and savings and loans, the final large targets for MBSs were pension funds. The Employment Retirement Income Security Act (ERISA) requires that pension fund managers invest in MBSs that have an investment-grade rating. Many pension fund documents also restrict managers to investing in MBSs rated AAA.

The result of the foregoing web of regulatory requirements was a huge market for MBSs with a AAA rating. That placed a large amount of pressure on issuers to obtain high ratings for their particular MBSs. As explained below, rating agencies provided such ratings, but the culprit was more than just conflicts of interest; it was problems with loss models and inputs.

B. The Failure of Ratings: Conflicts of Interest

In response to growing complexity – and with SEC’s active encouragement – MBS issuers began outsourcing warnings about risk to rating agencies. Or perhaps it is more accurate to say that investors began to outsource risk determinations to rating agencies, looking to the agency-assigned rating rather than the underlying facts. Either way, outsourcing alone was not a problem.

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174 See 12 C.F.R. § 1.3 (2013) (providing that a national bank may invest in “investment grade” securities); Partnoy, supra note 148, at 692 n.349. These requirements are overseen by the Office of the Comptroller of the Currency (OCC). See 12 U.S.C. § 24 (2012) (providing that investments by a national bank are subject to regulations promulgated by OCC); 12 C.F.R. § 1.2 (defining “investment grade”).

175 12 U.S.C. § 1831e(d)(1) (“No savings association may . . . acquire or retain any corporate debt security not of investment grade.”). “[I]nvestment grade” meant “rated in one of the 4 highest rating categories by at least one nationally recognized statistical rating organization.” Id. § 1831e(d)(4)(A) (1994). Money market mutual funds are restricted to investing in MBSs that “have received credit ratings from [nationally recognized credit rating agencies] in one of the two highest short-term rating categories.” Mark J. Flannery et al., Credit Default Swap Spreads as Viable Substitutes for Credit Ratings, 158 U. PA. L. REV. 2085, 2094 n.34 (2010) (citing SEC Money Market Funds, 17 C.F.R. § 270.2a-7 (2009)).

176 See Jennifer E. Bethel et al., Legal and Economic Issues in Litigation Arising from the 2007-08 Credit Crisis, in PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 163, 176 (Yasuyuki Fuchita et al. eds., Brookings Institution Press 2009) (“For ERISA fiduciaries, who must ‘use care, skill, prudence, and diligence’ in the course of investing plan assets, purchasing unrated RMBS and CDOs runs the legal risk that the instruments may be deemed imprudent.”).

177 Id. at 176 (“[I]nstitutional bond buyers are subject to legal limitations that permit them to buy only investment-grade or AAA-rated debt.”).
Outsourcing became problematic when the ratings were compromised by bad loss models incorporating inaccurate inputs.\textsuperscript{178}

The argument that conflicts of interest caused inaccurate ratings is well represented in the literature.\textsuperscript{179} The argument, in summary, is that the conflict of interest was caused by the issuer-pays model: (i) the issuer paid the rating agency for the MBS rating (making the issuer, not the investor, the customer), and (ii) the rating agency kept the customer (issuer) happy by providing AAA ratings.\textsuperscript{180} Indeed the conflict-of-interest argument has much to recommend it,\textsuperscript{181} including the axiom that the simplest explanation is often the correct one.\textsuperscript{182} The conflict-of-interest argument is so widely accepted that Dodd-Frank has ordered SEC to “carry out a study of . . . the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay . . . model[,],”\textsuperscript{183} and instructed SEC to thereafter “establish a system for the assignment of nationally recognized [rating agencies] to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer . . . from selecting the nationally recognized [rating agencies] that will determine the initial credit ratings and monitor such credit ratings.”\textsuperscript{184}

There are those, however, that reject the contention that “[i]ssuers could, and [did], ‘buy’ high ratings from willing sellers” as overly simplistic.\textsuperscript{185} Such


\textsuperscript{179} See, e.g., Kia Dennis, \textit{The Ratings Game: Explaining Rating Agency Failures in the Build up to the Financial Crisis}, 63 \textit{U. MIAMI L. REV.} 1111, 1136 (2009) (“A common criticism . . . is that reputational incentives are often outweighed by the conflict of interest inherent in the issuer pay model.”); Hill, supra note 92, at 586; Lynch, supra note 114, at 246 (“The transformation from a revenue model, in which investors paid for credit rating agency services, to one in which issuers pay, created a significant conflict of interest.”).

\textsuperscript{180} Dennis, supra note 179, at 1114 (“Lawmakers have recognized several discrete issues that undermine rating agencies’ performance [including] conflicts of interests arising out of the fact that agencies are paid by the issuers of the instruments they are hired to rate . . ..”); Lynch, supra note 114, at 246-47 (explaining but faulting the issuer-pays model).

\textsuperscript{181} During the real estate boom, forty-four percent of Moody’s revenue came from structured finance. Under such circumstances, it is plausible that the rating agency feared that it would lose a significant portion of its business if it did not provide a AAA rating; thus, providing a AAA rating became a matter of survival. Dennis, supra note 179, at 1136 (discussing the increased proportion of Moody’s total revenue that came from rating structured finance between 1998 and 2006).

\textsuperscript{182} The “Principle of Parsimony,” known as “Ockham’s Razor,” states that explanations “should not be multiplied needlessly,” that is, the simplest of two or more competing theories is preferable. \textit{The AMERICAN HERITAGE COLLEGE DICTIONARY} 944 (3d ed. 1993).


\textsuperscript{184} Id.

\textsuperscript{185} Hill, supra note 92, at 585.
skepticism is based upon a belief that a rating agency’s reputation is paramount, that is to say, “if investors think high ratings can be bought, the ratings will be worthless, and rating agencies will lose all their business.” Skeptics point out that “[i]ssuers also pay rating agencies to rate their corporate bond issues, yet very few corporate bond issues are rated AAA. If the rating agencies were selling high ratings, why weren’t high ratings sold for corporate bonds?” The skeptics forward an alternative explanation: that the “rating agencies ‘drank the Kool-Aid.’ They convinced themselves that the transaction structures could do what they were touted as being able to do: with only a thin cushion of support, produce a great quantity of high-quality securities.”

Each explanation has some merit. On the one hand, the issuer-pays model likely did create incentives for rating agencies to provide high ratings. On the other hand, the rating agencies must have “drank the Kool-Aid,” because it is a bizarre world if rating agencies would knowingly commit reputational suicide by selling ratings. The two explanations, however, need not be mutually exclusive. It is very possible that the rating agencies wanted to keep the issuers happy by providing high ratings, and the MBS structure allowed agencies to believe that such ratings were warranted and thus not a liability to their reputations.

C. The Failure of Ratings: Models and Inputs

Scholars focus on the issuer-pays model and associated conflict of interest as the cause of inaccurate ratings. However, conflicts of interest were at best an exacerbating factor in the inflation of ratings. Largely overlooked is the greater cause: problems with the loss models and inputs. This Article’s discussion of the rating process focuses on Moody’s because of Moody’s cooperation with the Financial Crisis Inquiry Commission (FCIC) investigation following the 2008 financial crisis. The FCIC report is one of the best sources for information on the rating process because it includes a detailed discussion of

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186 Id. at 596.
187 Id. at 585-86 (footnote omitted).
188 Id. at 586; see Staff of S. Subcomm. on Investigations, S. Comm. on Homeland Sec. & Governmental Affairs, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 277-78 (2011) (discussing statements by Moody’s Chief Credit Officer, including an internal email in which he said “we ‘drink the kool-aid’”).
189 There are several notable exceptions. See Dennis, supra note 179, at 1124-26 (“[A]gencies based their rating models on historical data that did not reflect the characteristics of subprime mortgages and subprime mortgage pools.”); McNamara, supra note 5, at 689 (“The mathematical rating models are the key to the ratings process.”); Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions (May 14, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=1027475) (arguing that methods used to rate bonds were inappropriately applied to the RMBS ratings process).
the models used as well as the loan-level and macroeconomic inputs. The following is a summary of the Moody’s multistep process:

1. Collect loan-level data;
2. Create macroeconomic trend data;
3. Input the data into the loss model to calculate the expected loss;
4. Assign a probability (Monte Carlo simulation) of each loss model;
5. Average the product of the probability and the loss to get the expected loss; and
6. Apply the expected loss to the finance structure (waterfall) to assign a rating to each tranche.

A visual representation of the above process (as more fully explained over the following pages) is set forth in Chart 4, below.

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190 See FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT, AUTHORIZED EDITION: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 120-21 (2011) (discussing the mathematical components and personal judgment components of the Moody’s credit-rating process). A definitive explanation is beyond the scope of this Article, partly because rating agencies jealously guard their models, which are trade secrets. In implementing the Credit Rating Agency Reform Act of 2006 (CRARA), and specifically its requirement of greater transparency, SEC expressed concern that too much transparency may compromise the rating agencies’ “proprietary models,” and thus SEC promulgated regulations that required only a “description of the . . . methodologies (not the submission and disclosure of each actual . . . methodology).” Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564, 33,575 (June 18, 2007); see Jeffrey A. Nemecek, Municipal Securities and Financial Institutions: Proposals for Reform, 30 MUN. FIN. J. 61, 77 (2009) (discussing SEC’s reluctance to expose the credit rating agencies’ proprietary models).

191 FIN. CRISIS INQUIRY COMM’N, supra note 147, at 14, 45; OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, supra note 1, at 7-8 (explaining how rating agencies determine possible losses).
The loan-level inputs and macroeconomic inputs are run through 1250 loss models. Each model is given a weight based on its probability. Then they are averaged. The result is the expected loss, which is deducted from the “perfect world cash flow” (“perfect world” because it assumes no borrower ever defaults) to get the “expected actual cash flow.” The expected actual cash flow is applied to the financial structure (waterfall). Each tranche’s position in the waterfall structure determines the likelihood that it will be impacted by a reduction in cash flow. It follows that the senior tranche receives an investment-grade rating, while the junior tranche does not.
1. Collect Loan-Level Data (Step 1)

The first step in calculating the expected loss was to collect data on the underlying mortgages (loan-level inputs). Loan-level inputs included both loan characteristics and borrower characteristics.\(^{193}\) On one hand, “[l]oan characteristics include information about the . . . interest rate and whether the loan is for the purchase of the home as a residence or for investment purposes.”\(^{194}\) On the other hand, “borrower characteristics include FICO score, debt-to-income ratio and income documentation levels.”\(^{195}\) The problem with collecting loan-level data was information asymmetry\(^{196}\) caused by many steps in the securitization process: information was lost from borrower to originator, then again from originator to securitizer, then again from securitizer to rating agency.\(^{197}\)

2. Assume Macroeconomic Trend Data (Step 2)

The next step was to create/assume the macroeconomic trends that would distinguish the different loss models into which the loan-level inputs are fed (Moody’s used 1250 loss models).\(^{198}\) The macroeconomic inputs include national trends in home values, interest rates, unemployment, and recovery rates and correlation.\(^{199}\) Like the loan-level inputs, the macroeconomic inputs

\(^{193}\) Office of Compliance Inspections & Examinations, supra note 1, at 34.

\(^{194}\) Id.

\(^{195}\) Id.

\(^{196}\) Levitin & Wachter, supra note 10, at 1182 (“[The private-label MBSs market] featured complex, opaque, and heterogeneous products with serious informational asymmetries between financial intermediaries and investors. Because of the nature of these products, investors underpriced risk, overvalued securities, and oversupplied mortgage finance.”); Louis A. Aguilar, Comm’r, SEC, Remarks at the SEC Open Meeting: Addressing the Information Asymmetry in the Securitization Market to Put Investors and the Economy on Safer Footing (Apr. 7, 2010), available at http://www.sec.gov/news/speech/2010/spch040710laa.htm (“The information asymmetry in this market between buyers and sellers must be addressed.”).

\(^{197}\) Judge, supra note 1, at 691 (“[T]here is an informational burden on the investor [due to the] investor’s ability to observe directly the quality of the assets underlying its investment.”); Levitin & Wachter, supra note 10, at 1229-30 (“Both mortgage borrowers and mortgage lenders have informational advantages over securitizers, and they ultimately all have informational advantages over investors because not all information on mortgage risk is embedded in the disclosures to investors.”); Levitin et al., supra note 7, at 165 (“[H]omeowners know more about their risks than mortgage originators, who in turn have information advantages over other mortgage securitization intermediaries and MBS investors.”).

\(^{198}\) Fin. Crisis Inquiry Comm’n, supra note 190, at 120.

\(^{199}\) McNamara, supra note 5, at 697-98 (discussing the role of macroeconomic forecasting in rating MBSs); Lauren E. Willis, Will the Mortgage Market Correct? How Households and Communities Would Fare if Risk Were Priced Well, 41 Conn. L. Rev.
were inaccurate. However, unlike the loan-level inputs, the problem was not information asymmetry, but instead human error.200 Each analyst made his or her best assumption as to what would happen in the future, but these assumptions turned out to be largely incorrect.201 For example, assumptions as to nationwide default rates were overly optimistic, because during the period of transition from a strong economy to a weak economy, the rating agencies likely assumed nationwide mortgage defaults in the range of one percent, when in fact the default rate was approaching five percent.202

Another problematic macroeconomic input was trends in home values. Amazingly, almost all of Moody’s loss models assumed that home prices would increase at four percent per year.203 Indeed, as to home values, the analysts at the rating agencies may have been struck by the same “bubble fever” as investors. “Moody’s position was that there was not a . . . national housing bubble.”204 As such, their loss models failed to take into account what the actual worst-case scenario could be. The objection here is that no one could have foreseen a forty-percent drop in housing values in the five years that followed 2006.205 There was, however, historical precedent for such a collapse.

1177, 1218 n.147 (2009) (“[F]or securities backed by [mortgages], the rating agencies would use historical data about macroeconomic factors to predict loan pool performance under various conditions . . . .”).

200 In the aftermath of the crisis, S&P implemented new procedures to improve the accuracy of the analysts’ market assumptions and to assure the public that “ratings models, processes, and analytical talent continue to be of the highest quality.” S&P Announces New Actions to Strengthen the Ratings Process, CREDIT WK., Feb. 13, 2008, at 12, 12; see Schwarcz, Protecting Financial Markets, supra note 11, at 403-04 & n.150 (discussing rating agency changes).

201 OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, supra note 1, at 35 (“[C]redit raters relied upon historical data in order to predict future behavior. . . . Further, the performance history that did exist occurred under very benign economic conditions.”). Although the vast majority of analysts did their best, under time pressure, some decided that rather than try to figure out the correct recovery rate, they would just use a number held over from a previous analysis. Id. (“Based on discussions with the rating agencies examined and documents provided by them, it appears that the parameters of the models were re-estimated by executing the model with new data infrequently.”).

202 Mortgages entering foreclosure rose from a historical rate of one percent to well above five percent by the end of 2009. U.S. CENSUS BUREAU, supra note 102, at 743 tbl.1194 (displaying data on mortgage originations and delinquency and foreclosure rates from 1990 to 2010). Some MBSs could absorb at most a one-percent loss before the investment-grade tranches were impacted. See supra Chart 2.

203 FIN. CRISIS INQUIRY COMM’N, supra note 190, at 120.

204 Id. at 121 (quoting interview by Fin. Crisis Inquiry Comm’n with Jay Siegel, Moody’s Investors Serv.) (May 26, 2010).

205 See Shiller, supra note 48 (showing that a home worth $198,000 at the peak of the housing bubble, January 2006, was worth $118,000 in 2011).
Professor Robert Shiller has shown that home prices fell over thirty percent in the five years prior to 1921.206 The expected recovery rate and timing was another macroeconomic input.207 Simply put, some of the mortgages underlying the MBS would inevitably default; how much cash could the issuer expect to recover in the foreclosure process, and how long would it take? Yet these inputs also had problems. “Recovery rates and recovery timing for assets vary depending on the nature of the asset . . . .”208 Further, “[t]his is far from an exact science—recovery times vary by jurisdiction, legal framework, and debtor’s rights.”209

The final problematic macroeconomic input to the loss models was correlation.210 Correlation is “a numerical measure of co-movement that ranges from -1 to 1.”211 If the correlation of two mortgages is negative one, then the default of the first mortgage will not be accompanied by the default of the second mortgage – they are negatively correlated.212 If the correlation is positive one, then the default of the first mortgage will be accompanied by the default of the second mortgage – they are positively correlated.213 There is a common saying in the financial community that “in a crisis, all correlations go to one.”214 Implicit in the foregoing is that if the correlation is zero, and the first mortgage defaults, we learn nothing about whether the second mortgage will default.215 The rating agencies were assuming that the correlation was close to zero: that is, if the first mortgage defaults, it tells us nothing about whether other mortgages that make up the mortgage pool will default.216

Assuming that mortgage defaults were not correlated led to higher ratings than were warranted.217 To illustrate,218 assume an MBS with two tranches is

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206 Id. (showing that a home worth $93,000 in 1916 was worth $65,000 in 1921).
208 Id.
209 Id.
210 Crawford, supra note 1, at 12-13; Hunt, supra note 171, at 132 (“[A] critical aspect of [MBS] rating and pricing is the correlation of defaults among the underlying [mortgages]. If raters rate the correlation too low, then the ratings will be too high.”).
211 Hunt, supra note 171, at 183.
212 Id.
213 Id.
214 Id. at 184 (citing Richard Bookstaber, A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation 26 (2007)).
215 Id.
216 Richard A. Epstein & M. Todd Henderson, Do Accounting Rules Matter? The Dangerous Allure of Mark to Market, 36 J. CORP. L. 513, 524 n.51 (2011) (noting that the assumed correlation was “very low”); Foote et al., supra note 141, at 24 (indicating that the rating agencies assumed “that individual loans might have high individual probabilities of default, but these probabilities are not likely to be correlated with one another”).
217 Brian J.M. Quinn, The Failure of Private Ordering and the Financial Crisis of 2008,
made up of ten mortgages, each with a 1/10 chance of default. Further, assume that as long as the cash flow remains at greater than seventy percent, the senior tranche will not default on its payments to investors. Three mortgages would have to default before the senior tranche is impacted. The chance of three mortgages defaulting is 1/10^3, or 1/1000. However, if the chance of default is perfectly correlated, then if one defaults, all default, thus making the chance that the senior tranche will be impacted 1/10. While the former chance (1/1000) may be appropriate for a certain rating (for example, AAA), the latter (1/10) may not.

Recall that “in a crisis, all correlations go to one.”\textsuperscript{219} In a crisis, mortgage defaults become highly correlated.\textsuperscript{220} In 2008, when the entire housing market suffered a shock and the traditional housing price index fell by twenty percent almost immediately,\textsuperscript{221} the failure to foresee any positive correlation proved catastrophic to the accuracy of ratings.\textsuperscript{222}

Many of these problems with macroeconomic inputs could have been solved by taking a broader look at the history of national trends in mortgage defaults, home values, and unemployment, as well as recovery rates and correlation. As Chairman of the Federal Reserve Alan Greenspan famously stated regarding the macroeconomic trend inputs used by the rating agencies:

The whole intellectual edifice . . . collapsed in the summer of last year because the data input into the risk-management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment.\textsuperscript{223}

\textsuperscript{5} N.Y.U. J.L. & BUS. 549, 573 (2009) (explaining that it is possible to give a AAA rating to a security that includes toxic assets because “as long as the default risk of the assets in a pool is not correlated, there will always be cash flow through the entity”).

\textsuperscript{218} For a further illustration of tranched MBSs without correlation, see Crawford, \textit{supra} note 1, at 12-13.

\textsuperscript{219} Hunt, \textit{supra} note 171, at 184 (quoting \textsc{Bookstaber, supra note 214, at 26}).

\textsuperscript{220} \textit{Id.} (“[D]efaults on the mortgages underlying RMBS turned out to be more correlated during the crisis than rating agencies or many investors anticipated.”).

\textsuperscript{221} See Shiller, \textit{supra} note 48.

\textsuperscript{222} Some commentators argue that correlation – more than any other factor – led to the failure of ratings. \textit{See, e.g.}, Crawford, \textit{supra} note 1, at 12-13 (illustrating how the assumption of no correlation “led to . . . large percentages of subprime-backed RMBS and mezzanine CDOs being labeled as ‘safe’”).

\textsuperscript{223} The Financial Crisis and the Role of Federal Regulators: Hearing Before H. Comm. on Oversight & Gov’t Reform, 100th Cong. 17-18 (2008) (statement of Alan Greenspan, Former Chair, Federal Reserve); see also Joe Nocera, \textit{Risk Mismanagement}, N.Y. TIMES MAG., Jan. 4, 2009, at 24 (criticizing the reliance on the dominant models used to calculate risk prior to the financial crisis).
3. Apply Expected Loss to the Financial Structure (Steps 3, 4, 5, and 6)

The process described above actually calculates many expected losses (again, Moody’s used 1250 loss models). Before the expected loss can be applied to the financial structure, the many expected losses must be reconciled into one single expected loss. This is done by giving each expected loss a weight corresponding to the chance it will occur, and then taking an average of these weights. This finalized expected loss “discounts” the cash flow that can be expected from the mortgages underlying the MBS. This discounted cash flow is then applied to the financial structure of the MBS in question, which takes the form of a waterfall. The cash flow must remain sufficient to ensure that each tranche stays below the default rate for a corporate bond given a like rating. Assuming that “corporate bonds with a 7-year life and a rating of AA have a 2% chance of default,” an MBS tranche with like characteristics seeking an AA rating may fail in only 2% of the scenarios modeled. If the default rate exceeds 2%, then the tranche would receive a lower rating. Each tranche receives its own rating.

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224 Each scenario is given a weight corresponding to its probability. The more likely scenarios receive more weight, the less likely scenarios receive less weight. To see how those losses will be distributed, they can be run through a Monte Carlo simulation. A Monte Carlo simulation is different from a simple discounted cash flow analysis. By using discounted cash flow calculations an investor can determine that:

Investment X has an expected internal rate of return of 9.2%, while for Investment Y a 10.3% return can be expected.

By contrast, [a Monte Carlo simulation] put[s] in front of the [investor] a schedule which gives him the most likely return from X, but also tells him that X has 1 chance in 20 of being a total loss, 1 in 10 of earning from 4% to 5%, 2 in 10 of paying from 8% to 10%, and 1 chance in 50 of attaining a 30% rate of return. From another schedule he learns what the most likely rate of return is from Y, but also that Y has 1 chance in 10 of resulting in a total loss, 1 in 10 of earning from 3% to 5% return, 2 in 10 of paying between 9% and 11%, and 1 chance in 100 of 30%.

David B. Hertz, Risk Analysis in Capital Investment, Harv. Bus. Rev., Jan.-Feb. 1964, at 95, 96. Once the probability of each loss scenario/model is calculated, the expected loss for the entire tranche is determined by averaging the product of the probability and the loss. See Fin. Crisis Inquiry Comm’n, supra note 147, at 45.

225 Office of Compliance Inspections & Examinations, supra note 1, at 8 (“[T]he analyst . . . conduct[s] a cash flow analysis on the interest and principal expected to be received by the trust from the pool of subprime loans to determine whether it will be sufficient to pay the interest and principal due on each RMBS tranche issued by the trust.”).

226 See supra Part I.C.

227 McNamara, supra note 5, at 690 (describing “cash flow simulations” that are used to ensure each tranche meets requirements).

228 Id.

229 Partnoy & Skeel, Jr., supra note 207, at 1042 (“[F]or a given tranche to receive a particular rating, the probability of defaults in its portfolio exceeding the portfolio default rate cannot exceed the default rate for a corporate bond with that rating.”).

230 For an example of the use of ratings by tranche in an MBS registration statement, see
D. Conclusions About Ratings as a Remedy for Information Problems

As David B. Hertz stated in 1964 in *Risk Analysis in Capital Investment*:

The fatal weakness of past approaches . . . has nothing to do with the mathematics of rate-of-return calculation. We have pushed along this path so far that the precision of our calculation is, if anything, somewhat illusory. The fact is that, no matter what mathematics is used, each of the [inputs] entering into the calculation of rate of return is subject to a high level of uncertainty.231

As this Article shows, problems existed with both loan-level inputs and macroeconomic-trend inputs. The former was plagued by information asymmetries, the latter by human error. The rating agencies – and the issuers that contracted with them – did not realize the problem until it was too late (or they were wilfully blind). It was not until “defaults and delinquencies on the underlying mortgage collateral rapidly developed . . . [that] the rating agencies revised their loss models.”232 The common result was that MBSs previously rated AAA were downgraded to CCC, or worse, junk.233

However, we need not – as Dodd-Frank does – “throw[] out the baby with the bath water.”234 FDIC Chair Sheila Bair “defended ratings as an effective way to evaluate the quality of investments such as corporate debt, [stating,] ‘I think we will also find that some of the more likely replacements . . . are far from perfect.’”235 By better verifying loan-level inputs (where observed), and updating macroeconomic inputs (where assumed), the rating agencies can move toward providing more accurate ratings, toward a more perfect substitute. Rating agencies simply need a nudge to do so. Under this Article’s proposal, rating agencies will receive said nudge from issuers (if the rating is not accurate, the rating agency will lose reputation and business). In fact, it was a lack of such a nudge that caused the loss models and inputs to atrophy:

Rating agencies should have been constantly updating their default and prepayment models to reflect the new mortgage products and new conditions underlying the subprime market. However, because updating these models is an expensive process and rating agencies were increasingly focused on the bottom line, such updating could fall through

supra Chart 2.

231 Hertz, *supra* note 224, at 96.


233 *Id.* (discussing Moody’s revised model resulting in the MBSs in question being downgraded to “junk” quality).


235 *Id.* (quoting Sheila Bair, Chair, FDIC).
the cracks. One former managing director of a rating agency reported in 2008 that his rating agency’s last loss and default model update was implemented in late 1998 or early 1999, and that a subsequent, more powerful model was never implemented, to his knowledge, for budgetary reasons.\footnote{Kurt Eggert, \textit{The Great Collapse: How Securitization Caused the Subprime Meltdown}, 41 \textsc{Conn. L. Rev.} 1257, 1301 (2009) (citing \textit{Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight \& Gov’t Reform}, 110th Cong. (2008) (emphasis added)).}

This Article’s proposal changes that economic calculus.

\section*{IV. Lack of Accountability for Bad Ratings}

\subsection*{A. Section 11 Primer}

The primary driver of disclosure under the Securities Act of 1933 is civil liability for failure to properly disclose.\footnote{Morrissey, \textit{supra} note 21, at 546 (discussing the importance of shareholder remedies in overcoming the issues raised by MBSs); Seigel, \textit{supra} note 21, at 1583 (explaining civil enforcement, as well as the criminal alternative).} Where the registration statement fails to properly disclose risk – perhaps because disclosure is absent or materially misleading – section 11 provides a remedy in the form of monetary damages.\footnote{Securities Act of 1933 § 11, 15 U.S.C. § 77k (2012).} Section 11 provides in relevant part:

\begin{quote}
In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue [any signatory, director, named expert, or underwriter] the difference between the amount paid for the security . . . and . . . the value thereof as of the time such suit was brought . . . .
\end{quote}

\footnote{Id.}

Section 11 imposes strict liability.\footnote{Panther Partners v. Ikanos Commc’ns, 681 F.3d 114, 120 (2d Cir. 2012).} All the plaintiff need show is a material misstatement.\footnote{Id.} There is no need for the plaintiff to show scienter on the part of the defendant, that he relied on the misstatement, or that the misstatement was the cause of his damages.\footnote{Id.} Logically, a rating agency would fall within section 11’s broad list of possible defendants as an expert, which is defined as “every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him.”\footnote{Securities Act of 1933 § 11, 15 U.S.C. § 77k.} Bringing a section 11 action...
against a rating agency, however, was (and remains) a very difficult proposition.\textsuperscript{244}

When dealing with fixed-income securities like MBSs, section 11 also has a huge advantage over more mundane causes of action such as breach of contract. A breach of contract action – presumably based on the fact that the investor fails to receive a scheduled payment of principal, interest, or both – is greatly complicated by the fact that the MBS is issued through a special purpose entity (SPE), often a trust.\textsuperscript{245} To illustrate: If Merrill Lynch sets up an SPE to issue an MBS, is any breach of contract action limited to the SPE, with which the investor is in privity?\textsuperscript{246} Can the investor sue Merrill Lynch? These are thorny questions. If an investor, however, can bring a successful action pursuant to section 11 based on flawed ratings (made easier by the burden-shifting model proposed in this Article), then all control persons are also liable pursuant to section 15.\textsuperscript{247} That is to say, control-person liability under section 15 attaches when the plaintiff “show[s] a ‘primary violation’ of [section] 11 and control of the primary violator by defendants.”\textsuperscript{248} Consider the case of \textit{Public Employees’ Retirement Fund of Mississippi v. Merrill Lynch & Co.}, where Merrill Lynch created an SPE to offer MBSs.\textsuperscript{249} When harmed investors sued Merrill and the SPE, Merrill tried to argue that such a relationship was “‘part and parcel of a pedestrian parent/wholly-owned subsidiary relationship’ and [was] therefore insufficient to evince control.”\textsuperscript{250} The court ruled, however, that plaintiffs met the pleading standard by pleading that revenue from the SPE’s securitizations went to Merrill Lynch, “Merrill Lynch & Co.” appeared on the front page of the prospectus, and that Merrill Lynch executives signed the SPE’s registration statement.\textsuperscript{251} As such, if the plaintiff prevails on its section 11 action, both the SPE and Merrill Lynch will be liable.\textsuperscript{252}

\textsuperscript{244} See infra Part IV.B.


\textsuperscript{246} MBIA Ins. Corp. v. Royal Bank of Can., No. 12238-09, 2010 N.Y. Misc. LEXIS 3958, at *73-74 (N.Y. Sup. Ct. Aug. 19, 2010) (“It is well settled, under New York law, that one who is not a party to an agreement cannot be bound by it.”).

\textsuperscript{247} Section 15 of the Securities Act states:

\begin{quote}
Every person who, by or through stock ownership, agency, or otherwise, . . . controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person . . . .
\end{quote}


\textsuperscript{248} In re Lehman Bros. Mortg.-Backed Sec. Litig., 650 F.3d 167, 185 (2d Cir. 2010).


\textsuperscript{250} Id.

\textsuperscript{251} Id. (“Merrill exercised greater control over the Merrill Depositor than that inherent in a typical parent-subsidiary relationship.”).

\textsuperscript{252} Id. (arguing that liability should attach to both Merrill and the SPE, due to the nature
In Wells Fargo Mortgage-Backed Certificates Litigation, Wells Fargo Bank set up Wells Fargo Asset Securities Corporation as depositor and issuer of various MBS certificates. The court had no trouble finding that Wells Fargo Bank was a control person for the issuing entity, stating that “Wells Fargo Bank had the power and influence, and exercised that power and influence, to cause the depositor to engage in violations of the Securities Act.”

Further, the court in Maine State Retirement System v. Countrywide Financial Corp. implied that, because in most MBS offerings the issuing SPE will be set up by the investment bank as “limited purpose finance entities” solely for the purpose of facilitating the issuance of the Certificates,” the court can infer that investment banks have “the power to direct or cause the direction of the [SPE defendants].” This makes sense because, as the court stated in Countrywide Financial Corp. Mortgage-Backed Securities Litigation, the “control person provisions were included in the federal securities laws to prevent people and entities from using dummies to do the things that they were forbidden to do by the securities laws.”

Further, section 11 allows recovery for more than just the failure to pay on the bond. That is to say, a cognizable injury under the securities law is not limited to failure to pay on the bonds as promised. As the court stated in New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc.:

Since Plaintiff does not allege that it failed to receive any principal or interest payments due under its Certificates, Defendants argue that Plaintiff failed to allege a cognizable injury. The alleged injury – 79% diminution of market value – is said to be immaterial in the context of mortgage-backed securities Certificates. Plaintiff might suffer a loss from the impairment of cash flow, but loss of value is not a cognizable loss. This is too cramped a reading of damages.

Many fixed-income debt securities, such as corporate bonds do not trade on national exchanges and yet institutional investors routinely purchase...
corporate bonds hoping to realize a profit through resale. Plaintiff may have purchased the Certificates expecting to resell them, making market value the critical valuation marker for Plaintiff. This is a securities claim, not a breach of contract case.259

B. Actions Against the Rating Agency

Investors in MBSs that relied on ratings as a stand-in for risk have had a very difficult time recovering under section 11. Beginning in 1982, SEC rule 436(g) exempted rating agencies from liability under section 11 of the Securities Act.260 Section 11 only allows recovery for statements in the registration statement, and rule 436(g) provided that the rating will not be considered part of the registration statement for purposes of section 11 in an action against the rating agency.261 This meant that investors harmed by inaccurate ratings were left without a remedy against the rating agency, at least under section 11.262

Dodd-Frank ended that.263 Specifically, Dodd-Frank provides, “[r]ule 436(g), promulgated by the Securities and Exchange Commission under the

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259 Id. at *5.
261 Id. (“[T]he security rating . . . shall not be considered a part of a registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.”).
262 Finding themselves barred from arguing that rating agencies are liable as experts under section 11, some plaintiffs have tried to argue that because of the role of rating agencies in the securitization process, they should be considered underwriters for purposes of section 11. In re Lehman Bros. Mortg. Backed-Sec. Litig., 650 F.3d 167, 183 n.11 (2d Cir. 2011) (“Perhaps it is because this Rule, still in effect at the time plaintiffs brought the instant lawsuits, prevented plaintiffs from suing the Rating Agencies under the ‘expert’ prong, that they urged new theories of liability under the ‘underwriter’ and ‘control person’ provisions.”). These attempts have failed. In Lehman Bros., the plaintiffs argued that the rating agencies were underwriters “because they structured the certificates here at issue to achieve desired ratings, which was a necessary predicate to the securities’ distribution in the market.” Id. at 175. The court rejected this argument, finding that “common to all categories of persons identified as ‘underwriters’ by the plain language of [the statute] is activity related to the actual distribution of securities.” Id. In short, aiding in structuring the security is not distributing the security. Id.
263 Further, post Dodd-Frank, when a rating agency is sued for securities fraud pursuant to section 10(b) of the Exchange Act, the heightened pleading requirements are presumed met as long as the plaintiff alleges in the complaint that the agency “recklessly or knowingly failed to conduct a reasonable investigation or failed to obtain a reasonable verification of
Securities Act of 1933, shall have no force or effect." 264 However, assuming that the goal of overruling rule 436(g) was to pressure rating agencies to provide more accurate ratings, there are several reasons to doubt the rule’s impact. One obstacle is that rating-agency liability for the expertized portion of the registration statement will be subject to a due diligence defense. 265 Further, a direct claim against a rating agency may be barred by the First Amendment. 266

Any cause of action pursuant to section 11 seeking to hold a rating agency liable as an expert will be subject to a due diligence defense. 267 Specifically, the rating agency can avoid liability by showing that it “had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true.” 268 It is very difficult to show that an expert did not conduct a reasonable investigation absent neglect. 269 For example, in Escott v. BarChris, the accountant (an expert) was found not to have conducted a reasonable investigation in his preparation of the audited figures contained in the registration statement (an expertized portion), but only because he never examined “important financial records.” 270 267 Thus, technically, a rating agency could face liability if it fails to examine the loan-level characteristics of the MBS it is being asked to rate. However, that did not appear to be the problem in the lead-up to the 2008 financial crisis. There, the problem was that the facts provided by third parties.” Nan S. Ellis, Is Imposing Liability on Rating Agencies a Good Idea?: Rating Agency Reform in the Aftermath of the Global Financial Crisis, 17 STAN. J.L. BUS. & FIN. 175, 210 (2012) (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 993, 124 Stat. 1376, 1883 (2010)).


265 Section 11 provides the following due diligence defense for expertized portions of the registration statement:

Notwithstanding the provisions of subsection (a) of this section no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . (3) that . . . (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true . . . .


266 Andrew F. Tuch, Multiple Gatekeepers, 96 VA. L. REV. 1583, 1668 n.295 (2010) (noting that credit rating agencies may be protected from liability by the First Amendment).

267 Securities Act § 11(b)(3)(B), 15 U.S.C. § 77k(b)(3)(B) (stating that an issuer may avoid liability under section 11 by proving that he made reasonable efforts to discover misstatements in the registration statement and reasonably believed such misstatements did not exist).

268 id.


270 id.
loan-level data that the rating agency input into the loss model was inaccurate due to information asymmetries.

This Article’s burden-shifting proposal focuses on the MBS issuer taking responsibility for inaccurate ratings (material misstatements) in the registration statement because the issuer cannot use the due diligence defense.271 Section 11 provides that, “no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof [that they] . . . had, after reasonable investigation, reasonable ground to believe . . . that the statements therein were true.”272 Thus, the issuer will be liable in the event that the rating is indeed a material misstatement.273 This will force the issuer to be very careful when deciding who to hire to prepare the ratings. In turn, the issuer will place large amounts of reputational pressure on the rating agency, with corresponding improvements in ratings’ accuracy.

The possible success of a First Amendment defense to claims against rating agencies cannot be discounted.274 “[C]redit rating agencies might avoid liability on grounds that ratings are protected by the First Amendment of the Constitution.”275 In the case of Compuware Corp. v. Moody’s Investors Service, Moody’s provided Compuware with an issuer rating “of ‘Ba1,’ which is the highest of Moody’s eleven non-investment grade (i.e., junk) ratings.”276 Compuware brought a lawsuit claiming that the rating was defamatory.277 The Sixth Circuit found that Compuware had to show actual malice – which it failed to do – because the rating was protected First Amendment speech.278

273 Id. (indicating that the due diligence defense does not pertain to the issuer).
274 Ellis, supra note 263, at 185; see Wendy Gerwick Couture, The Collision Between the First Amendment and Securities Fraud, 65 ALA. L. REV. (forthcoming 2014) (manuscript at 4) (on file with author) (“Sullivan [First Amendment] protections should apply in securities fraud cases when the defendant is a noncommercial speaker (such as an independent securities analyst, credit rating agency, or financial journalist) and the speech concerns a public company.”).
275 Tuch, supra note 266, at 1668 n.295.
277 Compuware Corp., 499 F.3d at 525-26 (discussing Compuware’s defamation claim against Moody’s).
278 Id. at 533-34 (holding that the First Amendment requires that Compuware demonstrate “actual malice,” and that Compuware’s breach of contract claim failed due to its inability to demonstrate “actual malice”).
C. Actions Against the Issuer

Absent the burden-shifting model proposed in this Article, recovery against the issuer for a misleading rating pursuant to section 11 is technically possible.\textsuperscript{279} Courts have held, however, that where the alleged material misstatement is a rating, it must be shown that the issuer knew that the rating was false, because future opinions are actionable as material misstatements only where not truly held at the time they are made.\textsuperscript{280} As the court in \textit{Bear Stearns} stated while discussing plaintiffs’ claim brought pursuant to section 11 of the Securities Act against the issuer, “Plaintiffs can state a claim by pleading that the . . . [issuer] did not believe that the ratings accurately reflected the quality of the securities.”\textsuperscript{281} Nevertheless, the court dismissed the section 11 claim finding that the plaintiff did not adequately plead lack of belief on the part of the issuer.\textsuperscript{282} This ruling was made despite the fact that plaintiff plead

\textsuperscript{279} \textit{In re Bear Stearns Mortg. Pass-Through Certificates Litig.}, 851 F. Supp. 2d 746, 770 n.26 (S.D.N.Y. 2012) (noting the plaintiff’s claim that the defendant unduly made misrepresentations in its ratings). In \textit{Genesee County}, the court held that “ratings in offerings documents can qualify as actionable misrepresentations under the Securities Act for others besides rating agencies,” and rejected the argument that 17 C.F.R. § 230.436(g) extended to the issuer as well. \textit{Genesee Cnty. Emps.’ Ret. Sys. v. Thornburg Mortg. Sec. Trust 2006-3}, 825 F. Supp. 2d 1082, 1196 (D.N.M. 2011) (“Nothing in the SEC’s discussion of this regulation at the time it proposed that regulation suggested that the SEC intended to insulate issuers of securities from liability when they included a credit rating from a third party in offering documents.”). The court stated that “SEC did not mention anything about making the ratings themselves exempt. Furthermore, it mentioned that ‘a security rating presented [in a filing] without any further explanation could mislead or confuse investors’ under some circumstances without additional information ‘making clear the source of the rating to which the interested investor can turn for further details.’” \textit{Genesee Cnty.}, 825 F. Supp. 2d at 1196 (citing Disclosure of Security Ratings in Registration Statements, 46 Fed. Reg. 42,024, 42,026 (Aug. 18, 1981)).

\textsuperscript{280} \textit{In re Bear Stearns}, 851 F. Supp. 2d at 770-71 ("It is well-settled that investment ratings are subjective opinions and, accordingly, only actionable where ‘the speaker did not truly believe the statements at the time it was made in public.’"); \textit{see also} Tsereteli v. Res. Asset Securitization Trust 2006-A8, 692 F. Supp. 2d 387, 395 (S.D.N.Y. 2010) (dismissing a section 11 action for failing to make allegations that the issuer “did not actually believe that the ratings they had assigned were supported by the factors they said they had considered”); \textit{Boilermakers Nat’l Annuity Trust Fund v. WaMu Mortg. Pass Through Certificates, Series AR1}, 748 F. Supp. 2d 1246, 1256 (W.D. Wash. 2010) (dismissing a section 11 action against an issuer and a rating agency based on inaccurate credit ratings, stating, “[t]he mere fact that the ratings would have been different under a different methodology is insufficient to state a claim”).

\textsuperscript{281} \textit{In re Bear Stearns}, 851 F. Supp. 2d at 771.

\textsuperscript{282} \textit{Id.} at 772 (granting the defendant’s motion to dismiss due to the plaintiff’s inadequate plea that the defendant knowingly made misrepresentations when it released the offering documents).
that Bear Stearns provided the inputs for the loss model knowing that they were incorrect.\textsuperscript{283}

In another case, \textit{New Jersey Carpenters Vacation Fund}, the plaintiffs claimed that the issuer should be responsible for misleading ratings in the offering documents, which the plaintiffs alleged, prevented them from accurately assessing the risk of the MBS.\textsuperscript{284} The court dismissed the cause of action, finding that the MBS in question actually received the ratings questioned in the complaint (thus there was no misstatement on the face of the offering document), and that the issuer would be liable only if it truly did not believe the ratings were accurate.\textsuperscript{285} There was no evidence of such doubt.\textsuperscript{286}

On the other hand, plaintiffs were able to properly plead a cause of action under section 11 of the Securities Act in \textit{Genesee County Employees’ Retirement System v. Thornburg} because unique circumstances allowed the plaintiffs to show the issuer actually knew the rating to be improperly engineered; specifically, there were inculpatory contemporary admissions from executives at the rating agency and a close relationship with the issuer.\textsuperscript{287} The court pointed to “several statements from S&P employees . . . along with the factual allegations regarding S&P’s interactions with the Defendants . . . that support a plausible inference that the ratings did not come from S&P’s ‘independent analysis and conclusion, but rather were predetermined.’”\textsuperscript{288}

However, victories for plaintiffs, like the one in \textit{Thornburg}, are rare. Indeed, it appears that dispositive in \textit{Thornburg} was the fact that the defendant played an active role in engineering the ratings.\textsuperscript{289} Most plaintiffs are not able to plead such facts. To conclude, ratings were given a special role in MBS offering documents as proxies for risk; when they were inaccurate, however, investors had a very difficult time showing that they were material misstatements giving rise to a proper cause of action under section 11 of the Securities Act.

\textsuperscript{283} Id. (“Plaintiffs will be granted leave to amend the complaint to plead facts demonstrating that Bear Stearns was aware, when it released the Offering Documents, that the Certificates’ ratings were based on inaccurate or incomplete information.”).


\textsuperscript{285} Id. at 271-72.

\textsuperscript{286} Id. (holding that the plaintiffs failed to offer sufficient evidence to support their claim that the defendants knowingly made misstatements).

\textsuperscript{287} Genesee Cnty. Empls.’ Ret. Sys. v. Thornburg Mortg. Sec. Trust 2006-3, 825 F. Supp. 2d 1082, 1193-95, 1203 (D.N.M. 2011) (holding that the plaintiffs sufficiently pled a cause of action to survive a motion to dismiss because they pointed “statements from S & P employees . . . that undermine the conclusion that S & P believed its ratings” and “S & P’s interactions with the Defendants”).

\textsuperscript{288} Id. at 1203 (quoting \textit{In re Wells Fargo Mortg.-Backed Sec. Litig.}, 712 F. Supp. 958, 973 (N.D. Cal. 2010)).

\textsuperscript{289} Id. (considering the role that the defendants may have had in generating the rating due to the close relationship between the defendants and S&P).
Toward a More Perfect Substitute: A Proposal to Improve the Accuracy of Ratings Through Burden-Shifting

Due to the complexity inherent in mortgage finance, it is very difficult for MBS issuers to accurately communicate risk information to prospective investors. To narrow the information gap, issuers began to rely on rating agencies to “reduce risks to discrete categories for the market to process” – AAA for investment grade on down to CCC for extremely speculative. At best, however, this method of communicating information became simply another necessary step in the MBS issuance process, simply another box to check. At worst, it became a way for the issuer to convince the investor that their “rat poison meets the five-part test for being apple pie.” Unfortunately, the issuers often did not care about the rating agencies’ reputation for “getting it right,” because there was no downside, no liability for the issuer when the rating agency “got it wrong.”

To increase the probability that issuers hire rating agencies that “get it right,” the following burden-shifting procedure should be used: where a plaintiff brings a cause of action against the issuer pursuant to section 11 of the Securities Act, based upon an allegation that an MBS (or similarly complex fixed-income security) registration statement contained an inaccurate rating, the burden shifts to the issuer to establish that (1) the loss model used was state of the art, and (2) all inputs were correct and up to date. If the issuer fails to meet this burden, then the plaintiff will have established a material misstatement within the registration statement, satisfying what is often the most troublesome element of a section 11 claim.

It is important to emphasize that the goal of this Article’s proposal is to make ratings more accurate, to make them a better tool for gauging the risk associated with a given investment. Ratings can never be accurate one-hundred percent of the time.

A. Burden-Shifting Is a Tool Regularly Used in Complex Securities Litigation

Burden-shifting is already present in the operation of the securities laws. Take for example section 10(b) of the Exchange Act and the requirement that the plaintiff establish the element of reliance. Because the element of reliance can be problematic in certain factual scenarios, presumptions are employed by the courts to find that the element is met. For example, using

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290 Manns, supra note 114, at 1035.
292 See supra Part IV (observing the difficulty of showing that a rating is a material misstatement).
294 Merrit B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. 237,
the fraud-on-the-market presumption, the Court in *Basic v. Levinson* held that “because most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentation, therefore, may be presumed for purposes of a Rule 10b-5 action.”

Likewise, in *Affiliated Ute Citizens*, the Court held that if the alleged misstatement is an omission, that is to say “a failure to disclose,” then “positive proof of reliance is not a prerequisite to recovery.” Instead, “[a]ll that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.” Given the foregoing, it is reasonable for a court to presume that if a rating agency’s rating is not based on a state-of-the-art loss model, or the most accurate and up-to-date inputs, it is a material misstatement. This is a better outcome, given the prominence of the rating in the registration statement, and that “a reasonable investor would consider it important in determining whether to buy or sell stock.”

Alternatively, this burden-shifting presumption can be viewed as removing the materiality determination from a “future looking opinion analysis,” which improperly incorporated a scienter requirement into an action pursuant to section 11, to an analysis of ratings as present facts. Indeed, ratings are properly viewed as present facts. They are an amalgamation of the current loan level inputs applied to the current financial structure of the MBS, not a promise as to how the MBS will perform in the future.

B. *State-of-the-Art Loss Model*

For this element, establishing that the loss model was state of the art, this Article borrows from the world of products liability. This seems appropriate, given that we now know that many MBSs were, in a sense, defective products. Under this Article’s burden-shifting procedure, once the plaintiff has pled that the rating in the registration statement was a material misstatement, the burden would shift to the issuer to show that the loss model used – the mathematical formula – was state of the art. In the products liability context, “state of the art” means that which is ‘scientifically and technologically feasible.’ This is

246-47 n.16 (2009) (discussing the reliance presumption).


297 *Id.* at 153-54.

298 Grossman v. Novell, 120 F.3d 1112, 1119 (10th Cir. 1997).

299 Couture, *supra* note 126, at 65 (mentioning that forward-looking statements are only actionable if they are made with knowledge that the statement is indeed false).

a higher standard than industry custom, “because an entire industry may be
negligent by not utilizing techniques which are feasible.”

However, how the concept of state of the art plays out in the rating agency
context is a little different. For purposes of the burden-shifting procedure, a
state-of-the-art loss model should be defined as a loss model based on the best
scientific knowledge and methods that are practical and available for use in
rating a similar debt issuance. There is certainly strong evidence that prior to
the 2008 financial crisis the sophistication of the loss models used by rating
agencies did not keep up with the sophistication of the products they were
rating. The models are always changing, as one author points out:

The current state-of-the-art techniques to measure and manage credit risk
involve the use of credit portfolio models. . . . [T]he Moody’s KMV
model . . . [is] based on the Merton principles and [is] the market leader[].
[Other models are] derived from actuarial science . . . [or integrate[]
explicitly macroeconomic variables and t[y] to measure their influence
on default risk.

This Article makes no attempt to suggest which mathematical model is best.
It is important, however, to observe that the models are always evolving.
“[T]oday’s best practice will be tomorrow’s minimum standard.” The
admissibility of testimony that a particular loss model is the most evolved –
state of the art – can be determined using the Daubert standard. The court
would consider whether the loss model is subject to peer review, how reliable
the loss model is (how often is it wrong), and whether the loss model is
accepted in the relevant scientific community. Further, the state-of-the-art

301 Id. at *11; see The T.J. Hooper, 60 F.2d 737, 740 (2d Cir. 1932) (“Indeed in most
cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a
whole calling may have unduly lagged in the adoption of new and available devices. It never
may set its own tests, however persuasive be its usages. Courts must in the end say what is
required; there are precautions so imperative that even their universal disregard will not
excuse their omission.”).

302 See, e.g., Wagner v. Case Corp., 33 F.3d 1253, 1256 (10th Cir. 1994) (mentioning a
comparable definition of state of the art in the products liability context).

(“Ratings quality might have suffered from not keeping up with the ‘state of the art.’”). But
see Brett McDonald, Don’t Panic! Defending Cowardly Intervention During and After a
Financial Crisis, 116 PENN. ST. L. REV. 1, 10 (2011) (“As the bonds became increasingly
complicated, this rating process became harder. The agencies developed complex
mathematical models, based upon state-of-the-art financial theory, for valuing the bonds.”).

304 LAURENT BALTHAZAR, FROM BASEL 1 TO BASEL 3: THE INTEGRATION OF STATE-OF-

305 Id. at 105.


307 Id. at 593-94 (considering specific questions the court would look to when
determining admissibility of expert testimony). In the products liability context, using the
Daubert test to evaluate the admissibility of state-of-the-art testimony is done routinely. See,
defense would be based on the prevailing financial theory at the time the rating is made, and must look beyond what the big three rating agencies are doing, since the entire industry may have fallen behind, as they apparently did prior to the 2008 financial crisis.

C. Correct and Up-to-Date Inputs

As discussed in Part III.C, above, a loss model is only as good as its inputs. Take the example of Bear-Stearns. While not a rating agency, Bear Stearns did use Value-at-Risk (VaR) models to determine the chance of default for various fixed-income securities that it held. Bear Stearns was, however, excoriated by SEC on numerous occasions for failing to “timely update inputs to its VaR models” and “[a]s the housing crisis spread . . . the Company knew that [macroeconomic trends], including falling housing prices and rising delinquency rates, were not reflected in the VaR figures it disclosed to the public.” The same thing was happening at rating agencies. As discussed in Part III.C, much of the reason for the failure of the loss models was that the loan-level inputs were incorrect and the macroeconomic trend inputs were not up to date.

As to loan-level inputs, the burden-shifting procedure will incentivize the issuer (who is in the best position to gather loan-level data) to provide accurate data to the rating agency. As to the macroeconomic trend inputs, one possible remedy is to allow the government to standardize them (that is, require certain assumptions as to national trends in home values, interest rates, and unemployment, as well as recovery rates and correlation). However, that is not an ideal solution. It would stifle the updating process, rendering rating agencies “unable to adapt” and their ratings incapable of “reflect[ing] changes in markets, instruments and criteria.” That is exactly the type of stagnation this proposal is trying to remedy. On the other hand, it makes sense to place the burden on the issuers to establish that the inputs used by the rating agency they hired were updated on a regular and frequent basis.


309 Id.

310 Id.

311 SEC, REPORT TO CONGRESS: CREDIT RATING STANDARDIZATION STUDY 28 (2012) (considering the issue of standardizing market stress conditions).

312 Id.
D. Restoring Reputational Pressure on Rating Agencies

Traditionally, the success of a rating agency was dependent on its reputation.313 If the rating agency had a strong track record of accurately predicting risk, then investors trusted it, and its ratings were in demand.314 Alternatively, if the ratings were not accurate, investors did not trust them, and the rating agency’s profits would fall.315 The crux of the reputational argument is summarized as follows:

[Rating agencies], as profit maximizing entities, will not jeopardize their primary asset, their reputations, by issuing fraudulent or inaccurate certifications. The long term financial losses that the agencies would suffer as a result of a decline in reputation, perhaps by the loss of business once it is discovered that they inaccurately certified, will always outweigh the benefits that were received as a result of that inaccurate certification.316

For reputational pressure to increase accuracy in the MBS context, the issuer must care about hiring rating agencies with high reputations for accuracy. This may not be the case. The fact that a rating given to an MBS is inaccurate (too high) only matters to the issuer if (1) it becomes apparent to the investors that the rating is too high, and (2) the investors have recourse against the issuer.317 Prior to the 2008 financial crisis, there was a feeling among MBS issuers that the real estate market would only get better, negating any fear that the inaccuracy of the ratings would become apparent. Further, as discussed in Part IV, even if the inaccuracy of the rating did become apparent (because an MBS rated AAA defaulted on a payment), there was no liability for the issuer arising from inaccurate ratings.

Current events have moved us part of the way toward restoring the role of reputation. The investing public now knows that many of the debt securities floated in the years prior to the 2008 financial crisis were given overly optimistic ratings. This Article’s burden-shifting proposal, if implemented, would bring us the remainder of the way to restoring the role of reputation.318

313 Cantor & Packer, supra note 157, at 4 (“If investors were to lose confidence in an agency’s ratings, issuers would no longer believe they could lower their funding costs by obtaining its ratings.”).
314 Dennis, supra note 179, at 1114 (explaining the “reputation capital” theory as one in which an “agency’s success is primarily a result of the agency’s track record in issuing accurate ratings”).
315 Id. at 1114 (inferring the inverse proposition from the “reputation capital” theory).
316 Id. at 1131.
317 Ellis, supra note 263, at 216 (contending that the “reputational capital” theory is meaningless where issuers will not choose credit rating agencies with a reputation for issuing low ratings, and that giving duped investors recourse through increased civil liability is a possible answer).
318 See supra Part V.
It connects the financial wellbeing of the issuer to the accuracy of the rating.\textsuperscript{319} The issuer will face liability where the loss model used was not state of the art, or the inputs were incorrect (in the case of loan-level data) or outdated (in the case of macroeconomic data).\textsuperscript{320} When this happens, issuers will be more concerned with the reputation for accuracy of the rating agency that they hire. Another way to think about the problem may be in terms of competing reputations.\textsuperscript{321} Before the financial crisis, MBS issuers cared about the rating agency’s reputation for providing high ratings.\textsuperscript{322} However, if this Article’s burden-shifting proposal is adopted, MBS issuers will be held liable for inaccurate ratings. As such, MBS issuers will care about the rating agency’s reputation for accuracy.

VI. POSSIBLE CRITICISM OF THE BURDEN-SHIFTING PROPOSAL

This Article proposes a burden-shifting procedure to improve the accuracy of ratings assigned to MBSs.\textsuperscript{323} The burden-shifting procedure is intended to make issuers (and control persons) liable for inaccurate ratings in registration statements, and thus shift the paradigm to one where an issuer cares about rating agencies’ reputations for accuracy.\textsuperscript{324} One possible criticism of this Article’s proposal is that the rating agencies, not the issuers, should be responsible for inaccurate ratings. A second criticism may be grounded in the belief that Dodd-Frank already strengthened the disclosure requirements for the offering of MBSs.

A. Is Issuer Liability Preferable to Rating Agency Liability?

Some may read this Article’s proposal and ask, “if it is the behavior of the rating agencies you want to change, why not just propose alternatives that would make it easier to prevail against the rating agencies?” First, this Article’s proposal tracks the “issuer as primarily responsible” policy evidenced by the structure of section 11. Section 11 is structured so that “[t]he issuer itself is strictly liable for material inaccuracies; [while] other parties have affirmative defenses to the extent they can show that they met specified levels of care.”\textsuperscript{325} This is consistent with the fact that it is the issuer that has the most

\textsuperscript{319} See supra Part V.
\textsuperscript{320} See supra Part V.
\textsuperscript{321} Ellis, supra note 263, at 216 (“In other words, there are two reputations that matter here – one that investors can rely on in terms of the accuracy of the rating and one the issuers can rely on in selecting the [credit rating agency].”).
\textsuperscript{322} Id. (explaining that a reputation as an accurate rater is meaningless if the agency gets no business from issuers due to their “reputation for issuing low ratings”).
\textsuperscript{323} See supra Part V.
\textsuperscript{324} See supra Part V.
\textsuperscript{325} Mahoney, supra note 117, at 1087; see In re Activision Sec. Litig., 621 F. Supp. 415, 424 (N.D. Cal. 1985) (“The purpose of § 11 is to protect persons who purchase securities in the distribution process or on the open market from misstatements or omissions in the
to gain from the offering, and it is the issuer that should have the most to lose. It is only fair that the issuer should have the most to lose where the offering is marketed using inaccurate ratings. This could be called the “buck stops here” theory of securities regulation. Indeed, the authors of the Securities Act wanted to avoid a situation where all parties could “pass the buck” on to others and therefore each escape liability.

Second, and closely related to the foregoing, this Article’s proposal recognizes that the issuer is best able to shoulder the burden of liability. Consider Wells Fargo, which was the second-largest MBS issuer prior to the 2008 financial crisis, and is still a major player in the private-label MBS market. For 2012, its net income was $18.8 billion, and it had assets approaching $1.5 trillion. Based on assets, Wells Fargo is 375 times larger than Moody’s.

Third, if we accept that rating agencies play an important role in closing the information gap between issuer and investor, then we want to keep the rating agencies involved in the offering process. If we threaten rating agencies with direct liability, they will simply withdraw from involvement in MBS issuances. In fact, following Dodd-Frank’s nullification of SEC rule 436(g), making rating agencies liable for inaccurate ratings, “the [rating agencies] made it known that they would not consent to the inclusion of their ratings in MBS registration statements. This had the effect of bringing the market for publicly-offered MBSs to a standstill . . . .” SEC quickly backed down.

registration statements. . . . Issuers or management must assume primary responsibility for the information disseminated in the registration statement.”

326 Fligstein & Goldstein, supra note 78, at 35 (providing rankings as of 2007 and ranking Wells Fargo second, behind Countrywide).

327 According to Wells Fargo’s most recent annual report, it has $133 billion in MBSs available for sale. Wells Fargo & Co., Annual Report (Form 10-K) 46 tbl.11 (Feb. 27, 2013).

328 Id. at 32 tbl.1.

329 Id.

330 Moody’s had a net income of $690 million in 2012. Moody’s Corp., Annual Report (Form 10-K) 26 (Feb. 26, 2013). It had total assets approaching $4 billion. Id.

331 See supra Part III.A.

332 Benjamin H. Brownlow, Note, The Dodd-Frank Wall Street Reform and Consumer Protection Act: Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities, 15 N.C. BANKING INST. 111, 111 (2011) (“The rating agencies . . . . were unwilling to consent to inclusion of their rating because of Dodd-Frank’s rescission of SEC Rule 436(G) [sic], which had previously shielded rating agencies from civil liability.”).

333 McNamara, supra note 5, at 740-41. The reason that the issuance of MBSs ground to a standstill was because regulation AB, which covers the issuance of MBSs, “requires the disclosure of [rating agencies] and their ratings in securities registration documentation,” Brownlow, supra note 332, at 112 (quoting Stephen Joyce, Dodd-Frank Impact on Rating Agencies Includes Expanded Liability, SEC Authority, BNA BANKING DAILY, Aug. 30, 2010).
Finally, making the issuer primarily responsible neutralizes the First Amendment defense that has been successfully used by rating agencies. That is to say, the issuer – unlike the rating agency – cannot use the First Amendment defense.

B. What Is Wrong with Dodd-Frank’s Approach?

The legislative response to the 2008 financial crisis was the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). As such, another possible objection to this Article’s burden-shifting proposal is that Dodd-Frank already implements a two-pronged approach to preventing a future private-label MBSs bubble. First, Dodd-Frank requires that private-label MBS issuers provide more information. Second, in an attempt to align the interests of originators, issuers, and investors – and thus alleviate information asymmetries – Dodd-Frank implements skin-in-the-game requirements. Unfortunately, these requirements will, as more fully set forth below, only marginally improve disclosure, while quashing the private-label MBS industry.

1. More Information

Section 942 of Dodd-Frank places additional disclosure requirements upon issuers, providing that they must “at a minimum . . . disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence.” SEC acted to implement this new requirement by

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334 When one MBS issuer could not get a ratings agency to sign on, SEC quickly issued a no-action letter stating that it would no longer require such disclosure. Ford Motor Credit Co., SEC No-Action Letter, 2010 WL 2882538 (Nov. 23, 2010) (extending protection originally offered in July 22, 2010 letter); see Parsont, supra note 26, at 1020 (explaining that the rating agencies nullified Congress’s attempt to expose them to section 11 liability by withholding their ratings).

335 See supra Part IV.B.

336 See SEC v. Tex. Gulf Sulphur Co., 446 F.2d 1301, 1306 (2d Cir. 1971) (“[T]he First Amendment deals with the free exchange of ideas and not with commercial ‘factual’ speech.”).


338 Section 942 of Dodd-Frank provides:

(b) SECURITIES ACT OF 1933.—Section 7 of the Securities Act of 1933 (15 U.S.C. 77g) is amended by adding at the end the following:

“(c) DISCLOSURE REQUIREMENTS.—

“(1) IN GENERAL.—The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

“(2) CONTENT OF REGULATIONS.—In adopting regulations under this subsection, the Commission shall—

“(A) set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes; and

“(B) require issuers of asset-backed securities, at a minimum, to disclose asset-level or
adding item 1111A under regulation AB (a subpart of regulation SK), which adds a new schedule L.339 The SEC-proposed regulations more clearly define the information that must be provided, for example, “in the case of residential mortgages, . . . credit score of the obligors, employment status, income, and how that information was verified.”340

However, while Dodd-Frank may increase the amount of information provided to a prospective investor, it is not clear that it will improve that investor’s appreciation of risk. Consider one of the MBSs at the center of current litigation: IndyMac Residential Mortgage-Trust Series 2006-L2.341 The 2006 prospectus provided information such as the geographic location of the mortgaged homes, the rating of the borrowers, the loan terms (such as rate and balloon payments), and LTV ratios.342 However, this information is buried deep within the prospectus, while within the first few pages of the prospectus investors are presented with a prominent display of the risk rating provided by Moody’s and S&P, Aaa and AAA respectively.343 Further, as discussed above, even if an investor did review the particularized information, it is unlikely that the investor would understand how each piece of information impacted others.344

That being said, section 942’s requirement of more loan-level disclosure may have the beneficial effect of creating discipline among the originator and issuer, especially considering that it is reinforced by section 945 of Dodd-Frank, which requires the issuer of an MBS to conduct due diligence as to the loan-level data, if such data are necessary for investors to independently perform due diligence, including—

“(i) data having unique identifiers relating to loan brokers or originators;
“(ii) the nature and extent of the compensation of the broker or originator of the assets backing the security; and
“(iii) the amount of risk retention by the originator and the securitizer of such assets.”

Dodd-Frank Wall Street Reform and Consumer Protection Act § 942.


340 Id. at 23,357. The proposed regulations require the issuer to provide detailed information as to the originator, servicer, loan amount, and interest rate. Id. at 23,422-23. Further information must be provided as to the mortgage purpose, mortgage insurance, balloon payments, broker, and prepayment penalties. Id. at 23,423. As to the property itself, the issuer must provide information as to geographic location, occupancy status, sales price, property type, property value, and LTV ratio. Id. at 23,424. Finally, the issuer must disclose information as to the borrower’s FICO score, cash reserves, other mortgaged properties, monthly debt, debt-to-income ratio, employment and whether the borrower claims to be self-employed, income, previous bankruptcies, and previous foreclosures, together with whether the foregoing has been verified. Id. at 23,424-25.

341 IndyMac Prospectus, supra note 93.

342 Id.

343 Id.

344 Levitin et al., supra note 7, at 166 (“What is impossible for investors to tell, however, is the relationship between these terms.”).
assets underlying the MBS, and to “disclose the nature of the review.”\textsuperscript{345} To implement these new statutory requirements and to remedy a concern that “due diligence practices in [MBS] offerings had eroded significantly,” the SEC promulgated rule 193 under the Securities Act of 1933.\textsuperscript{346} Rule 193 provides:

An issuer . . . offering and selling [an MBS] pursuant to a registration statement shall perform a review of the pool assets underlying the asset-backed security. At a minimum, such review must be designed and effected to provide reasonable assurance that the disclosure regarding the pool assets in the form of prospectus . . . is accurate in all material respects.\textsuperscript{347}

This due diligence will hopefully serve a verification function, both for the issuer (that they are securitizing what they think they are securitizing) and for the investor (that they are getting what they bargained for). Important for our purposes, complying with section 945 and rule 193 could go part of the way toward meeting the second requirement of this Article’s proposal: that all inputs used by the rating agency were correct and up to date.\textsuperscript{348} Such compliance is not a complete solution, however, because it neither guarantees that the loan-level data that makes it to the rating agency is accurate nor does anything regarding failed macroeconomic assumptions.

2. Dodd-Frank’s Skin-in-the-Game Requirement

This Article has focused on the information problems between issuer and investor, and the ability of ratings to alleviate that problem. A slightly different (yet closely related) take on the information problem is presented by Professor Bar-Gill:

Securitization created a host of agency problems, as a series of agents — intermediaries tasked with originating loans, pooling and packaging them into mortgage-backed securities, and assessing the risk associated with the different securities — stood between the principals, the investors who ultimately funded the mortgage loans, and the borrowers. The compensation of these agents-intermediaries was not designed to align their interests with those of the principals-investors: their fees were based on the quantity, not quality, of processed loans. As a result, the agents-intermediaries had strong incentives to increase the volume of


\textsuperscript{347} 17 C.F.R. § 230.193 (2013).

\textsuperscript{348} See supra Part V.
Sensibly, the authors of Dodd-Frank adopted the theory that a misalignment of interests was the predominant cause of the MBSs bubble. The interests of mortgage originators were not aligned with the interests of mortgage securitizers. The interests of mortgage securitizers were not aligned with the interests of investors. In an attempt to align the interests of the originator, securitizer, and investor, Dodd-Frank requires that any MBS issuer retain five percent of the credit risk for any asset. Unfortunately, this approach, colloquially referred to as “skin-in-the-game,” will result in private-label MBS issuers being frozen out of the market in favor of GSE issuers. This amounts to “throwing out the baby with the bathwater.” The Author agrees with Professor Bar-Gill that the interests are misaligned, and that those interests should be aligned; the Author simply believes that a five-percent retention requirement raises more problems than it solves. A better approach is the burden-shifting proposal set forth in Part V of this Article.

Dodd-Frank’s skin-in-the-game requirements will greatly reduce, if not eliminate, private-label MBS offerings, and will reinstate the virtual GSE monopoly that existed prior to the passage of the SMMEAA and the TRA.

349 Bar-Gill, supra note 43, at 1081.
350 Bd. of Governors of the Fed. Reserve Sys., Report to the Congress on Risk Retention 6 (2010) (“Section 941 is intended to help align the interests of key participants in the securitization process, notably securitizers and originators of the assets underlying an ABS transaction, with the interests of investors. The Act requires, as a general matter, that the securitizer or originator retain some of the credit risk of the assets being securitized.”).
351 Id. at 43-44 (explaining that originators typically retained no interest in mortgages sold for securitization, while securitizers did).
352 Id. at 4 (“Incentive alignment problems may also exist between servicers and investors in the securitization.”).
354 Levitin & Wachter, supra note 10, at 1257-58.
355 David Line Batty, Dodd-Frank’s Requirement of “Skin in the Game” for Asset-Backed Securities May Scalp Corporate Loan Liquidity, 15 N.C. Banking Inst. 13, 32 (2011) (reporting one recent study that shows eighty-seven percent of issuers would stop securitizing loans that would trigger the retention requirements).
357 Issa, supra note 71, at 408 (“Fannie Mae and Freddie Mac nearly achieved monopoly results thanks to numerous competitive advantages guaranteed through their unique relationship with the federal government.”). In fact, when the risk retention rules were re-proposed on August 29, 2013, the GSEs retained their exempt status despite comments that “opposed the treatment of the Enterprises in the original proposal [from those who] generally believed that it would provide the Enterprises with an unfair advantage over private capital” and “that this aspect of the original proposal, if adopted, would prevent...
Specifically, Dodd-Frank requires that the “securitizer retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party.”\textsuperscript{358} Dodd-Frank further provides that such retention requirement shall be “not less than five percent of the credit risk for any asset.”\textsuperscript{359} The only exception is where the asset is a qualified residential mortgage (QRM).\textsuperscript{360}

By differentiating between QRMs and non-QRMs, government officials can “steer issuers away from” MBS issuances that they deem too risky.\textsuperscript{361} It follows that the definition of QRM becomes very important to defining who will be impacted – and importantly, who will not.\textsuperscript{362} For a mortgage to qualify as a QRM, the originator must follow certain procedures for making the loan, and follow restrictions on the substantive provisions of the loan.\textsuperscript{363} The procedural requirements to qualify as a QRM are fairly uncontroversial.\textsuperscript{364} The substantive terms required to qualify as a QRM are more problematic, as they would forbid the type of mortgages that private-label issuers often securitize: mortgages with less than a twenty-percent down payment, mortgages that private capital from returning to the mortgage markets and would otherwise make it difficult to institute reform of the Enterprises.” Credit Risk Retention, 76 Fed. Reg. 57,928, 57,960 (Sept. 20, 2013).

\textsuperscript{358} Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376, 1890.

\textsuperscript{359} Id. § 941(b)(c)(1)(B)(i).

\textsuperscript{360} Id.


\textsuperscript{362} Dodd-Frank Wall Street Reform and Consumer Protection Act § 941(b) (exempting qualified residential mortgages from the retention requirement). Pursuant to Dodd-Frank, the risk retention rule and the QRM exception thereto are determined by at least seven separate agencies. Specifically, the risk retention rule is promulgated by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, SEC, Federal Housing Finance Agency, and Department of Housing and Urban Development. Credit Risk Retention, 76 Fed. Reg. 24,090, 24,090 (proposed Apr. 29, 2011) (to be codified at 12 C.F.R. pt. 43) (allowing the above-mentioned agencies to define the definition of a QRM). In addition, “the Agencies expect to monitor the rules adopted under [the Truth in Lending Act] to define a [Qualified Mortgage (QM)] and will review those rules to determine whether changes to the definition of QRM are necessary or appropriate.” Id. at 24,118. That is to say, these agencies will use rules later promulgated pursuant to the Truth in Lending Act as to QM to inform later changes to the definition of QRM. \textit{Id.} The definition of QM is to be established by rule promulgated by the by the Consumer Financial Protection Bureau. \textit{Id.}

\textsuperscript{363} Credit Risk Retention, 76 Fed. Reg. at 24,117-18 (factoring in aspects of the loan such as the credit history, down payment, and debt-to-income ratio, among others).

\textsuperscript{364} \textit{Id.} at 24,120-21 (providing that the written application must be signed and certified as true by the borrower under threat of civil or criminal liability, and the borrower must undergo a credit check).
provide for interest-only payments, mortgages that contain an adjustable rate higher than two percent per year, or mortgages that include a balloon payment. The resulting debt-to-income ratio cannot exceed twenty-eight percent.

Interestingly, MBSs issued by Fannie Mae are automatically deemed safe, and thus are not subject to the retention requirement. While Fannie Mae is not expressly exempt under the statute, the proposed rules exempt them. Fannie Mae is currently under the conservatorship of the Federal Housing Finance Agency (FHFA), and “the proposed rule provides that the guaranty provided by an Enterprise while operating under the conservatorship . . . of FHFA with capital support from the United States will satisfy the risk retention requirements of the Enterprise under section 15G of the Exchange Act with respect to the mortgage-backed securities issued by the Enterprise.”

Further, as discussed above, GSEs were historically the predominant issuers of securities made from QRM mortgages due to their strict underwriting criteria. It was only in the years immediately prior to the 2008 financial crisis that GSEs ventured into securitizing more risky loans. To fill the gap, private-label issuers evolved to issue MBSs featuring pools of loans subject to less strict underwriting criteria. Thus, it is the private-label issuers that will be securitizing non-QRM mortgages. It is the private-label issuers that will be subject to the five-percent retention requirement. The five-percent retention requirement is a major disincentive to issuing those types of MBSs that the government regulator deems risky. Issuers will avoid any securitization that would implicate the skin-in-the-game requirements. The reason is clear. The retention requirement returns us to the days before the originate-and-distribute model, at least partially. Each new securitization will lock up capital. Assume a bank has $100,000 in capital. Under the originate-and-distribute model, it could make one home loan for $100,000, distribute it, make another loan for

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365 Id. at 24,122.
366 Id. at 24,125.
367 Id. at 24,112.
368 Id.
369 Id.
370 Anchor Sav. Bank, FSB v. United States, 81 Fed. Cl. 1, 17-18 (citing LORE & COWAN, supra note 85, at 1-2 to 1-3). For a discussion of the political pressure that forced the GSEs into securitizing more risky loans, see supra note 32 and accompanying text.
371 Anchor, 81 Fed. Cl. at 17. The other side of this coin is that the dominance of the GSEs crowded the private-label MBSs into risky subprime, alt-A, and jumbo loans. Horton, supra note 1, at 859-63 (“The result is that private-label issuers may originate conforming mortgages, but they sell them to the GSEs to securitize while keeping and securitizing the more risky non-conforming mortgages.” Id. at 860).
372 Batty, supra note 355, at 32 (discussing that eighty-seven percent of issuers would have difficulty retaining the five-percent risk).
373 Id.
$100,000, distribute it, ad infinitum.\textsuperscript{374} However, if there is a five-percent retention requirement the issuer can make one home loan for $100,000, distribute it, make another loan for $95,000, distribute it, make another home loan for $90,250, another loan for $85,737 . . . $81,450 . . . $77,378 . . . $69,833 . . . eventually its free capital runs out.

Admittedly, the retention requirement does not set up a situation as illiquid as the pure originate-and-hold model,\textsuperscript{375} but it will set up a situation where issuers are forced to lock up an ever increasing amount of capital.\textsuperscript{376} J.P. Morgan stated in response to the proposed risk retention rules, “[a]t some point this would restrict the capacity of even the largest securitization sponsors to continue to issue [private-label MBSs].”\textsuperscript{377} That J.P. Morgan is concerned is more than noteworthy. J.P. Morgan is a private-label MBS issuer in its own right\textsuperscript{378} and is now responsible for Bear Stearns’ MBSs portfolio.\textsuperscript{379} In fact, some commentators are treating the fact that the risk retention requirements will act as a barrier to the securitization of non-QRM as a given.\textsuperscript{380} Professors Levitin, Pavlov and Wachter opine: “[I]t may be that the purpose of Dodd-Frank’s risk retention requirements is to “crowd[] out . . . non-QRM products from the market by making them too expensive [and] noncompetitive.”\textsuperscript{381} It seems they are correct. Private-label MBS issuers are trying to get deals done before Dodd-Frank’s regulations kick in,\textsuperscript{382} concerned about their capacity to

\begin{footnotesize}
\begin{enumerate}
  \item See supra Part I.B.
  \item See supra Part I.A.
  \item Michael Wade Strong, Rethinking the Federal Reserve System: A Monetarist Plan for a More Constitutional System of Central Banking, 34 IND. L. REV. 371, 383 (2001) (indicating that the Federal Reserve retention requirement “require[s] that the issuer keep a larger sum of [money] on account, and therefore, have less money available for lending”).
  \item Fligstein & Goldstein, supra note 78, at 35 (stating that in 2007, J.P. Morgan was the sixth-largest issuer of private-label MBSs).
  \item Levitin et al., supra note 7, at 163.
  \item Id.
  \item Letter from Sec. Indus. & Fin. Mkts. Ass’n, to the Office of the Comptroller of the Currency, U.S. Dep’t of the Treasury, at vii (June 10, 2011), available at http://www.sifma.org/issues/item.aspx?id=25925 (“[M]embers are so disheartened by the approach taken by the Agencies in drafting the proposed credit risk retention rules that they are speaking in terms of having one year, or two years, remaining ‘to get deals done’ – a reference to the effective dates of the risk retention rules for residential mortgage-backed securities and other ABS, respectively.”).
\end{enumerate}
\end{footnotesize}
“comply and remain active in the securitization market.” This is similar to the old tax adage, “[i]f you want more of something, subsidize it; if you want less, tax it.” The five-percent retention requirement is simply a tax by another name.

Without a vibrant private-label MBS industry, revival of the housing industry will be difficult. “[A]ny sort of restoration of a private housing finance system in the United States requires the return of private risk capital to the system.” In January 2012, Acting Comptroller of the Currency John Walsh stated:

It is hard to imagine full recovery of the financial system without the liquidity and funding avenues provided by a well-functioning securitization market. Certainly, it is hard to foresee a strong recovery for the housing industry without securitization. And it seems unlikely we will experience strong and sustained economic growth without a rebound in the housing sector.

If we assume that a general economic recovery is dependent on a housing recovery, then the question becomes, can housing recover without the recovery of private-label MBSs? Mr. Walsh rightly suggests that the answer is “no.” Yet Dodd-Frank actively prevents the recovery of private-label MBSs by empowering federal bureaucrats to place obstacles on the path to private-label

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385 The private-label MBS industry is already struggling in the aftermath of the 2007 economic crisis. The Author could find only one active private-label MBS issuer at the time of writing: Redwood Trust, Inc. Redwood closed one deal in 2010, two deals in 2011, and three in 2012. Jody Shenn, Redwood Conquering Jumbos Targets Loans BofA Shuns, BLOOMBERG (Aug. 6, 2012), http://www.bloomberg.com/news/2012-08-06/redwood-conquering-jumbos-targets-loans-bofa-shuns-mortgages.html. Redwood Trust specializes in securitizing jumbo mortgages, a genre of mortgage which is often non-QRM. Redwood Trust, Inc., Annual Report (Form 10-K) 1 (Feb. 27, 2012). Redwood’s most recent annual report warns its investors that because many of its securitizations involve non-QRM, “[i]t is difficult to predict with certainty how the Dodd-Frank Act . . . will affect our future ability to successfully execute participate in securitization transactions.” Id. at 19.

386 Levitin et al., supra note 7, at 157.

MBS offerings. The federal experts serve as gatekeepers, preventing private-label MBS offerings that they deem too risky (a regime much like merit review); Dodd-Frank takes the position that private-label MBSs are so complex – and potentially toxic – that investors should be prevented from investing in them. The thought, however, of a benevolent federal government protecting us from private-label MBS loses its appeal when we consider the tradeoff: Fannie Mae regaining an MBSs monopoly, with a

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388 This Article focuses on practical objections to the operation of Dodd-Frank. The philosophical objections to rule-by-expert are treated by this author elsewhere. See Brent J. Horton, The TARP Bailout of GM: A Legal, Historical, and Literary Critique, 14 TEX. REV. L. & POL. 217, 260 (2010) (discussing problems arising from rule-by-expert).

389 An interesting question is whether Dodd-Frank adopted merit review for MBSs. As such, Dodd-Frank rekindled an age-old debate. The merit model requires that a company’s issuance be given a permit before it can be offered to the public. Daniel J. Morrissey, The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review, 44 U. RICH. L. REV. 647, 679 (2010). In the aftermath of the 1929 stock market crash, early proposals of a federal securities law included such merit review, providing for:

[T]he revocation of an issuer’s registration upon a finding that “the enterprise or business of the issuer, or person, or the security is not based upon sound principles, and that the revocation is in the interest of the public welfare,” or that the issuer “is in any other way dishonest” or “in unsound condition or insolvent.”

Id. at 679 (quoting S. 875 & H.R. 4314, 73d Cong. 1st Sess. § 6(c), (e), (f) (1933), reprinted in 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at item 28 & 22, at 13 (1973)). Thus merit review – with regulators empowered to make judgments about the riskiness of a proposed offering – is the opposite of the disclosure model, “which allow[s] issuers to sell very risky or even unsound securities, provided they gave buyers enough information to make an informed investment decision.” See BAINBRIDGE, supra note 119, at 39. The drafters of the Securities Act of 1933 rejected the merit model. Stephen M. Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 95 MINN. L. REV. 1779, 1801 (2011).

Merit review is often criticized as paternalistic because it takes choice away from investors based on the fear that investors’ choices will be unwise. Cheryl Farson, At What Cost Paternalism? A Call to State Legislatures to Reconsider the Propriety of Merit Review of Securities Offerings, 22 ARIZ. ST. L.J. 963, 977 (1990) (“Excessive paternalistic legislation indicates a lack of government confidence in the ability of its citizens to make wise decisions.”). Merit review commonly allows government agents to determine which securities are too risky and further empowers them to block the offering of such securities. Dodd-Frank’s treatment of MBSs largely follows that model. Specifically, Dodd-Frank subjects the MBS to a test to see if it is risky: an MBS fails if it is made up of nonqualified residential mortgages. Once the MBS fails the test – as most private-label MBSs will – it will likely never be issued because it is subject to barriers to issuance, including a five-percent retention requirement. David A. Skeel, Jr., The SEC in Bankruptcy: Past, Present and Future: Welcome Back, SEC?, 18 AM. BANKR. INST. L. REV. 573, 578-80 (2010) (discussing how additions to the Securities Laws under Sarbanes-Oxley and Dodd-Frank can give regulators powers that are reminiscent of merit review). The choice is made at the governmental level, not at the investor level. That is to say, choice is removed from the investor.
corresponding lack of competition and further politicization of the mortgage market.\footnote{390}{Stanton, supra note 32, at 229-30, 234-35 (discussing multiple examples of political pressure on Fannie Mae); Duhigg, supra note 32, at A1 (describing pressure from Congress); Holmes, supra note 32, at C2 (describing pressure from Clinton Administration).} Congress should have accepted the important role that private-label MBSs can play in mortgage finance, and instead acted to strengthen the disclosure that those private-label issuers provide. Indeed it is disclosure,\footnote{391}{See supra Part II.} not merit review, which the securities laws embody.

CONCLUSION

\textit{There are fools anywhere, and a fool and his money are soon parted.}\footnote{392}{Wall Street and the Law, WALL ST. J., Nov. 18, 1926, at 1, cited in John H. Walsh, Can Regulation Protect “Suckers” and “Fools” from Themselves? Reflections on the Rhetoric of Investors and Investor Protection Under the Federal Securities Laws, 8 J. BUS. \& SEC. L. 188, 198 n.132 (2008).}

The foregoing quote summarizes the policy behind a hands-off approach to regulation of securities. That ideology was partially abandoned in the aftermath of the 1929 stock market crash with the passage of the Securities Act of 1933, which still allows investors to take tremendous risk, but only after being told just how foolish they are being (that is to say, after full disclosure).\footnote{393}{Securities Act of 1933 § 5, 15 U.S.C. § 77e (2012) (requiring that any offer of a security be accompanied by a prospectus).} The Securities Act of 1933 balances fraud prevention and individual responsibility.

This Article’s proposal embraces that balance by aiming to provide investors with more accurate information, but still allowing them to make investment decisions for themselves. Historically, this was done by the inclusion of ratings in offering documents. This Article proposes a way to improve the accuracy of the ratings through pressure on the issuer. To that end, this Article proposes a simple burden-shifting procedure: where a plaintiff brings a cause of action pursuant to section 11 of the Securities Act against the issuer, based upon an allegation that a MBS (or similarly complex fixed-income security) registration statement contained an inaccurate rating, the burden shifts to the issuer to establish (1) that the loss model used was state of the art, and (2) all inputs were correct and up to date. If the issuer fails to meet this burden, then the plaintiff will have established a material misstatement within the registration statement, satisfying what is often the most troublesome element of a section 11 claim. Thus, this Article’s proposal, like the Securities Act of 1933 that it builds upon, balances fraud prevention and individual responsibility. Armed with information, investors can decide for themselves whether they want to invest in a particular MBS issuance.
Some scholars, however, believe that Congress did not go far enough when it passed the Securities Act of 1933.\textsuperscript{394} They believe Congress missed an opportunity to put in place rules that shield investors from risky investments.\textsuperscript{395} These proponents of merit review argue that “the framers of [the Securities Act of 1933] put too much faith in the prudence of investors and the self-policing mechanisms of the capital markets.”\textsuperscript{396}

Unfortunately, proponents of merit review seem to have gotten their wish with the passage of Dodd-Frank, which allows government officials to decide which MBSs should be offered to the public (or more precisely, allows government officials to place barriers to issuance in front of MBSs they deem too risky).\textsuperscript{397} The result will be the extinction of the private-label MBS industry, or at least the extinction of complex MBSs crafted from creative mortgage options; in turn, there will be fewer credit options for home buyers, calling into question President Franklin Roosevelt’s dream of “a nation of home owners, of people who own a real share in their own land.”\textsuperscript{398}

\textsuperscript{394} Morrissey, supra note 389, at 649 (“[Congress] passed up the opportunity to exercise more meaningful control over the quality of issued securities by a regime of merit regulation [in the 1930s].”).

\textsuperscript{395} Id.

\textsuperscript{396} Id.


\textsuperscript{398} Home Owners Hailed in Roosevelt Note, N.Y. Times, Nov. 17, 1942, at 35.