BELLING THE CAT: TAMING THE SECURITIZATION BEAST WITHOUT KILLING IT

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Introduction

Much has been written about the financial meltdown of 2008, the reverberations of which are still being felt both in the U.S. and European economies as well as in the U.S. presidential campaign. Different commentators have pointed fingers in many different directions in trying to assess blame for the greatest financial collapse since the Great Depression. Among those blamed are (i) government sponsored enterprises ("GSEs")—namely, Freddie Mac and Fannie Mae—for their overzealous origination of residential mortgage loans for borrowers ill-suited to repay the loans;[1] (ii) elected members of the U.S. Congress for unduly pressuring GSEs to make home ownership affordable to lower-income families;[2] (iii) Congress and the Clinton White House for passing the Gramm-Leach-Bliley Act,[3] which repealed key provisions of the Glass-Steagall Act,[4] which had, since its passage shortly after the Great Depression, mandated a separation of traditional banking from the riskier investment banking functions;[5] (iv) Congress and the second Bush Administration for aggressively pursuing a policy of deregulation of the financial markets and for placing too much faith

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[1] *See, e.g.*, THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xx (2011) [hereinafter "FINANCIAL CRISIS REPORT"]; *see also* R. Christopher Whalen, *The Subprime Crisis—Cause, Effect and Consequences*, 17 J. AFFORDABLE HOUS. & CMTY. DEV. L. 218, 220 (2008).

[2] *See, e.g.,* William Poole, *Causes and Consequences of the Financial Crisis of 2007-2009*, 33 HARV. J.L. & PUB. POL'Y 421, 425 (2010); FINANCIAL CRISIS REPORT, *supra* note 1, at 444-45 (Wallison, dissenting).

[3] *See* Gramm-Leach-Bliley Act, Pub.L. 106-102, 113 Stat. 1338 (1999).

[4] *See* Banking Act of 1933, Pub.L. 73-66, 48 Stat. 162 (1933).

[5] *See, e.g.*, Alessandra Stanley, *The Epoch of Clinton, So Close Yet So Far*, N.Y. TIMES, Feb. 20, 2012, at C1.

in the free market;[6] (v) Alan Greenspan, as Chairman of the Federal Reserve Board, for placing too much confidence in the effectiveness of market discipline as a constraint on market excesses and for maintaining a low interest rate environment;[7] (vi) Ben Bernanke, as Greenspan's successor, for underestimating the potential for the subprime mortgage market to undermine the entire economy;[8] (vii) the federal regulators for turning a blind eye to the excesses and abuses in the capital markets;[9] (viii) the large banks for ignoring and, in many cases, firing their risk managers for imposing restraints on the banks' exposure to the subprime market;[10] (ix) the credit rating agencies for letting the pursuit of market share trump their obligations to consider the severe risks of the subprime mortgage securities and subprime mortgage-backed collateralized debt obligations ("CDOs");[11] (x) residential mortgage originators for unscrupulous and deceptive practices in originating subprime mortgage loans to borrowers who were obviously unable to repay the loans;[12] and (xi) subprime borrowers, who were gullible enough to let themselves be an easy mark for the unscrupulous mortgage brokers.[13]

Of course, the "Great Collapse of 2008" had many causes. Each of the aforementioned factors played a role in unleashing a

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[6] *See, e.g.,* FINANCIAL CRISIS REPORT, *supra* note 1, at 53; Jo Becker et al, *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1.

[7] *See, e.g.,* Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 24, 2008, at B1; FINANCIAL CRISIS REPORT, *supra* note 1, at xviii; *but see* Whalen, *supra* note 1, at 222.

[8] *See, e.g.,* John Cassidy, *Anatomy of a Meltdown*, NEW YORKER, Dec. 1, 2008, at 48.

[9] *See e.g.*, KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 204-05 (2011).

[10] *See, e.g.*, FINANCIAL CRISIS REPORT, *supra* note 1, at 177 (describing how Lehman Brothers' management "regularly disregarded . . . warnings from risk managers").

[11] *See, e.g.,* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 120-24 (2009); FINANCIAL CRISIS REPORT, *supra* note 1, at xxv.

[12] *See, e.g.,* FINANCIAL CRISIS REPORT, *supra* note 1, at xxi-xxii.

[13] *See, e.g.,* Eli Lehrer, *Subprime Borrowers: Not Innocents*, BLOOMBERG BUSINESSWEEK, http://www.businessweek.com/debateroom/archives/2008/01/subprime_borrow.html (last visited Mar. 6, 2012).

combination of forces that converged to produce the tsunami of 2008. However, all of these factors together were incapable of producing such cataclysmic results without the introduction of one potentiating agent into the mix—securitization technology. Only with such technology could these various forces be combined to create financial products and financial strategies of such enormous scale and volatility as to take down hundreds of financial institutions, including several icons of American finance, threaten the existence of several more, and bring the U.S. and European economies to their knees.

The first part of this article will trace briefly the evolution of securitization technology. It will begin with its origins as a vehicle for creating liquidity in the U.S. residential market in the 1970s and describe its adaptation as an instrument for creating liquidity in the disposition of the commercial real estate assets of the savings and loan industry when that industry imploded in the late 1980s. It will then trace securitization's use in the 1990s and early 2000s to bring liquidity to non-real estate asset classes and its final mutation into a vehicle for delivering outsized arbitrage profits to banks and other originators.

It is the author's belief that with this final mutation, securitization technology crossed into a new and dangerous place, where it ceased to be deployed in the service of issuers needing liquidity for their economic pursuits through the securitization of financial assets, and was instead appropriated for a new purpose—as an arbitrage delivery vehicle. Subprime mortgages and CDOs became the poster children for this new paradigm because they were plentiful, they could be replicated quickly and in large volumes, and they were high-risk, high-yielding frogs that—through the alchemy of the ratings process—could be turned into highly-rated, low-yielding princes. The story of this corruption of securitization technology, from an asset-centric issuer-driven paradigm to an originate-to-distribute model pursued solely to squeeze arbitrage juice from the securitization process, is a narrative which holds a magnifying mirror up to the current national debate about what constraints on the financial markets are acceptable. This story focuses attention away from ideological predispositions and toward practical, common sense considerations of what is good and should be preserved, and what is too harmful to be tolerated in our current financial system.

Securitization technology has served the U.S. economy – and others around the world – well for over thirty-five years, bringing

unprecedented liquidity to many corners of the global markets. Yet, its power has the potential to be misused to produce calamitous results. From its inception in the 1970's and into the first few years of the 21st century, despite the financial and national upheavals brought about by the collapse of Long-Term Capital Management in 1998, the collapse of Enron in 2001 and the horror of 9-11, the securitization market had been notably resistant to the virile strains which periodically infected the non-securitized segments of the market. What great mutation occurred between then and 2006, when securitization became a toxic agent for the entire economy? And what is the proper way to prevent the abuses of securitization without killing it and depriving all of us of its beneficial results?

To answer these questions, the first part of this article will identify the key applications of the securitization techniques that materially contributed to the 2008 financial collapse. In the process, it will explore the line between acceptable uses of securitization technology and uses that are too toxic to be tolerated, even if the line does not run a straight and clear course. While identifying and tracing this line, it will be necessary to make a few deep dives into the intricacies of the financial products developed by the securitization industry that led to such unexpected and disruptive outcomes.

Congress and industry regulators have had time to develop their own responses to the financial collapse through the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[14] and numerous rules proposed thereunder, as well as other rules which attempt to regulate the participants in the securitization process in light of their perceived contribution to the meltdown. The second part of this article will examine some of these rules to determine whether they hit their mark, fell short or overshot their goals.

[14] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter "Dodd-Frank Act"].

I. The Shifting Securitization Paradigm

A. Agency Residential Mortgage-Backed Securities

The origin of securitization was pass-through securities created by Ginnie Mae and Freddie Mac in the early 1970s.[15] These products involved the pooling of residential mortgages into special-purpose vehicles usually qualifying as "grantor trusts" for U.S. tax purposes, and the issuance of pass-through certificates representing undivided interests in the assets of the trusts.[16] Fannie Mae followed suit in the early 1980s.[17] Although there were qualitative differences among the types of guarantees supporting each of the agencies' securities, the purpose behind the mortgage-backed securities programs of each GSE was the same—to provide a ready source of liquidity to the GSEs so that they could, in turn, provide liquidity to the bank and mortgage company originators of the single-family residential loans.[18]

Thus, the original securitization vehicles were based on an originate-to-distribute model—the same model that propelled the exponential issuance volume of the subprime mortgage and CDO markets that contributed to the meltdown 30 years later. However, there were a few important differences: First, the loans in the GSE pools received the benefit of various levels of guarantees which were backed, or quasi-backed, by the full faith and credit of the United States.[19] To put it differently, the U.S. government had "skin in the

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[15] *See Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the H. Subcomm. on Hous. & Cmty. Opportunity* 108th Cong. (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP) ("The first mortgage-backed securities arose from the secondary mortgage market in 1970. Investors had traded whole loans, or unsecuritized mortgages, for some time before the Government National Mortgage Association (GNMA), also call Ginnie Mae, guaranteed the first mortgage pass-through securities . . .").

[16] *Id.*

[17] *Id.*

[18] *See* 12 U.S.C. 1716 (2006) (establishing "secondary market facilities" to increase "the liquidity of mortgage investments and [improve] the distribution of investment capital available for residential mortgage financing").

[19] For further analysis of the federal government's "guarantee," see David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L.

game." Thus, the loans had to meet strict underwriting standards to qualify for the guaranty and, by extension, the pools.[20] Also, the seller-servicers of these loans were obligated to make certain baseline representations and warranties as to certain characteristics of the loans and thus have accountability (and a repurchase obligation) in some instances if the loans were defective.[21]

B. Commercial Mortgage-Backed Securities

The next major development in the mortgage securitization market came in the late 1980s and early 1990s, when the savings and loan industry, which had leaned way over its skis by gorging on commercial real estate loans that were aggressively underwritten, collapsed. The Resolution Trust Corporation, which was formed by the U.S. government to dispose of or otherwise resolve the billions of dollars of real estate assets on the balance sheets of failed savings and loan associations, turned to securitization as a means of creating the liquidity needed to recover some of the losses to the federal insurance system.[22] Commercial real estate loans lacked the uniformity of underwriting standards and documentation that prevailed in the residential housing market, thus creating challenges

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REV. 1019, 1025 (2008) ("The federal government's guarantee of Fannie and Freddie's obligations is . . . implied in the American financial system's regulatory environment.").

[20] *See* Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 157 (2009) ("Fannie Mae and Freddie Mac required that loan originators meet relatively strict underwriting guidelines and use standardized forms in order to qualify for purchase by the two GSEs.") (citing Anand K. Bhattacharya et al., *Overview of the Mortgage Market*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 3, 22 (Frank J. Fabozzi, ed., McGraw Hill 5th ed. 2001)).

[21] *See* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1307 (2009) (describing how repurchase obligations and representations and warranties were used as safeguards during the securitization process).

[22] Joseph F. DeMichele & William J. Adams, *Commercial Mortgage-Backed Securities*, *in* THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES 73, 74 (Frank J. Fabozzi & David P Jacob eds., 2d ed. 1998).

in the pooling, structuring and rating processes.[23] These obstacles were overcome, however, and a robust Commercial Mortgage Backed Securities ("CMBS") market emerged by the early 1990s, financing newly issued privately originated loans as well as detritus from the S&L collapse.[24] Banks and other mortgage originators quickly understood that the CMBS market enabled large lenders to securitize their own loan origination. Securitization was, in those cases, a means of "lightening" the lenders' balance sheets and providing liquidity for new loan originations or for other purposes such as improving regulatory capital.

The next step in the evolution of the CMBS market was the origination of loans, not on the banks' balance sheet, but instead through special purpose subsidiaries, or conduits.[25] The conduits often funded their originations with commercial paper until enough loans were originated to issue long-term securities. Through this process, the loan originators could issue rated securities at yields far lower than those on the loans themselves, thereby retaining the spread for themselves. The securitized loans could then, under then applicable accounting standards, qualify for off-balance-sheet treatment. Although the conduits had interest rate exposure during the aggregation period, they began to develop ways to hedge against interest rate risk.

Thus, the CMBS market—like the residential mortgage backed securities ("RMBS") market that preceded it—quickly adopted an originate-to-distribute paradigm, but without a U.S. guarantee providing "skin in the game." The exigencies of commercial real estate finance, however, imposed their own restraints on the underwriting metrics of the CMBS market: the loans originated by the conduits were predominantly loans to commercial real estate owners with significant equity invested below the debt

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[23] *See* FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 417 (1998) ("In the past, securitization structures had been used to sell performing residential mortgage loans rather than commercial mortgages because commercial mortgages were perceived to be riskier because of the lack of homogeneity in loan term, size, and structure.").

[24] *See id.* (stating that the commercial loan security market had evolved into an $80 billion market by 1997).

[25] Galia Gichon, *The CMBS Market: Past, Present, and Future*, *in* THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES 3, 6 (Frank J. Fabozzi & David P Jacob eds., 2d ed. 1998).

portion of the capital stack; and the assets were in almost all cases substantial in size relative to single-family residential loans, thus creating lumpiness in the pool which required that ratings agencies consider each asset in the pool. Moreover, in order to market the commercial mortgage securities, and to give borrowers the advance rate that they required, the sponsors were required to include "B-pieces," "B notes" or both in the capital structures. These instruments act like mezzanine loans and were generally held by sophisticated real estate investors that were reasonably comfortable that their risk exposure was tolerable, thus adding an additional level of "skin in the game."[26]

C. Asset-Backed Securities

As the CMBS market was maturing, so too was the market for securitizing non-real estate assets such as auto loan receivables, credit card receivables, trade receivables and, eventually, more esoteric asset classes such as cell towers for wireless telecommunication, aircraft and other equipment leases, structured settlements, franchise and patent royalties, and legal fee receivables.[27] The auto loan and credit card securitizations – like the RMBS and CMBS transactions discussed previously – followed the originate-to-distribute paradigm. Although these transactions were structured with less tangible "skin in the game," the banks that originated the assets that went into these pools did receive significant excess spread. This spread was valuable cash flow to them in their credit card or auto lending businesses, but was at risk of being lost if the portfolio experienced sub-par performance. As a result, the historical performance on auto loan and credit card securitization pools has been, with some exceptions, relatively stable.

The more esoteric asset classes generally did not fall into the originate-to-distribute model but were instead one-off transactions to provide liquidity to the sponsor either to fund business operations or to fund other economic activities.[28] And because of the non-

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[26] *See* CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY 50 (2010) (describing the role of "B-pieces" in the CMBS market).

[27] FINANCIAL CRISIS REPORT, *supra* note 1, at 45.

[28] For a discussion of "one-off" transactions, see Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 138-40 (1994).

commoditized, "off-the-run" nature of the assets, the ratings agencies, as well as the monoline insurers that frequently wrapped the senior-most securities with their financial guarantees, spent considerable time scrubbing the assets and reviewing the financial structures to assure satisfactory performance. Ironically, the bespoke nature of the assets and the structures that were used in the more esoteric asset-backed security ("ABS") transactions focused the attention of the ratings agencies and the financial guarantors, resulting generally in sound rating methodologies and strong performance trends even through the 2008 collapse and its aftermath.

D. Securitization Paradigm

The ABS securitizations, like the securitizations of residential mortgage loans and commercial real estate loans, used the same basic structure—that of an originator transferring the assets to be securitized into a newly created special-purpose vehicle ("SPV") in a manner designed to qualify for a "true sale" opinion from a law firm.[29] The true sale opinion was to the effect that the transfer was a completed transfer for full consideration that would be respected as such in the event that the transferor is the subject of a bankruptcy proceeding.[30] When this result obtains, then the transfer achieves "bankruptcy-remoteness": the bankruptcy of the originator will not disrupt the operations or, most importantly, the collection and disbursement of revenues at the level of the SPV, and the investors in the securities issued by the SPV would be insulated from the risk of the bankruptcy of the originator.[31] This is the key to the magic of securitization—the turning of unrated assets and cash flows into gold-plated highly rated securities assigned rating categories not constrained by the ratings, or lack thereof, of the originator.

E. Fortress of Redundancies

To fortify the bankruptcy-remote SPVs further against risk of loss, a virtual fortress of redundant safeguards was erected around the securitization structures. They included: (i) ratings agencies charged with severely stressing the assets and structures to test their sustainability against extreme adverse financial scenarios; (ii)

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[29] *Id.* at 135.
[30] *Id.*
[31] *Id.* at 135-36.

monoline guarantors running their own independent stress tests before agreeing to issue financial guarantees of the senior tranches of the securitization structures; (iii) bank originators and underwriters with robust risk management offices, and C-suite managers assigned the responsibility of protecting shareholder values against undue risk; (iv) sophisticated institutional investors with resources to vet the securities thoroughly and reject those with unacceptable risk; (v) securities and bank regulators that oversaw the market and had the tools and power to quickly impose sanctions on players engaged in bad practices; (v) lawyers—both the transactional lawyers that assisted in the due diligence, structuring, disclosing and documenting of the deals as well as the plaintiffs' lawyers, whose large contingent fees created an incentive to pounce on bad actors for defective disclosure and fraud; and (vi) the securitization paradigm itself, in which the assets collateralizing the securities were safely ensconced in (supposedly) bankruptcy-remote SPVs. This system of redundancies gave the market participants a feeling of security and even immunity against major market abuses and large-scale defaults, as well as economic recessions. And for thirty years this sense of well-being proved to be justified: there were no major disruptions in the securitization market, and no large-scale defaults, despite isolated instances of fraud and other forms of malfeasance. And so one is compelled to ask: What went so terribly wrong in the years leading up to the spring of 2008, and why?

F. The Fortress is Breached

As stated in the Introduction, a huge paradigm shift occurred in the securitization market roughly between 2000 and 2006. While issuance volumes in the agency RMBS, private label (non-GSE) RMBS, CMBS and ABS sectors followed a generally consistent growth trajectory, a shadowy parallel securitization universe began to take shape without much notice or fanfare. Fueled by the issuance of subprime RMBS and CDOs, this new market expanded at a rate far exceeding the rate of expansion in other securitization markets.[32] By 2006, the total annual aggregate U.S. issuance volume of subprime RMBS and CDOs was approximately $850 billion, compared to $1.2 trillion for the *entire* U.S. ABS market (including subprime RMBS and CDOs) and only $350 billion for the more traditional forms of

[32] *See* Eggert, *supra* note 21, at 1267 (describing the rapid increase in subprime securitization).

ABS.[33] In other words, aggregate subprime and CDO issuance exceeded seventy percent of the issuance volume of the entire ABS market in this high-watermark year.[34] By contrast, in 2001, the total issuance volume of *all* ABS in the U.S. was slightly less than $300 billion—CDOs did not have sufficient volume to be separately broken out, and were instead grouped under the category of "Other," collectively at under $50 million.[35]

Mainstream authors have written several excellent narratives of the precipitous rise and fall of the subprime and CDO markets and their impact on the U.S. economy.[36] These accounts are not only informative, but are also raucously amusing, terrifying and sad in parts. Threading through the story of the Collapse of 2008 is the story of the obscure parallel universe of subprime mortgage securities and CDOs, and how those financial inventions, in the hands of unscrupulous or clueless market participants, became instruments of mass destruction that breached the redundant

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[33] KAREN WEAVER, DEUTSCHE BANK, *US Asset-Backed Securities Market Review and Outlook*, *in* GLOBAL SECURITIZATION AND STRUCTURED FINANCE 2008, at 18, 19 (2008).

[34] *Id.*

[35] ANTHONY THOMPSON, *U.S. Asset-Backed Securities: Market Overview*, *in* AMERICAS SECURITISATION AND STRUCTURED FINANCE GUIDE 2001, at 1, 2 (2001). "Exponential" understates such a growth arc over just six years. Such growth is better captured by comparison to the growth of V838 Monocerotis, a so-called red variable star in the constellation Monoceros, which was unknown until 2002 and experienced an unexplained expansion until it brightened to a million times the luminosity of the sun and became one of the largest stars in the Milky Way in only a few months. (it should also be noted that in only a few months V838 had returned to its original size before the eruption). There are several theories of what caused the precipitous expansion of V838, none of which will be helpful in explaining the hyper-growth of the subprime RMBS and CDO sectors in the first 6 years of the 21st century. Instead, something more elemental (although perhaps no less complex) was at work.

[36] *See, e.g.*, MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010); BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS (2010); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2009); GREGORY ZUCKERMAN, THE GREATEST TRADE EVER: THE BEHIND-THE-SCENES STORY OF HOW JOHN PAULSON DEFIED WALL STREET AND MADE FINANCIAL HISTORY (2009).

safeguards put in place to protect both the securitization market and the overall economy.

G. Peering into the Breach

Subprime RMBS and CDOs were securitization vehicles that shared a common DNA, and this DNA distinguished them from other forms of securitization that preceded them. They were, for all practical purposes, a separate species from agency RMBS, CMBS and ABS. And it was their distinguishing characteristics that made subprime and CDO securities so toxic.

Subprime mortgage securities used the same basic structure as the other securitizations discussed previously, but with one major difference: These bankruptcy-remote vessels were filled with single-family mortgage loans which were underwritten and sold to homeowners who had no ability to pay the loans back. In many cases, the loans were marketed to homeowners with a "teaser" or "sucker" rate that was low enough to be tolerable for the short term.[37] These loans included an automatic interest rate reset feature, however, that was triggered after the origination date.[38] The increased rate often created a debt service requirement that was unaffordable to the borrower even at the borrower's current earnings level—not to mention if the borrower suffered a health issue or a hiatus in employment.[39] To make matters worse, as the subprime market grew, the underwriting standards became looser until eventually loans were being given to borrowers without any documentation of earnings or other financial data.[40] Moreover, the borrowers were often allowed to qualify for the loans with no or nominal down payments.[41] The loan origination machines around the

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[37] Ruth Simon, *Teaser Rates On Mortgages Approach 0%*, WALL ST. J., Feb. 15. 2005, at D1.

[38] *Id.*; s*ee* FINANCIAL CRISIS REPORT, *supra* note 1, at 6 ("New variants on adjustable-rate mortgages, called "exploding" ARMs, featured low monthly costs at first, but payments could suddenly double or triple, if borrowers were unable to refinance.").

[39] *See* FINANCIAL CRISIS REPORT, *supra* note 1, at 105-06 (describing how the interest rate reset on "hybrid ARMs" created a significant risk of the borrower defaulting).

[40] Brent J. Horton, *In Defense of Private-Labeled Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 861 (2009).

[41] *See* FINANCIAL CRISIS REPORT, *supra* note 1, at 109-10 (describing how piggyback mortgages were used to reduce down payment requirements).

country sold the loans almost as quickly as they were originated to the banks, which just as quickly securitized them.[42] The banks were also under no requirements to retain any of the loans or any interests in the securities resulting from the securitization.

Like other forms of securitization, the securities were structured as a series of tranches (literally, "slices" in French), starting with the senior series (which had the first call on cash flows), running through a series of progressively more subordinated tranches, and ending with the series having the last call on cash flows (known as the "first-loss" position).[43] Due to their greater risk, the lower tranches received lower ratings and, when sold to investors, paid higher interest rates.[44] The banks' goal in the ratings process was to make the senior tranches with the higher ratings and lower interest rates as large as possible, while minimizing the size of the subordinated tranches which were sold cheaper (that is to say, at the higher rates) into the market.[45] This was crucial because the process of securitizing subprime mortgages was designed to create large differentials, or spreads, between the prices at which the subprime mortgages were purchased from the originating mortgage brokers and the prices at which they could be sold to investors. The process of origination (by brokers), sale (to banks) and securitization (to investors) was like the child's game of hot potato, with the potato ending up in the hands of the investors, which purchased various tranches based on their risk tolerance and yield objectives. And in the case of tens of billions of these securitizations, the potato did not stop there. The monoline insurers, many of which had been formed in the 1980s to insure municipal bonds, were unable to resist the gravitational pull of the subprime mortgage securities market because the volumes were so great, and the premiums they could charge were

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[42] *See* NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD 268 (2008) ("Instead of putting their own money at risk, [banks] pocketed fat commissions on signature of the original loan contracts and then resold their loans in bulk to Wall Street banks. The banks, in turn, bundled the loans into high-yielding residential mortgage-backed securities (RMBS) and sold them on to investors around the world . . . .")

[43] FINANCIAL CRISIS REPORT, *supra* note 1, at 43.

[44] *Id.*

[45] *See* John C. Coffee Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 243 (2011) ("By increasing the size of the AAA tranche, the rating agencies made the CDO more valuable and . . . easier to sell.").

so much higher than the premiums to insure municipal bonds.[46] These insurers began wrapping the highest tranches of the subprime RMBS.[47] By putting themselves between the investors in these tranches and the risk of loss, the insurers allowed the tranches to be sold at even higher prices (*i.e.*, lower interest rates) and collected the differential for themselves.[48]

In short, it appeared to be a win-win-win proposition for everyone along the assembly line. The brokers earned mortgage brokerage fees (which were often higher if the mortgage was risky because the loan could be bought by banks at an even cheaper price, widening the banks' spread on securitization even further). The banks earned their generous spreads. The investors earned their yields on the bonds they purchased. The monolines earned their hefty premiums. And, not to be omitted, the lawyers and the rating agencies earned generous fees for documenting and rating the transactions.

This system is not inherently evil. To the contrary, this origination-securitization model was pumping huge profits into the economy. There was, however, one fundamental difference about the subprime market: No one in the production chain had skin in the game, which turned the incentives to exercise a high standard of care on their head.[49] The brokers were paid more the lower the quality of loans they sold to the banks. The banks received a greater spread the lower the quality of loans that went into the pools. The lawyers received greater fees the more deals they could process through their legal assembly lines. And the ratings agencies, which are after all for-profit enterprises, were under increasing pressure to maintain and (if possible) increase market share by keeping their rating bar as low as their competitors, since the issuers and the banks hired them and

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[46] Christine Richard, *Ambac, MBIA Lust for CDO Returns Undercut AAA Success*, BLOOMBERG (Jan. 22, 2008, 5:28 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aw1Oh4B0Wvv8.

[47] *Id.*

[48] FINANCIAL CRISIS REPORT, *supra* note 1, at 132.

[49] FINANCIAL CRISIS REPORT, *supra* note 1, at xxiv; *see* Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Prevent Future Crises?*, 64 SMU L. REV. 1243, 1261-63 (discussing how the securitization process altered market participants' behavior by allowing them to shift credit risk to other actors).

paid their fees.[50] In just a few years, the subprime mortgage industry had grown into an originate-to-distribute machine on steroids; and the only ones left with skin in the game once the dust had settled were those left holding the potato—the investors and the monolines.

There were other factors that contributed to the unchecked growth and irresistible allure of the subprime securities. First, there was a basic, unquestioned assumption lying at the heart of the ratings agencies' methodologies and the investors' and monolines' acceptance of risk exposure: that real estate, like politics, is local.[51] There had never been a nationwide collapse of the residential real estate market. Instead, downturns in the real estate market had in the past occurred in one or at most a few regions at a time, such as the Southwest real estate recession in the late 1980s that led to the birth of the CMBS market. Because of the diverse zip codes represented by the subprime pools being securitized, the portfolio effect was expected to protect the higher rated tranches of the pools. Another assumption was that the residential real estate market was not only secure against national devaluation but was more likely to continue to *increase* in value over the foreseeable future.[52] Thus, the fact that the homeowners would be incapable of paying the debt service after the teaser rates converted to higher rates was deemed immaterial because rising real estate values would allow the loans to be either refinanced or paid off through the sale of the house. What was never contemplated was what actually happened: a massive devaluation of the residential real estate markets in virtually all zip codes, leading to massive default rates (over thirty-three percent) in mortgage portfolios, and ending in massive defaults and downgrades of both junior and senior tranche securities.

But this was still only part of the story, and actually the smaller part. At the same time that the subprime mortgage market

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[50] *See* F. Phillip Hosp, *Problems and Reforms in Mortgage-Backed Securities: Handicapping the Credit Ratings Agencies*, 79 MISS. L.J. 531, 548-49 (2010) ("[T]he 'issuer pays' fee structure creates perverse incentives for CRAs to overstate their ratings or dilute rating requirements.").

[51] MARK ZANDI & CHRISTIAN DERITIS, MOODY'S ANALYTICS, THE FUTURE OF THE MORTGAGE FINANCE SYSTEM 5 (2011), *available at* http://www.economy.com/mark-zandi/documents/Mortgage-Finance-Reform-020711.pdf.

[52] *See id.* ("The long history of house price gains since the Depression . . . led to the strong conclusion that prices, in aggregate, would never decline.").

was expanding, the subprime CDOs began to be issued at an even more feverish pace. The CDOs, like the subprime RMBS, used the same basic SPV and multi-tranche structure as the rest of the securitization market. In the case of CDOs though, the SPVs were filled with a potpourri of subordinated tranches of other subprime RMBS deals, whole subprime mortgage loans, and subordinated interests in CMBS pools. The ratings agencies were staring into murky pools when they were asked to rate the CDOs, since the actual assets supposedly generating the cash flows were several layers beneath the instruments held by the CDO issuers, and these instruments were themselves composed largely of subordinated tranches rated below investment grade.[53] Yet, the agencies developed models that permitted the senior tranches of the CDOs to be rated AAA/Aaa.[54] CDO issuance volumes accelerated quickly, thus producing even more arbitrage profits for the banks, even though the underlying assets were of a quality inferior to the subprime mortgages themselves.

Perhaps the most creative response to the problem of a finite number of mortgages supplying an infinite demand for securities was the synthetic CDO, in which the bankruptcy remote SPVs issuing the securities were filled with . . . nothing. The proceeds from the investors investing in the synthetic CDOs were used not to buy subprime MBS, subordinated tranches of CMBS or whole loans. Instead, the proceeds were used to write bets on specified pools of subprime mortgage securities or other CDOs through the use of another financial product that had been used for a number of years by companies to manage risk exposures to other corporate credits, called credit default swaps ("CDS"). Under these CDS instruments—a form of a derivative security—one party bets with another party (the "counterparty") that a specified pool of assets (the "reference securities") will perform.[55] The bet takes the form of a type of

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[53] *See* Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., April 27, 2008, at 36 (describing why ratings agencies are particularly ill-equipped to provide accurate ratings for highly intricate securities).

[54] *See id.* (stating that despite the factors hindering the ratings agencies from accurately measuring the securities' risk, the agencies invariably generated investment grade ratings).

[55] *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007) ("[A] credit default swap is a private contract in which private parties bet on a debt issuer's bankruptcy, default, or restructuring.").

insurance policy under which the first party agrees to pay a sum certain to the counterparty if the reference securities default.[56] For this protection, the counterparty pays the first party (who is deemed to have "written" the CDS) a periodic premium based on the perceived risk inherent in the bet.[57] In the context of the synthetic CDO, the SPV issuer of the CDO securities writes the CDS and receives the premiums from the counterparty taking the opposing bet, which it distributes to the investors.[58]

The theory behind the synthetic CDO was that the CDS written by the issuer was simply another "synthetic" way to give the investors the desired exposure to the reference securities without the prosaic feature of having the issuer actually own the assets.[59] But the more significant impact was to unleash virtually unlimited CDO issuance capacity since the same reference securities could theoretically be used an infinite number of times in an infinite number of CDS underlying an infinite number of CDOs.[60]

The narratives covered by some of the most popular books on the subject of the 2008 Collapse traced the trading strategies of some of the hedge fund traders who realized early in the game that the subprime market was a fragile house of cards ready to fall.[61] They placed large bets against the subprime market by taking the opposing side of the CDS issued by synthetic CDOs. The hedge funds also bet against billions of dollars of CDS written by a subsidiary of the insurance giant AIG and the monolines which wrote CDS on the subprime market to supplement the premiums they charged on their insurance policies for other subprime RMBS and CDOs. To

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[56] Kristin N. Johnston, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 194 (2011).

[57] *Id.*

[58] *See* FINANCIAL CRISIS REPORT, *supra* note 1, at 142 (describing the mechanics of a synthetic CDO).

[59] *See id.* at 143 ("Because there were no mortgage assets to collect and finance, creating synthetic CDOs took a fraction of the time. They also were easier to customize, because CDO managers and underwriters could reference any mortgage-backed security—they were not limited to the universe of securities available for them to buy.").

[60] *See id.* at 145-46 (describing how a single ABS could serve as a reference security for multiple CDOs).

[61] *See, e.g.,* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM (2009).

complete the circle of risk, most of the largest banks—whose securitization divisions structured and sold the subprime RMBS or subprime-backed CDOs, without retaining any skin in the game—took huge positions in the billions of dollars on the opposite side of these bets through their proprietary trading desks, thus re-exposing the banks' balance sheets to the same risk that they had offloaded in the securitization process.

The rest is history. We now know that the lonely and often harrowing vigils of the handful of traders making huge bets against the subprime market were eventually vindicated as the default rates of the subprime mortgages began to accelerate precipitously in late 2007. We now know that most of the major banks had far greater exposure to these toxic assets through their proprietary trading desks than was originally realized, either by the traders or by the risk managers or by the banks' senior management. And we also now know that the defaults in these securities—which were often occurring at the same rate across all tranches of the pools—resulted in the virtual collapse of Bear Stearns and its fire sale to JP Morgan Chase, the required government bail-outs of AIG, Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the forced sale of Merrill Lynch to Bank of America, the absorption of Wachovia Bank into Wells Fargo, and the near-collapse of Morgan Stanley, Citibank and Goldman Sachs. Even as this is being written, Bank of America is still struggling with the effects of its exposure to the subprime market that it assumed when it bought the largest single-family residential mortgage originator—Countrywide—in 2008. Indeed, the U.S. economy, as well as economies in other parts of the world, continues to struggle with the effects of the housing over-hang on unemployment rates.

The impact of securitization technology in the subprime RMBS and CDO markets on this outcome should be clear and undeniable. Without the ability to bundle large pools of assets into securities, the false sense of security provided by the Fortress of Redundancies, and the added ability to expand issuance volume even further through the use of credit default swaps, it is inconceivable that the subprime and CDO securities could have been issued on such a scale. But the far harder question is whether we can prevent these abuses from recurring in the future by establishing restrictions that are properly designed and calibrated to have the desired prophylactic effect without unnecessarily snuffing out financial growth and ingenuity.

II. Taming the Beast

A. The Regulatory Response

The Dodd-Frank Act, enacted in July 2010, is the primary legislative response to the 2008 financial collapse.[62] The most comprehensive financial reform law since the cornucopia of acts following the Great Depression, the Dodd-Frank Act is actually best described as a compendium of general principles addressing the multi-faceted causes of the meltdown, plus more than two hundred delegations of rule-making authority to the various securities and bank regulators. As the Act's title suggests, it uses a top-down and bottom-up approach to the problem: the Act combines new regulatory controls over financial institutions and market participants with a new agency, the Consumer Financial Protection Bureau, which is designed to protect consumers from fraudulent and predatory practices by lenders.

Of the hundreds of rulemaking projects mandated by Dodd-Frank, many have resulted in final rules.[63] At the time of this writing, however, the majority of them are only proposed rules, despite it being eighteen months after the passage of the Dodd-Frank Act. In addition, outside the mandate of the Dodd-Frank Act, the Securities and Exchange Commission ("SEC") has issued a rule directed at ratings agencies and the issuers that use the agencies to rate their securitized transactions.[64] It is sufficient for the purpose of this paper to examine briefly a few of these regulations in an attempt to answer the question posed at the outset of this paper: measured against the specific abuses which they were intended to prevent, did these rules hit their mark, fall short, or overshoot? This examination will not be at a deeply technical level, but will instead compare the general approach taken in the particular rule to the abuse at which the rule is targeted.

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[62] *See generally* Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[63] *See, e.g.,* Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793 (Dec. 29, 2011) (to be codified at 17 C.F.R. pts. 230, 239, 270, and 275); Security Ratings, 76 Fed. Reg. 46,603 (Aug. 3, 2011) (to be codified at 17 C.F.R. 200, 229, 230, 232, 239, 240, and 249).

[64] *See generally* 17 C.F.R. § 240.17g-5 (2010).

B. Sampling the Rules

1. Risk Retention: Section 15G of the Securities Exchange Act of 1934 ("1934 Act") as added by Section 941(b) of the Dodd-Frank Act

This provision was intended to address the deficiency that was clearly at the core of the subprime RMBS and CDO phenomenon—lack of skin in the game. Besides certain representations and warranties, each of the participants in the chain of creating the subprime RMBSs and CDOs had no incentive to exercise a high standard of care because they had no financial exposure if the final product crashed and burned.[65] In fact, they had perverse incentives to employ lower underwriting standards because such standards resulted in higher profits.[66] To prevent this from occurring in the future, Section 15G requires that at least five percent of the net economic exposure in a securitization transaction be retained by the originator, the sponsor of the securitization or both in combination.[67] The five percent risk retention requirement may be satisfied in one of several ways under currently proposed rules,[68] and no distinction is made between the type of securitization involved or whether the transaction involves the issuance of public or private securities.[69]

Although insufficient skin in the game was a major factor contributing to the excesses of the subprime/CDO market, the risk retention rules extend the five percent risk retention requirement into all types of securitizations, including the market sectors that were functioning well before and during the meltdown.[70] Moreover,

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[65] *See supra* notes 49-50 and accompanying text.
[66] *Id.*
[67] Dodd-Frank Act § 941(b) (to be codified at 15 U.S.C. 78o-11(c)(1)).
[68] *See generally* Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011) (to be codified at 12 C.F.R. pt. 373).
[69] The Dodd-Frank Act does create an exception for RMBSs that involve the securitization of what are called "Qualified Residential Mortgages." *See generally* Dodd-Frank Act § 941(b) (to be codified at 15 U.S.C. 78o-11(c)(1)).
[70] *See id*. (authorizing the SEC to promulgate regulation that implements the credit risk retention statutes by requiring "any securitizer to retain an economic interest in a portion of the credit risk for any asset that the

Section 15G does not always take into account the fact that many types of transaction structures have skin in the game embedded in the capital structure, either in the form of equity in the issuer as in many of the esoteric and CMBS securitizations, or in the form of the mezzanine, "B" pieces or "B" notes that are common in CMBS. Since the risk retention rules are only in proposed form and may be significantly revised before they are final, it is possible that the final rules will take a more nuanced approach by explicitly permitting these forms of skin in the game to satisfy the five percent requirement.

2. Ratings Process Integrity: Rule 17g-5 and Section 21D(b)(2) of the Securities Exchange Act of 1934 as required under Section 943 of the Dodd-Frank Act

Rule 17g-5, promulgated by the SEC independently of the Dodd-Frank Act, requires that issuers seeking ratings from ratings agencies create a password-protected website to which they must post all documents and data to be considered by the agency when issuing a rating.[71] All other qualified ratings agencies not requested to give the rating must be given access to the site and any additional information communicated by the issuer to the invited agency, whether orally or in writing, for the purpose of allowing the uninvited agencies to issue unsolicited ratings on the transaction.[72] This rule was intended to prevent "rating-shopping" by giving all qualified agencies the same access to data and the same right to issue a rating as the agency chosen by the issuer. However, in actuality, all that 17g-5 has so far achieved is to place new formalities and constraints on the communications between issuers and ratings agencies.[73] No unsolicited ratings have been issued by uninvited

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securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party").

[71] Conflicts of Interest, 17 C.F.R. §§ 240.17g-5(a)(3)(iii)(A)-(D) (2010).

[72] *See id.* §§ 240.17g-5(a)(3)(i)-(ii) (requiring that an invited credit ratings agency maintain and provide access to a password-protected website on which the agency posts information from issuers).

[73] If rating agency shopping is the abuse being targeted, then a more direct approach is to replace the current system, under which the sponsor seeking the rating hires the ratings agency, with a system under which the agencies are assigned at random. Dodd-Frank mandates the SEC to study and report

ratings agencies for the understandable reason that they are not willing to invest the time and expense to provide a rating without being paid for it, and an investor market for unsolicited ratings reports has not materialized.

Section 21D(b)(2) of the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act, alters the pleading standards applied to actions against ratings agencies.[74] The provision allows plaintiffs to survive a motion to dismiss if particular facts are alleged that give rise to a strong inference that the ratings agency knowingly or recklessly failed to conduct a reasonable investigation of the factual elements on which it relied in evaluating the credit risk of the securities and that it failed to obtain reasonable verification of those factual elements.[75] This has in practice required ratings agencies to act more independently in investigating and verifying facts on which they rely and to obtain independent verification of material facts. This new standard could have a positive effect on the ratings process, could possibly prevent the blindfolded approach which the ratings agencies took in rating subprime RMBSs and CDOs, and, most importantly, could render opaque securities such as CDOs and CDOs squared incapable of being rated at all.

Rule 17g-7 adds the further requirement that each rating agency must include in its rating report a table which compares the representations and warranties and remedies for breach in the deal being rated with the reps and warranties and remedies for breach in comparable deals previously rated.[76] Although this exercise may uncover glaring deficiencies in the reps and warranties of a particular deal, there is no requirement that the comparative analysis be an integral part of the ratings methodology, and thus this requirement could devolve into a perfunctory exercise in the ratings process.

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on such a system. *See* Dodd-Frank Act § 939F(b)(2) (to be codified at 15 U.S.C. § 78o-9(b)) (requiring a study on "the feasibility of establishing a system in which a public or private utility or a self–regulatory organization assigns nationally recognized statistical rating organizations to determine the credit ratings of structured finance products.").

[74] *See generally* Dodd-Frank Act § 933(b) (to be codified at 15 U.S.C. 78u-4(b)(2)(B)).

[75] *Id.*

[76] Report of Representations and Warranties, 17 C.F.R. § 240.17g-7 (2010).

3. Sponsor and Originator Integrity: Proposed Rule 127B implementing Section 621 of the Dodd-Frank Act; Rule 193 implementing Section 945 of the Dodd-Frank Act; and Rule 15Ga-1 implementing Section 943 of the Dodd-Frank Act

The SEC's proposed Rule 127B would prohibit certain material conflicts of interest between those who create and distribute ABS and the investors who buy ABS.[77] Specifically, it would prohibit a securitizer of an ABS, prior to one year following first closing of the sale of the ABS, from engaging in "any transaction that would involve or result in a material conflict of interest with respect to any investor in a transaction arising out of such activity."[78] This rule was designed in response to the fact pattern exemplified by the controversy surrounding Goldman Sachs in connection with the synthetic CDO known as Abacus 2007-AC1. According to allegations by the SEC in its fraud complaint against Goldman Sachs, the investors in the synthetic CDO were not informed that the subprime securities selected as "reference securities" for the transaction were actually selected by Paulson & Co., the hedge fund that made billions betting against the subprime market, and that the same hedge fund, a client of Goldman Sachs, bet against the same reference securities.[79] The efficacy of this Rule is self-evident. If it is effectively enforced, it should have a positive impact on the market.

Rule 193 requires that any issuer in a registered public offering of an ABS perform a review of the pool of assets underlying the ABS[80] and disclose in the prospectus the nature of such review and the identity of any third party engaged by the issuer for the purpose of performing the review.[81] Like Rule 127B, this rule is clearly meritorious. It requires that securitization return to the basic principle on which it was founded: know the assets being securitized.

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[77] Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60,320, 60,350 (proposed Sept. 28, 2011) (to be codified at 17 C.F.R. § 230.127B).
[78] *Id.*
[79] Complaint at 1-2, SEC v. Goldman Sachs & Co., 790 F.Supp.2d 147 (S.D.N.Y. 2011) (No. 10 Civ. 3229).
[80] 17 C.F.R. § 230.193 (2011).
[81] *Id.* § 229.1111(a)(7).

Although this rule is limited by its terms to publicly registered securitizations, this author has been advised by at least one major bank underwriter that it intends to require compliance with this rule even in unregistered deals under Rule 144A.[82]

Rule 15Ga-1 requires the disclosure of fulfilled and unfulfilled repurchase requests across all securitization vehicles aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.[83] This Rule is in effect and required the first filing on Form ABS-15G on February 14, 2012, covering the three-year period ending on December 31, 2011.[84] Although this Rule may be burdensome on large securitization sponsors and could raise many issues of interpretation – not the least of which is what constitutes a "repurchase" request – it will offer more transparency for investors willing and able to mine the data and should have a positive effect on the market.

4. Financial Institution Integrity: Section 619 of the Dodd-Frank Act (the "Volcker Rule")

Section 619 of the Dodd-Frank Act, known as the "Volcker Rule," is intended to prohibit proprietary trading activities and sponsorship and ownership of hedge funds and private equity funds by regulated financial institutions.[85] While broader than just prohibiting the monumental bets that banks placed on the subprime market—as stated above, virtually every major bank's proprietary trading desk was betting in favor of rather than against the subprime market—the Volcker Rule is clearly needed in some form to prevent a recurrence of the subprime crisis. The bank regulators, plus the Commodity Futures Trading Commission ("CFTC"), were charged with rule-making under Section 619 of the Dodd-Frank Act and have issued notices of proposed rulemaking.[86]

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[82] *See generally id.* § 230.144A. Note that it is possible that Rule 193 will be extended to Rule 144A offerings in the future.

[83] Repurchases and Replacements Relating to Asset-Backed Securities, 17 C.F.R. § 240.15Ga-1(a) (2010).

[84] *Id.* § 240.15Ga-1(c)(1).

[85] Dodd-Frank Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620 (2010) (to be codified at 12 U.S.C. § 1851).

[86] *See generally* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private

The above sampling of the rules drafted to address the financial crisis makes it clear that the reach of the new regulatory regime will not be limited to the parallel universe of subprime RMBS and CDOs that brought the market down, but will instead extend to the entire securitization market, including those segments which continued to observe best practices and which performed well throughout the crisis. This is not unexpected, not only because

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Equity Funds, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011) (to be codified at 12 C.F.R. pts. 44, 248 and 351, and 17 C.F.R. pt. 255) (describing rule proposed by OCC, the Federal Reserve Board, FDIC, and SEC); Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75) (describing rule proposed by CFTC). Although on its face the Volcker Rule does not directly apply to securitizations, the rules promulgated under it do affect the securitization market by prohibiting banking entities from investing in "covered funds," which are defined broadly to include any entity that would be an investment company under the Investment Company Act of 1940, *but for* the exemption from such classification under Section 3(c)(1) or Section 3(c)(7) of such act. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,950; Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8429. Many securitization issuers rely on these exemptions and thus the rules could, without a specific exemption, prohibit banking entities from securitizing assets they have originated in order to free up capacity to make new loans. The proposed rules do contain a "securitization exclusion" which excludes from the "covered funds" prohibition the activity of owning interests in an ABS issuer that is comprised solely of loans, contractual rights or assets directly arising from those loans, and certain derivatives used for hedging purposes. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,954; Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 77 Fed. Reg. at 8433. Ironically, the exclusion would not apply to many types of securitization in the esoteric segment of the ABS market, even though they have proved to be among the strongest performers in the spectrum of securitization transaction types. In short, as beneficial as the Volcker Rule is to the safety and soundness of the banking system, the proposed rules are overly broad in their impact on the securitization market and should be narrowed before they are in final form to permit the legitimate and productive uses of securitization by financial institutions.

financial reform legislation is inherently a blunt instrument, but also because of functional necessity: Compliant and benign markets, as well as rogue and toxic markets, need to be regulated to prevent malignancies from growing and metastasizing into the broader markets, as they did between 2000 and 2006. The key goal and the greatest hope as the dialectic between the industry and the regulators continues is that the final rules will be optimally calibrated to target the tumors and minimize collateral damage to the healthy tissue.

C. Stepping Back: Final Observations

The 2008 Collapse and the legislative and regulatory responses to it are still very much an unfinished story at this writing. The 2012 presidential election will be, among other things, a national referendum over what restraints, if any, should be imposed on the free market economy, and whether the Dodd-Frank Act is a jobs-killing regulatory coup de main that should be repealed or substantially watered down. It is a debate in which each end of the logical cleft stick is slippery, and what is self-evident one moment seems totally wrongheaded the next. This is illustrated by the initial responses to the financial collapse. The first response was to authorize the injection of $700 billion of capital quickly into the banks under the Troubled Asset Relief Program ("TARP"),[87] which seemed essential to preserve the banking system on which our economy depends. But TARP soon became a dirty word and a symbol of bailing out a financial oligopoly that had created the crisis with their profligacy and greed.[88] Another early response was the Term Asset-Backed Securities Loan Facility ("TALF") program, in which the Federal Reserve Bank of New York opened a window to

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[87] *See generally* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §115, 122 Stat. 3765 (to be codified at 12 U.S.C. § 5225); Deborah Solomon & Greg Hitt, *TARP Funds' Second Half Set for Release as Senate Signs off on Request*, WALL ST. J., Jan. 16, 2009, at A3 (describing Congressional approval of the second half of the $700 billion authorized under TARP). *But see* Jackie Calmes, *TARP Cost Will Be Less than Once Expected*, N.Y. TIMES, Oct. 1, 2010, at B1 (reporting that, at the deadline for committing TARP money, the Treasury had committed $470 billion out of the available $700 billion).

[88] *See, e.g.*, Simon Johnson, *The Quiet Coup*, ATLANTIC, May 2009, at 46 (comparing financial institutions that received TARP funds to "emerging-market oligarchs" who helped create financial crises in countries like Russia yet were the first to receive governmental help).

make up to $1 trillion of low-cost loans to buyers of highly rated newly issued ABS backed by certain types of assets.[89] The TALF program was successful in priming the securitization pump and getting the market functioning again,[90] but the combined message from these two government initiatives was the following: "Yes, the banks' misuse of securitization technology was at the root of the greatest financial crisis since the Great Depression, but to restore the economy, it is essential that we use taxpayer dollars to preserve both the banks and their use of securitization." In short, to pull the ox out of the ditch, we need to pay the people who got the ox in the ditch and replace the wheels on their wagon.

This message infuriated large segments of the population who are suffering from the results of the Great Recession and has contributed to both the Tea Party and Occupy Wall Street movements.[91] On a policy level, this causes one to ask whether we are destined to live in a perpetual feedback loop. In other words, will we use securitization to inject liquidity into the economy and, when securitization creates excess leverage, will we endure a "corrective" period of de-leveraging and recession until banks and securitization bring us back from the abyss once again?

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[89] *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Announces the Creation of the Term Asset-Backed Securities Loan Facility (TALF) (Nov. 25, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm (announcing an initial fund of $200 billion); Edmund L. Andrews & Eric Dash, *U.S. Expands Plan to Buy Banks' Troubled Assets*, N.Y. TIMES, Mar. 24, 2009, at A1 (describing the expansion of TALF to a fund of up to $1 trillion).

[90] See Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Announces Agreement with the Treasury Department Regarding the Reduction of Credit Protection Provided for the Term Asset-Backed Securities Loan Facility (TALF) (July 20, 2010), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20100720a.htm (announcing that, to date, TALF had experienced no losses and all outstanding loans were "well collateralized").

[91] *See* Conor Friedersdorf, *Why the Tea Party and Occupy Wall Street Should Cooperate*, ATLANTIC (Oct. 11, 2011), http://www.theatlantic.com/politics/archive/2011/10/why-the-tea-party-and-occupy-wall-street-should-cooperate/246413/ (describing the Tea Party movement as "an organization opposed to the Wall Street bailouts" and Occupy Wall Street as a group of people "so mad that they're taking to the streets, partly because of the bailouts").

Another source of disorientation from the financial meltdown and its response is the confusion about the effect of complex regulation on the markets and the questions of how much regulation is too much. Where is the tipping point between effective regulation and a regulatory regime that is so complex and so voluminous that it collapses under its own weight? No objective observer with an understanding of the facts surrounding the subprime market can sincerely question whether such abuses are anathema to the public good and should be subject to controls, although there is plenty of room for an honest dialogue about where to draw the regulatory lines. But thoughtful students of the 2008 Collapse who are supporters of financial reform have begun to question whether too much complexity can create its own inherent risk. In an Op-Ed for *The New York Times*, Joe Nocera posed the question of "complexity risk"; specifically, whether overly complex rules may become a real impediment to economic recovery by being impossible to enforce and easier for the intended targets of the regulation to game.[92] Citing comments of Karen Petrou, a consultant who was critical of banks for their role in creating the subprime crisis, Nocera quotes her as saying that there are incompatible thrusts to the rules being promulgated under Dodd-Frank:[93] The new rules vacillate between trying to avoid the systemic risk that almost brought down our banking system while at the same time imposing new capital requirements on larger institutions to make it harder for them to fail, implicitly admitting that these institutions are still too big to fail. And, to validate this final point, the concentration of assets into a few large banks is greater now than in 2008, leaving the economy vulnerable to an even bigger and deeper trauma the next time.[94]

The final and perhaps biggest piece of the puzzle in safeguarding against a recurrence of the 2008 Collapse is enforcement. Even the most surgically crafted regulatory regime is only as good as those enforcing it; and in order to use the tools that Dodd-Frank has made available to take proactive steps against systemic risk, the regulators who hold these tools must have the

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[92] Joe Nocera, Op-Ed., *Keep It Simple*, N.Y. TIMES, Jan. 17, 2012, at A23.
[93] *Id.*
[94] See SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 180 (2010) ("The shakeout of 2008 left the big banks even bigger . . . . Consolidation among the big banks and the collapse of the nonbank mortgage lenders meant much larger market shares for the fewer but bigger megabanks.").

knowledge that systemic risk is imminent. Perhaps the most startling fact of the subprime meltdown is that the bank CEOs, the financial regulators and the most eminent and qualified of the central bankers were generally unaware that the subprime exposure was creating systemic risk. As the recently released minutes of the meetings of the Federal Reserve Board during 2006 reveal, little concern was voiced over the risk of the subprime market.[95] The question then becomes: "Who regulates the regulators?" Just as there were redundancies built into the securitization market, should there also be someone or some agency charged with no duty other than to serve as ombudsman for the regulators and to blow the whistle when it sees an agency asleep at the switch? Of course, such an ombudsman would have to have the resources and staff to understand the complex instruments and products that the capital markets will produce in the future. Recent history does not create a high level of confidence that this is a realistic objective.

Another alternative to complex government regulation is, of course, the plaintiffs' bar, which can be an efficient instrument of enforcement where government falls short.[96] The Private Securities Litigation Reform Act of 1995 ("PSLRA") tilted the playing field in

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[95] Jon Hilsenrath et al., *Little Alarm Shown at Dawn of Housing Bust*, WALL ST. J., Jan. 13, 2012, at A1.

[96] This is perhaps best demonstrated by the state Medicaid reimbursement litigation against the tobacco industry in 1998. *See* Wendy E. Parmet, *Tobacco, HIV, and the Courtroom: The Role of Affirmative Litigation in the Formation of Public Health Policy*, 36 HOUS. L. REV. 1663, 1710-12 (arguing that tobacco litigation has played "a positive role in the advancement of a public health agenda" where government regulation is lacking). The major tobacco companies had succeeded in obscuring the dangers of cigarette smoking for many years by sponsoring pseudo-scientific reports and giving misleading testimony to Congressional committees, until plaintiffs' lawyers devised a litigation strategy that finally brought the industry to the settlement table. *See* Tucker S. Player, Note, *After the Fall: The Cigarette Papers, the Global Settlement, and the Future of Tobacco Litigation*, 49 S.C. L. REV. 311, 322-29 (1998) (describing the "Cigarette Papers," documents disclosed in 1994 revealing that, despite its public representations to the contrary, "the industry has known conclusively since the sixties that tobacco use directly correlated with cancer and that the central ingredient in cigarettes, nicotine, was an addictive drug"). This is not dissimilar from the repeated assertions by the participants in the subprime RMBS and CDO markets both to their CEOs and to their shareholders that these securities did not pose dangers to the health of their banks or the capital markets.

favor of defendants in securities cases by imposing new requirements on securities class action lawsuits, including a requirement that the complaint describe false statements with particularity and the specific reasons why the statements are misleading.[97] Although the dockets are now full of cases filed by plaintiffs against various participants in the subprime industry,[98] it is worth inquiring whether PSLRA created impediments to the filing of earlier actions when the abuses were so obscured by the numbing complexity of the structures and documents that it would not have been possible to frame allegations of sufficient specificity to overcome the hurdles imposed by the Act. But even if the impediments of PSLRA were removed and plaintiffs' counsel had full access to the analytical skills and foresight of the handful of traders who placed early bets against the subprime market, it is likely that suits brought before the extent of the damage was known would have been dismissed

Of course, even if abuses similar to those that led to the 2008 Collapse cannot be detected early enough to prevent systemic risk, the threat of future civil or criminal sanctions could be a deterrent. However, the remedies being pursued to date have for the most part sought monetary relief against the institutions rather than criminal or civil remedies against the individuals whose conduct caused such harm.[99] As long as it is possible for individuals who engage in

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[97] Private Securities Litigation Reform Act of 1995, § 101(b), 15 U.S.C. § 78-4(b)(1) (2006).

[98] *See, e.g.*, Gretchen Morgenson, *Legal Fees Mount at Fannie and Freddie*, N.Y. TIMES, Feb. 22, 2012, at B1 (citing a government study finding that Fannie Mae and Freddie Mac have spent $50 million in legal fees defending former executives accused of securities fraud following the government rescue of Fannie Mae and Freddie Mac); Louise Story & Gretchen Morgenson, *A.I.G. to Sue Bank on Loss in Fiscal Crisis*, N.Y. TIMES, Aug. 8, 2011, at A1 (citing a private study that found that at least ninety lawsuits related to mortgage-backed securities had been brought since the financial crisis, seeking a total of at least $197 billion in damages); Nick Timiraos et al., *U.S. Sues Big Banks over Home Mortgages*, WALL ST. J., Sept. 3, 2011, at A1 (describing a lawsuit filed by the Federal Housing Finance Authority against seventeen financial institutions for selling risky home loans to Fannie Mae and Freddie Mac without adequate disclosure).

[99] Until very recently, except for unsuccessful criminal charges brought against former Bear Stearns hedge fund managers, no major figures in the subprime crisis have been required to respond to large damage claims, much less criminal proceedings. Despite the public outrage over the practices that led to the subprime crisis, the cases that have been filed have been primarily

reckless conduct to exercise the "trader's option" by walking away with large bonuses and leaving their institutions to pick up the tab, the possibility of future recurrences of the recent financial crisis will remain very much with us.

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civil, and they have resulted in monetary settlements with the companies which, though large in absolute terms, bear little relationship to the profits generated through the bad acts or the harm caused by those acts. In his 2012 State of the Union address, President Obama announced a new investigation into mortgage abuses, which will be co-chaired by Eric Schneiderman, the New York State Attorney General. Edward Wyatt & Shaila Dewan, *New Housing Task Force Will Zero In on Wall St.*, N.Y. TIMES, Jan. 26, 2012, at B1. Only time will tell whether this initiative will produce results that are any different from those that preceded it. Within two weeks of being appointed to the mortgage task force, Schneiderman had signed on to a $25 billion multi-state settlement with banks over fraudulent foreclosure practices and filed suit against Bank of America, Wells Fargo and JPMorgan Chase, alleging fraudulent practices related to an electronic mortgage database. *See* Brady Dennis & Sari Horwitz, *Settlement Launches Foreclosure Reckoning*, WASH. POST, Feb. 10, 2012, at A1; *New York Sues Banks over Electronic Mortgage System*, REUTERS (Feb. 3, 2012, 5:51 PM), http://www.reuters.com/article/2012/02/03/banks-mortgages-idUSL2E8D3CCR20120203. Although there is no apparent connection between it and the new Administration initiative, the Manhattan U.S. Attorney's office filed criminal charges on February 1, 2012, against three former traders at Credit Suisse for misleading investors in subprime mortgage securities by booking inflated prices of the bonds to boost their bonuses, despite knowing that the values of those securities had fallen. As of this writing, two of the three former employees had plead guilty to conspiracy to falsify books and records and to commit wire fraud in trading RMBS, signaling the first successful criminal prosecution related to the 2008 financial crisis. *See* Susan Pulliam et al., *Guilty Pleas Hit the 'Mark:' Moves in Bond Inquiry Are 1st Successful Criminal Case Related to Meltdown*, WALL ST. J., Feb. 2, 2012, at A1. Just as interesting is the fact that the U.S. Attorney's office did *not* file criminal charges against the bank itself. *Id.* It remains to be seen whether this will portend a change in enforcement policy which focuses on individual misconduct.