

DEVELOPMENTS IN BANKING AND FINANCIAL LAW:  
2009-2010

THE SHADOW FINANCIAL SYSTEM

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## II. *Credit Default Swaps: Use and Regulation*

### A. Introduction

A Credit Default Swap (CDS) is an over-the-counter agreement between two parties intended to transfer or hedge against credit risk.<sup>1</sup> Financial institutions use CDSs primarily to insure against the risk of default on their debt investments.<sup>2</sup> For example, suppose Company A issues \$100 in corporate bonds. Company B buys those corporate bonds, yet worries about Company A's financial stability. As a result, Company B negotiates an insurance contract with Company C against the default of those bonds. That insurance is a CDS. Company B pays Company C an ongoing premium for the assurance that Company C will pay Company B a contractually negotiated amount should certain credit events occur.<sup>3</sup> These credit events may include bankruptcy, default on bonds or loans, the lowering of that company's credit rating or any other event that the companies contractually agree upon.<sup>4</sup> Oftentimes, the CDS contract will require the insuring company to post collateral should the value of the asset underlying the CDS fall.<sup>5</sup>

In addition to using CDSs to hedge against the risk of default, some financial institutions buy CDSs against a company even when they do not possess that company's bond or other debt instrument. Rather, they buy CDSs to speculate on the credit worthiness of that company.<sup>6</sup> To continue the example above, Company D believes that Company A will default on its loans, therefore it buys the CDSs against Company A from Company B. This type of transaction is called a "naked" CDS.

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<sup>1</sup> Leah Campbell & Robin Choi, *State Initiatives to Regulate Credit Default Swaps Deferred Pending Federal Action*, METROPOLITAN CORPORATE COUNSEL, Sept. 2009, Northeast Edition, at 20.

<sup>2</sup> Serena Ng, *Swap Platform Gets a Boost—Large Banks Back Effort; Trading More Transparent*, WALL ST. J., Nov. 7, 2008, at C3.

<sup>3</sup> Campbell & Choi, *supra* note 1, at 20.

<sup>4</sup> *Id.*

<sup>5</sup> Carrie Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

<sup>6</sup> Campbell & Choi, *supra* note 1, at 20.

## B. Credit Default Swaps' Role in Prolonging the Financial Meltdown

The unregulated nature of the CDS market prolonged the financial turmoil that began in Fall 2008. Fannie Mae and Freddie Mac's failure provides an example of the problems associated with unregulated CDSs and the unexpected failure of large financial institutions. When the federal government brought Fannie and Freddie into receivership, the takeover triggered a payout clause in the CDS contracts that had been written against those companies' debt.<sup>7</sup> However, at the time of the takeover, no one knew exactly the volume of CDSs written on Fannie and Freddie.<sup>8</sup> Estimates ranged from \$200 billion to over \$1 trillion.<sup>9</sup> This problem arose because of an inherent feature in CDS contracts. Unlike stocks or bonds, there is no fixed supply of outstanding CDSs.<sup>10</sup> Firms could write an infinite amount of CDSs, as long as a buyer existed.<sup>11</sup> The large volume of the payouts on the Fannie and Freddie debt combined with the ambiguity as to the exact amount presented a potential systemic impact on the market.<sup>12</sup>

Lehman's bankruptcy further exposed the risk that CDSs brought to the financial markets. When Lehman fell, it could no longer honor the CDSs that it had written on other companies' debt.<sup>13</sup> The collapse also triggered payouts for the CDSs written against Lehman's debt.<sup>14</sup> Banks and hedge funds worried that other investment banks would meet similar fates so they scrambled to buy CDS contracts on those banks.<sup>15</sup> The result was an increase in CDS prices and a fear as a result of those prices that many financial institutions would default.<sup>16</sup> To illustrate, in the midst of the crisis

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<sup>7</sup> Serena Ng & Liz Rappaport, *Crisis on Wall Street: Credit-Swap Players Puzzle over Fan-Fred Fallout—Lehman Situation Adds to Urgency to Settle Questions*, WALL ST. J., Sept. 15, 2008, at C3.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Serena Ng & Emily Barrett, *Crisis on Wall Street: New Data Will Report Credit Swaps Tied to Bonds*, WALL ST. J., Nov. 1, 2008, at B2.

<sup>11</sup> *Id.*

<sup>12</sup> Ng & Rappaport, *supra* note 7.

<sup>13</sup> Serena Ng, *Crisis on Wall Street: Credit-Default Market Freezes as Risk Grows*, WALL ST. J., Sept. 19, 2008, at C3.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

buyers paid \$900,000 annually for insurance on \$10 million in Morgan Stanley debt over a five year span.<sup>17</sup> That price was double what the debt cost a few days earlier and triple what it cost a week earlier.<sup>18</sup>

The brunt of the CDS crash fell squarely on the American International Group, Inc. (“AIG”). For years prior to the financial meltdown, AIG had been one of the largest sellers of CDSs.<sup>19</sup> By June 2007, AIG had written CDSs on over \$440 billion in debt.<sup>20</sup> Approximately \$80 billion of that was tied up in multi-sector collateralized debt obligations.<sup>21</sup> When the value of those assets began to drop in late 2007, AIG’s trading partners came to AIG asking for collateral.<sup>22</sup> By the end of July 2008, AIG had paid out over \$16.5 billion in collateral calls on its swaps.<sup>23</sup> On September 15, the same day that Lehman filed for bankruptcy and the bond markets froze, credit agencies slashed AIG’s credit ratings.<sup>24</sup> AIG executives estimated that the downgrade would require an additional \$18 billion posting in collateral.<sup>25</sup> The government stepped in with a bailout because it seemed unlikely that AIG would meet the collateral calls and the government believed an AIG failure might lead to further financial complications.<sup>26</sup> As of September 2009, the government had extended AIG an \$182.3 billion credit line.<sup>27</sup> A significant portion of those funds went to resolve CDS contracts with its trading partners.<sup>28</sup> As a result, the U.S. government now owns approximately 80% of AIG.<sup>29</sup>

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<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Mollenkamp et al., *supra* note 5, at A1.

<sup>20</sup> Serena Ng, *The Financial Crisis: AIG at Risk: Financial Firms Gird for Backlash From Weakened AIG*, WALL ST. J., Sept. 17, 2008, at A10.

<sup>21</sup> Mollenkamp et al., *supra* note 5, at A1.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> U.S. GOV’T ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: STATUS OF GOV’T ASSISTANCE PROVIDED TO AIG 29 (Sept. 2009).

<sup>28</sup> Mary Williams Walsh, *A.I.G. Lists Firms To Which It Paid Taxpayer Money*, N.Y. TIMES, Mar. 16, 2009, at 1.

<sup>29</sup> *Id.*

### C. Proposed Regulation: Pros and Cons

The legislative bodies in the United States responded quickly to regulate CDSs. In New York, Governor Patterson announced on September 22, 2008, only a week after the meltdown, that the state would regulate portions of the CDS market as insurance beginning in January 2009.<sup>30</sup> Missouri and Virginia quickly followed suit with similar legislation.<sup>31</sup> However, these states, along with the rest of the nation, are waiting to act until the federal government makes its own comprehensive proposals.<sup>32</sup> Several proposals are currently floating through Congress.

#### 1. Banning Credit Default Swaps

Rep. Maxine Waters (D-CA) has taken the most forceful position against CDSs by introducing legislation to ban CDSs.<sup>33</sup> This bill would give the SEC the power to essentially seek out and destroy any contract that looks like it provides insurance “against the risk of a loss of value because of the occurrence or non-occurrence of an event or contingency . . . relating to a security, loan, or other reference asset.”<sup>34</sup> The rationale behind a CDS ban is that had the contracts not existed, there would not have been the massive aftershock that followed the collapse of the sub-prime mortgage market. According to critics of CDSs, removing the financial instrument from circulation would serve as a preventative measure to any further damage to the U.S. economy.<sup>35</sup>

A complete ban on CDSs seems unlikely because of the role these contracts play in the business world. CDS contracts grease the credit market by creating a safety net for lenders of credit should their borrowers default. Thus, a ban on CDSs would make lenders even more hesitant to provide credit to borrowers because CDSs would not exist to guarantee lenders some recoupment of their money. To see how CDSs can promote lending, suppose a financial institution buys a bond trading at 75 cents on the dollar and a swap

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<sup>30</sup> Campbell & Choi, *supra* note 1, at 20.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> Credit Default Swap Prohibition Act of 2009, H.R. 3145, 111th Cong. (2009).

<sup>34</sup> *Id.* §§ 3, 4, 7A.

<sup>35</sup> *Id.* § 2(b)(2).

on that bond trading at 90 cents on the dollar. If the bond defaults and nets only 25 cents on the dollar, then the institution would have lost 50 cents on the bond, yet would have earned an additional 65 cents on the swap.<sup>36</sup> In essence, firms can use CDSs to cover their lending positions and this makes them more likely to extend credit. Without the ability to cover themselves through CDSs, many firms would not lend credit for fear of borrower default. Along these same lines, CDS prices can also work as a barometer for a company's financial health.<sup>37</sup> A high price of CDSs written against a company's debt reflects the market's belief that the company is more likely to default. Furthermore, many industries use financial derivatives in their normal flow of business to hedge against day-to-day business risks such as fluctuations in currency or fuel prices.<sup>38</sup> Thus, banning CDSs would have the adverse effect of hindering investment by making financial institutions unable to adequately cover their business and investment decisions.

## 2. Banning Naked Credit Default Swaps

Another current legislative proposal that has received some attention is the proposal to ban naked CDSs.<sup>39</sup> Critics of naked CDSs argue that engaging in the practice is like buying insurance for somebody else's car or home.<sup>40</sup> Others argue against naked CDSs because they create incentives for investors to hope for a company to lose value.<sup>41</sup> Critics point out that holders of CDSs may hasten the demise of struggling financial institutions by refusing to renegotiate debt because holders of the contracts hope for a big payout should

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<sup>36</sup> Heidi N. Moore, *Brighter Side of 'Evil' Swaps—Reviled by Many for Role in AIG Troubles, CDS Help Drive Bond Revival*, WALL ST. J., May, 4 2009, at C3.

<sup>37</sup> L. Gordon Crovitz, *Information Age: Derivatives and the Wisdom of Crowds*, WALL ST. J., May 18, 2009, at A15.

<sup>38</sup> *Id.*

<sup>39</sup> American Clean Energy and Security Act of 2009, H.R. 2454, 111th Cong. §355 (2009); Prevent Unfair Manipulation of Prices Act of 2009, H.R. 2448, 111th Cong. § 7 (2009).

<sup>40</sup> John Carney, *How Banning Naked Credit Default Swaps Would Crush Markets*, THE BUSINESS INSIDER, July 24, 2009.

<sup>41</sup> Sarah N. Lynch, *Rep. Stupak Seeks to Empower CFTC to Regulate OTC Derivatives*, DOW JONES NEWSWIRE, May 15, 2009.

the company default.<sup>42</sup> Finally, there is also a worry for potential abuse in the CDS market by short-sellers.<sup>43</sup> The theory is that holders of short positions on a company would buy up CDS contracts against that company in order to increase that company's CDS price and raise a fear that the company may default.<sup>44</sup> The result would be to drive down the price of stock and give the holders of the short positions a big payout.<sup>45</sup>

A universal ban on naked CDSs seems unlikely for a few reasons. First, proponents of naked CDSs argue that an outright ban would lead to higher funding costs throughout corporate America.<sup>46</sup> Without speculative investors providing added liquidity and depth to the market, companies would not have as deep of pool to turn to when hedging business risks.<sup>47</sup> This decrease in supply would thus raise prices. Furthermore, lawmakers and regulators are not adamant about requiring the ban. Barney Frank (D-MA) has said that banning naked CDS is an option, yet he has mentioned that there may be other alternatives to a ban.<sup>48</sup> Likewise, Treasury Secretary Timothy Geithner does not believe a ban is necessary.<sup>49</sup> Furthermore, given the tenacity with which Wall Street creates financial products, some have expressed the concern that a ban might lead to the creation of an unregulated instrument that functions similarly to naked CDSs.<sup>50</sup> Thus, given the strong reaction by Wall Street against the ban and the lukewarm reception by regulators and lawmakers towards the ban, a universal ban on naked CDS seems unlikely.

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<sup>42</sup> Kevin G. Hall, *Lawmakers Plan to Shine a Light on 'Dark Markets'*, MCCLATCHY NEWSPAPERS, July 30, 2009.

<sup>43</sup> Carney, *supra* note 40.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Dawn Kopecki & Shannon D. Harrington, *Banning 'Naked' Default Swaps May Raise Corporate Funding Costs*, BLOOMBERG.COM, July 24, 2009,

<http://www.bloomberg.com/apps/news?pid=20601103&sid=afcm03ioxxqk>.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Kara Scannell & Serena Ng, *Derivatives Plan is Expected*, WALL ST. J., July 30, 2009, at C7.

<sup>50</sup> Sarah N. Lynch, *Rep Conway Hesitant to Ban Naked Credit Default Swaps*, DOW JONES NEWSWIRES, Feb. 3, 2009.

### 3. Comprehensive Legislation

At the time of writing, the most promising plan to regulate the CDS market comes from Barney Frank's Over-the-Counter Derivatives Market Act of 2009.<sup>51</sup> The legislation is complex, yet addresses a few key concerns affecting the CDS market. To begin, the legislation creates three broad categories that should capture institutions engaging in CDSs: swap dealer, major swap participant, and major security-based swap participant.<sup>52</sup> With large financial institutions and hedge funds in mind, the legislation defines the last two categories as any person or corporation that is not a swap trader who maintains a "substantial net position in outstanding swaps."<sup>53</sup> The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have sixty days to define the term—creating some obvious wiggle room for regulators to capture organizations under their umbrella.<sup>54</sup> The legislation also requires the SEC and CFTC, in conjunction with federal banking agencies, to adopt rules governing daily trading, reporting and recordkeeping for each of these categories' participants within a year of the legislation's enactment.<sup>55</sup>

The bill also has specific instructions regarding what swaps need to be cleared as well as margin and capital requirements. The bill requires regulators to identify specific swap contracts that in the public interest should be cleared.<sup>56</sup> Again, what constitutes public interest is a loose definition that gives regulators some wiggle room. The bill also requires that the trades have adequate margin and capital requirements as determined by regulators after the legislation's enactment.<sup>57</sup> The bill, however, does not require all trades to be cleared. Clearing is not required for a financial institution when no registered clearing organization will accept the swap or

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<sup>51</sup> Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong. (2009).

<sup>52</sup> H.R. 3795 §111(a) (9)-(11).

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at § 4s(f)-(g).

<sup>56</sup> James Hamilton, *Chairman Frank Circulates Draft Legislation Regulating OTC Derivatives*, WOLTERS KLUWER CCH FINANCIAL CRISIS NEWS CENTER, Oct. 7, 2009, <http://www.financialcrisisupdate.com/2009/10/chairman-frank-circulates-draft-legislation-regulating-otc-derivatives.html>; H.R. 3795 § 113(j)(1).

<sup>57</sup> H.R. 3795 § 4s(e)(1).



when one of the counterparties is not a swap dealer or major swap participant.<sup>58</sup> Although, institutions engaging in these non-cleared trades will need to report them to a registered swap repository or the SEC.<sup>59</sup> Regulators must also require higher capital requirements if the deal is not cleared through an approved organization.<sup>60</sup> Regulators also may choose to impose more demanding margin requirements on these un-cleared trades.<sup>61</sup> An interesting loophole in the bill is that the definition of major swap participant and major security based swap participant excludes companies who use derivatives for “risk management” purposes.<sup>62</sup> This means that a company who uses CDS to protect against the default of certain investments would not need to adhere to the same marginal and capital requirements as a firm who is merely speculating in the CDS market.

The main criticisms of Frank’s bill revolve around one concern; namely, that the bill is too soft. To begin, Frank’s bill does not ban naked CDSs.<sup>63</sup> Furthermore CFTC Chairman Gary Gensler has argued that the bill has too many loopholes that would allow hedge funds or other financial firms to evade central clearinghouse requirements.<sup>64</sup> Gensler finds particular ire in the “risk management” exclusion.<sup>65</sup> Because many firms use derivative swaps for risk management purposes, the exclusion could have the effect of excluding a vast majority of players in the CDS market.<sup>66</sup> Indeed, Frank’s bill is looser than the Obama Administration’s bill that would force all CDS transactions to be executed “on an exchange or processed through a regulated clearinghouse . . . .”<sup>67</sup> Furthermore,

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<sup>58</sup> Hamilton, *supra* note 56; H.R. 3795 § 113(j)(8).

<sup>59</sup> Hamilton, *supra* note 56; H.R. 3795 § 113(j)(4).

<sup>60</sup> Hamilton, *supra* note 56; H.R. 3795 § 4s(e)(3)(A)(ii).

<sup>61</sup> Hamilton, *supra* note 56; H.R. 3795 § 4s(e)(4).

<sup>62</sup> H.R. 3795 § 111(a)(10)-(11).

<sup>63</sup> Dawn Kopecki, ‘Abusive Swaps’ Would Be Banned Under Frank’s Derivatives Plan, Bloomberg.com, Oct. 3, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=amik0fY5tT7c>.

<sup>64</sup> Dawn Kopecki & Tina Seeley, *Frank’s Derivatives Plan May Leave ‘Gaps,’ CFTC Says*, BLOOMBERG.COM, Oct. 7, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aT69rJHBGD88>.

<sup>65</sup> Tina Seeley and Dawn Kopecki, *Derivatives Bill’s Loophole May Exempt Most Firms, Gensler Says*, BLOOMBERG.COM, Oct. 8, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=a7fAFtZGaGak>.

<sup>66</sup> *Id.*

<sup>67</sup> Kopecki & Seeley, *supra* note 64.

Henry Hu of the SEC's newly formed Risk, Strategy, and Financial Innovation Division believes that the significant regulatory differences between swaps and securities created by the bill would lead to gaming opportunities.<sup>68</sup> These opportunities would exist because a CDS would not be regulated in the same way as other securities.<sup>69</sup> Frank, himself, has said that the bill needs to be sharpened, although at the time of writing the Financial Services Committee voted the bill through with the "business risk" loophole attached.<sup>70</sup>

#### D. Other Alternatives

A private market response may pose a potential solution to the CDS market. In April 2009, the International Swaps and Derivatives Association created what they termed the "Big Bang Protocol" to streamline swap trading as well as promulgate procedures on how to settle swaps if the bonds or loans default.<sup>71</sup> At the time of the protocol, approximately 1,800 market participants agreed to abide by the new standards.<sup>72</sup> By September 2009, fifteen large Wall Street banks—including Goldman Sachs, J.P. Morgan Chase, Credit Suisse, and Deutsche Bank—told the Federal Reserve Bank of New York that they anticipate clearing more than 90% of their derivative trades by December 2009.<sup>73</sup> Indeed, since the financial meltdown, a healthy competition has arisen between European exchanges and American exchanges to clear the swaps—thus creating a market for the swaps absent legislation by the U.S. government.<sup>74</sup> This private market response may be adequate in

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<sup>68</sup> Ronald D. Orol, *SEC and CFTC Criticize Parts of House Derivatives Reform*, MARKETWATCH, Oct. 7, 2009, <http://www.marketwatch.com/story/sec-and-cftc-criticize-parts-of-derivatives-bill-2009-10-07>.

<sup>69</sup> *Id.*

<sup>70</sup> Seely & Kopecki, *supra* note 65; Press Release, House Comm. on Fin. Services, Financial Services Committee Approves Legislation to Regulate Derivatives (Oct. 15, 2009); H.R. 3795 § 111(a)(9)-(11).

<sup>71</sup> Serena Ng & Emily Barrett, *For Credit-Default Swaps, Today Comes the Fix-It*, WALL ST. J., Apr. 8, 2009, at C4.

<sup>72</sup> *Id.*

<sup>73</sup> Jacob Bunge, *Big Banks to Expand Swaps Clearing—Firms Expect to Route 90% of Trades Through Third Parties by December*, WALL ST. J., Sept. 9, 2009, at C14.

<sup>74</sup> Sean Walters, *Swaps Aplenty to Go Around for Exchanges*, WALL ST. J., Aug. 29, 2009, at B10.

bringing transparency to the system. However, a purely private fix seems unlikely. Although the exchanges provide more transparency in the CDS market, many of these exchanges grew out of the inevitability of regulation.<sup>75</sup> Without the threat of regulation, CDS and other derivative trading might go back to pre-financial crisis conditions. Furthermore, anger and resentment among Americans over the use of bailout funds will likely continue to push lawmakers to act.<sup>76</sup> Thus, a private market solution will complement rather than trump public regulation of the CDS market.

### E. Conclusion

The CDS market grew out of financial institutions' desire to protect themselves against the potential default of their debt and loan investments. Nevertheless, CDS contracts proved to prolong the financial crisis as companies who underwrote the CDSs could not cover their positions during the financial turmoil of Fall 2008 and the months thereafter. As a result of the crisis, Congress has reacted vigorously with a few key regulatory options. Some members of Congress wish to ban CDSs, while others have tried to ban naked CDSs. Of those two options, only the banning of naked CDSs seems to still be viable. The most promising regulatory options for CDSs hinge on Congressman Barney Frank's bill. The bill seeks to bring CDSs out of the dark by requiring financial institutions trading swaps to record, report, and meet margin or capital requirements before they can engage in a trade. The final state of the bill is still uncertain, although the "business risk" loophole seems to be drawing a lot of ire from both regulators and private analysts. Thus, one can expect members of Congress to try and tighten the bill in session—with the result being CDSs subject to regulation within the near future.

Caleb Sainsbury<sup>77</sup>

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<sup>75</sup> Abigail Moses & Shannon D. Harrington, *Credit Swaps Lose Crisis Stigma as Confidence Returns*, BLOOMBERG.COM, Sept. 16, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aC4fk9xBjdzk>.

<sup>76</sup> Walsh, *supra* note 28, at 1.

<sup>77</sup> Student, Boston University School of Law (J.D. 2011).

### **III. *Hedge Funds and Private Equity Developments***

#### **A. Introduction**

Although hedge funds and private equity firms have traditionally not been subject to burdensome federal or state regulations, the recent financial crisis has given rise to many proposals that will have an impact on the regulatory status of hedge funds and private equity funds.<sup>1</sup> While the regulatory landscape will certainly shift regarding private equity firms and hedge funds, analysts note that uncertainty exists surrounding the proposed regulations, especially because the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs are both releasing revised versions of the Obama Administration's financial reform proposals.<sup>2</sup> Although the focus of this article is on reforms taking place within the United States, it is also important to examine the global context of the changing legal landscape affecting hedge funds and private equity. For example, proposed European regulation of managers of alternative investment funds could substantially limit the operation of U.S. funds in the European Union.<sup>3</sup>

#### **B. Relevance of Hedge Funds and Private Equity to Current Financial Conditions**

Notwithstanding the current financial crisis, hedge funds appear to be thriving in 2009.<sup>4</sup> In fact, hedge funds have not had such a bright year since 1998, although according to industry analysts, managers stand far below their positions prior to the market's fall in 2008.<sup>5</sup> Although only eight percent of funds demonstrated a full turnaround from the drawdowns that began in early 2007, hedge fund

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<sup>1</sup> See *What U.S. Regulatory Reform Could Mean for Private Equity*, 9 DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT 3, 3 (Spring 2009).

<sup>2</sup> Arthur B. Laby, *Moving Toward a New Era for Hedge Fund Regulation*, 241 N.Y. L.J. 4, Apr. 18, 2009 (Col. 1); Client Memorandum, *The House and Senate Debate Resolution Authority*, Davis Polk, Nov. 12, 2009, at 1.

<sup>3</sup> Financial Institutions Advisory, *Proposed European Regulation of Alternative Investment Fund Managers: Impact on US Fund Managers*, Covington & Burling LLP, Sept. 2, 2009, at 1.

<sup>4</sup> Joseph A. Giannone, *Hedge funds soar in '09, most still in the red*, REUTERS UK, Aug. 18, 2009, <http://uk.reuters.com/article/idUKTRE57H5TZ20090818>.

<sup>5</sup> *Id.*

assets under management did rise 2.5 percent in July.<sup>6</sup> August marked the sixth positive month in a row for hedge funds, as cumulative industry assets increased by 2.56 percent, or \$47.09 billion, since July, reaching an estimated \$1.886 trillion.<sup>7</sup> Strong equity markets account for this positive hedge fund performance.<sup>8</sup> The top performing funds were from the finance sector, while short bias, technology and macro funds were among the worst performers.<sup>9</sup>

Conversely, the current private equity outlook is not as positive.<sup>10</sup> Comparing the performance of hedge funds to private equity funds is difficult because the success of each type of fund is measured according to different standards and over different periods of time.<sup>11</sup> Performance for private equity firms cannot be measured over the course of one year since private equity funds have longer hold periods on investments.<sup>12</sup> Instead, fundraising is used as a way to provide a snapshot of the state of the investments.<sup>13</sup> It should come as no surprise that the current fundraising environment for private equity firms is very difficult, leading to the lowest volume of deals in years because endowments and pension funds lack liquidity.<sup>14</sup> According to PitchBook, the first half of 2009, with only 407 deals closing, was the slowest six months since 2002.<sup>15</sup> In the second quarter of 2008, private equity firms raised a record-breaking \$213 billion, while the second quarter of 2009 paled in comparison with

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<sup>6</sup> *Id.*

<sup>7</sup> Peter Laurelli, *HFN Monthly Performance Report: August 2009*, Sept. 21, 2009, <http://www.hedgefund.net/publicnews/default.aspx?story=10438>.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Peter Carbonara, *Private Equity 2009 Half Time Stats*, BUSINESSWEEK, July 1, 2009, [http://www.businessweek.com/investing/wall\\_street\\_news\\_blog\\_/archives/2009/07/private\\_equity\\_1.html](http://www.businessweek.com/investing/wall_street_news_blog_/archives/2009/07/private_equity_1.html).

<sup>11</sup> See Mark K. Thomas, *Key Differences between Hedge Funds and Private Equity Funds*, THE SECURED LENDER, March 1, 2006, <http://www.allbusiness.com/business-finance/equity-funding-private-equity/896062-1.html>.

<sup>12</sup> *Id.*

<sup>13</sup> See Dow Jones & Company, *U.S. Private Equity Fund-Raising Continues Steep Decline, Drops 70% in Third Quarter*, PR NEWswire, Oct. 8, 2009, <http://www.prnewswire.com/news-releases/us-private-equity-fund-raising-continues-steep-decline-drops-70-in-third-quarter-63745547.html>.

<sup>14</sup> Carbonara, *supra* note 10.

<sup>15</sup> *Id.*

only \$76 billion in new funds raised worldwide.<sup>16</sup> Not all of the news is bleak however, as more funds were raised in the second quarter of 2009 than the first, where only \$60 billion was raised—the lowest amount in the last five years.<sup>17</sup>

Investors have been looking at hedge funds and expecting them to make certain changes to their rules. Due to poor returns, hedge funds were expected to lower their fees, reduce the length of time between redemption dates in order to appease investors or enact both changes.<sup>18</sup> However, the funds have not yet reduced their fees nor have they softened any of their conditions.<sup>19</sup> Analysts cite improved performance in 2009 as the reason for the lack of changes.<sup>20</sup> Despite increased profitability for hedge funds in 2009, several large hedge fund managers are closing their hedge funds.<sup>21</sup> Managers who closed their funds and returned investor money all cited large losses caused by a tumultuous market in mid-2008 to 2009.<sup>22</sup> Managers' fees also motivated the closings because managers, who normally earn twenty percent of the profits they generate for their clients as performance fees, must earn back investors' losses before they can begin earning the performance-based fees again.<sup>23</sup> Some hedge fund

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> Andrew Ross Sorkin, *Hedge Fund Fees Remain Intact, Report Finds*, Dealbook Blog—NYTimes.com, <http://dealbook.blogs.nytimes.com> (Sept. 24, 2009, 7:00 EST).

<sup>19</sup> *Id.*

<sup>20</sup> Margo Patrick, *Hedge Funds Still Aren't Reducing Their Fees*, WALL ST. J., Sept. 24, 2009, <http://online.wsj.com/article/SB125373918707235213.html>.

<sup>21</sup> Jenny Strasburg & Peter Lattman, *Two Money Managers Will Close Large Funds*, WALL ST. J., June. 4, 2009, <http://online.wsj.com/article/SB124397181744578265.html>; Jenny Strasburg, *Cantillon Joins Rush to Close Hedge Funds*, WALL ST. J., June. 18, 2009, <http://online.wsj.com/article/SB124525398751723701.html>; Atticus to Close Two Funds, Return \$3 Billion to Investors, CNBC.COM, Aug. 11, 2009, <http://www.cnbc.com/id/32373214/>.

<sup>22</sup> Strasburg & Lattman, *supra* note 21; Strasburg, *Cantillon*, *supra* note 21; Atticus, *supra* note 21.

<sup>23</sup> Beth Healy, *Pallotta Shutting His Hedge Funds*, THE BOSTON GLOBE, June 3, 2009, [http://www.boston.com/business/articles/2009/06/03/hedge\\_fund\\_manager\\_pallotta\\_to\\_shut\\_funds\\_return\\_money/](http://www.boston.com/business/articles/2009/06/03/hedge_fund_manager_pallotta_to_shut_funds_return_money/).

managers are investing money in new funds, a move that makes them eligible for performance fees again.<sup>24</sup>

The lightly regulated hedge funds and private equity firms are especially relevant in the context of the financial crisis because some analysts suggest that both types of funds contributed to current financial conditions.<sup>25</sup> Many hedge funds and private equity funds “were overleveraged and overly interconnected with large problematic financial institutions” and they invested in risky financial assets.<sup>26</sup> Hedge and private equity funds would have been “major contributor[s] to the financial crisis” if the risky assets had defaulted.<sup>27</sup> Since private equity firms and hedge funds are so highly leveraged, Congress is concerned about increased systemic risk and forthcoming legislation will single out both types of funds.<sup>28</sup>

### C. Current Regulations Impacting Hedge Funds and Private Equity Firms

Hedge funds and private equity firms are exempt from the majority of the regulations that greatly impact banks and other financial institutions in many jurisdictions because they are selective in the type of investors they accept.<sup>29</sup> As a result, hedge funds and private equity firms fall under exceptions to current Securities Exchange Commission (“SEC”) regulations and other regulations governing short selling, derivatives, leverage, fee structures and the liquidity of the fund’s interests.<sup>30</sup> Hedge funds and private equity

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<sup>24</sup> See Alistair Barr, *Raptor’s James Pallotta to Invest \$10 Million In New Fund*, WALL ST. J., Sept. 25, 2009, <http://online.wsj.com/article/BT-CO-20090925-713459.html>.

<sup>25</sup> See Anita K. Krug, *Financial Regulatory Reform and Private Funds*, Berkeley Center for Law, Business and the Economy, July 2009, at 2-3, available at [http://www.law.berkeley.edu/files/FinancialRegulatoryReform\\_Krug.07.09\(1\).pdf](http://www.law.berkeley.edu/files/FinancialRegulatoryReform_Krug.07.09(1).pdf).

<sup>26</sup> Ronald D. Orol, *Hedge and Private Funds to Register, Open Up Books to SEC*, MARKETWATCH, Oct. 27, 2009, <http://www.marketwatch.com/story/bill-sets-rules-for-hedge-funds-and-private-equity-2009-10-27>.

<sup>27</sup> *Id.*

<sup>28</sup> See Krug, *supra* note 25, at 3-4; Orol, *supra* note 26.

<sup>29</sup> See 15 U.S.C. § 80a-3(c)(7) (2006).

<sup>30</sup> Gerald T. Lins, Thomas P. Lemke, Kathryn L. Hoenig, & Patricia Schoor Rube, *Chapter 3. Registration and Regulation of Fund Managers: The Investment Advisers Act of 1940*, HEDGE FUNDS AND OTHER PRIVATE

firms are in a unique position because their registration with the SEC is voluntary, thus the funds can choose whether to be subject to increased reporting, bookkeeping and other requirements.

Most hedge funds and private equity firms are included in the exemption in § 3(c)(1) of the Investment Company Act of 1940 for funds with fewer than 100 investors.<sup>31</sup> Additionally, § 3(c)(7) of the Investment Company Act of 1940 exempts funds with investors that are qualified purchasers, but the fund must have fewer than 499 investors to avoid registering with the SEC.<sup>32</sup> Private equity and hedge funds are not subject to the Securities Act of 1933's disclosures because the disclosure requirements only apply to companies seeking funds from the public.<sup>33</sup>

Furthermore, both types of funds can only be offered to "accredited investors," defined as individuals with either a net worth of \$1 million or an annual income of \$200,000 if single or \$300,000 if married.<sup>34</sup> Regulation D requires hedge and private equity funds to file an amended Form D, comprised of a brief notice including the names and addresses of the company's executive officers and stock promoters and to disclose the date of the first sale in the offering.<sup>35</sup> Private equity and hedge funds must also file Form 13F, applicable to all institutional money managers holding \$100 million or greater in Section 13F securities, as required by the Securities Exchange Act of 1934.<sup>36</sup> Lastly, the Investment Advisers Act of 1940 prohibits both types of fund advisers from making false or misleading statements to, or otherwise defrauding, investors or prospective investors.<sup>37</sup>

The Obama Administration's proposal for restructuring the U.S. financial regulatory system makes clear their belief that because private equity firms and hedge funds have not been required to register with the SEC and other regulators, "the government lacked reliable, comprehensive data with which to assess . . . [de-leveraging

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FUNDS: REGULATION AND COMPLIANCE DATABASE, updated November 2008.

<sup>31</sup> 15 U.S.C. § 80a-3(c)(1) (2006).

<sup>32</sup> 15 U.S.C. § 80a-3(c)(7) (2006).

<sup>33</sup> 15 U.S.C. § 77(a) (2006).

<sup>34</sup> See 17 C.F.R. §§ 230.501 *et seq* (2009); see 15 U.S.C. § 80a (2006).

<sup>35</sup> SEC. AND EXCH. COMM'N, REGULATION D OFFERINGS, available at <http://www.sec.gov/answers/regd.htm> (last visited Dec. 2, 2009)

<sup>36</sup> Marcia L. MacHarg & Kevin R. Learned, *SEC Provides Welcome Guidance for Form 13F Filers*, Debevoise & Plimpton, LLP, May 4, 1999.

<sup>37</sup> 17 C.F.R. § 275 (2009).



and] potential systemic implications of . . . hedge funds and other private pools of capital . . .”<sup>38</sup> The proposal boldly asserts, “it has also become clear that there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisors and the funds that they manage.”<sup>39</sup> The exemptions listed above may have exacerbated the current financial situation by preventing transparency in hedge and private equity funds, leaving regulators uninformed.

#### **D. Proposed Regulatory Reform and Effects on Hedge Funds and Private Equity Firms**

The year 2009 has brought a new administration to the U.S. capitol as well as new leadership in the SEC.<sup>40</sup> With the public seeking accountability in light of the financial crisis, regulatory reform is already underway.<sup>41</sup> Hedge funds and private equity firms are targets of increased supervision that will extend to advisers and managers.<sup>42</sup> This article focuses on regulatory measures, specifically those regarding registration, that are being considered by the House Financial Services Committee (“House Committee”), chaired by Representative Barney Frank (D-MA) and by the Senate Committee on Banking, Housing, and Urban Affairs (“Senate Committee”) chaired by Senator Christopher Dodd (D-CT).<sup>43</sup> Subsequently, the article briefly considers the effects of the proposed E.U. Directive on Alternate Investment Fund Managers.

On October 27, 2009, the House Committee passed the Private Fund Investment Advisers Registration Act (“PFIARA”) by a vote of 67-1, representing a strong showing of bipartisan support.<sup>44</sup> PFIARA requires many hedge funds and private equity firms to

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<sup>38</sup> THE DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, 37 (2009) [hereinafter TREASURY REPORT].

<sup>39</sup> *Id.*

<sup>40</sup> Laby, *supra* note 2.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Press Release, *Committee to Continue Consideration of Financial Regulatory Reform Legislation*, H. Comm. on Financial Services, Oct. 17, 2009; Press Release, *Dodd, Banking Committee Democrats Unveil Comprehensive Financial Reform*, S. Comm. on Banking, Housing and Urban Affairs, Nov. 10, 2009.

<sup>44</sup> Press Release, *Committee Approves Private Advisor Registration Bill with Bipartisan Support*, H. Comm. on Financial Services, Oct. 27, 2009.

register with the SEC and thus managers of hedge funds and private equity funds will be subject to increased recordkeeping and disclosures regarding transactions.<sup>45</sup> The legislation effectively eliminates the current exemptions enjoyed by hedge funds and private equity firms by requiring those that “have until this time largely escaped any meaningful regulation” to register.<sup>46</sup> The House Committee did include an exemption to registering with the SEC for small hedge funds with less than \$150 million and another provision exempts venture capital managers.<sup>47</sup> One direct effect on private equity and hedge funds of the PFIARA will be increased operating costs.<sup>48</sup> Managers of funds are granted a one-year transitional period before registration requirements take effect.<sup>49</sup>

On November 11, 2009, the Senate Committee issued a Discussion Draft of its Restoring American Financial Stability Act (“Senate Draft”) and Senator Dodd asserted that he “will eliminate regulatory gaps that allow risky practices to fly beneath the radar – including . . . hedge funds.”<sup>50</sup> Representative Frank congratulated Senator Dodd, noting that the House and Senate bills “are moving in the same direction.”<sup>51</sup> Upon close examination, however, the proposals reveal some interesting differences regarding registration requirements. Most notably, although the Senate Draft removes the House’s exemption for small private fund advisers, it carves out an exemption for “private equity funds.”<sup>52</sup> It is possible that Senator Dobbis agreed with the prior negative response of private equity firms towards proposed regulations that was motivated by fear of creating an undue burden on the firms, as the firms asserted that private equity investments do not create systemic risks.<sup>53</sup>

Despite the differences in exemptions, the Senate and House bills both require firms to file (or in the case of the House bill,

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<sup>45</sup> Orol, *supra* note 26.

<sup>46</sup> *Committee Approves Private Advisor Registration Bill*, *supra* note 44.

<sup>47</sup> Davis Polk Summary, *Summary of the Restoring American Financial Stability Act of 2009, Introduced by Senator Christopher Dodd (D-CT) November 10, 2009 Discussion Draft*, Davis Polk, Nov. 13, 2009, at 13.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Dodd, Banking Committee*, *supra* note 43.

<sup>51</sup> Press Release, *Frank Statement on Senator Dodd’s Financial Reform Package*, H. Comm. on Financial Services, Nov. 10, 2009.

<sup>52</sup> Davis Polk Summary, *supra* note 47, at 13.

<sup>53</sup> AltAssets, *US Treasury Propose Greater Regulation of Private Equity Funds*, March 27, 2009, [www.altassets.net](http://www.altassets.net).

maintain or file) similar information.<sup>54</sup> Reports filed with the SEC must include the amount of assets under management, use of leverage and other information deemed necessary by the SEC.<sup>55</sup> The Senate bill also requires disclosure of valuation methodologies of funds.<sup>56</sup> Both bills explicitly permit the sharing of information disclosed to the SEC with the Federal Reserve that is deemed necessary for assessing systemic risk, although the information will remain confidential.<sup>57</sup> Unregistered hedge funds and private equity funds should be concerned about imminent registration, bookkeeping and reporting requirements that could substantially increase costs to fund sponsors.<sup>58</sup> As noted above, registration has previously been voluntary for private equity and hedge funds and many have already registered, which “clearly involv[ed] increased costs and burdens” that the rest of private funds should expect if these bills are approved by Congress.<sup>59</sup> If the Senate Draft is enacted, the SEC and Federal Reserve will have six months to establish rules addressing the required form and content of reports to be filed by registered managers.<sup>60</sup> The new regulatory scheme remains uncertain, although private fund managers should expect increased registration and reporting requirements in the first part of 2010.<sup>61</sup>

Because the effects of the financial crisis have spread worldwide, it is important to examine the global context of regulatory reform for hedge funds and private equity firms. Transparency is becoming increasingly important to the Obama Administration and Congress, leading to the proposal of legislation that would remove the exceptions advisors and managers of hedge funds and private equity firms currently rely on to avoid registering.<sup>62</sup> However, the call for the regulation of alternative investment fund managers reaches beyond the U.S. The European Union is considering imposing regulations on managers of hedge funds, private equity

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<sup>54</sup> Davis Polk Summary, *supra* note 47, at 14.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT, *supra* note 1, at 4.

<sup>59</sup> *Id.*

<sup>60</sup> Business & Finance Newsflash, *Status of Proposed Legislation Requiring Registration of Investment Advisers to Private Investment Funds*, Morgan Lewis, Sept. 29, 2009, at 2-3.

<sup>61</sup> *Id.* at 3.

<sup>62</sup> Client Update, *Proposed US Legislation Requires Advisers of Private Investment Funds to Register with the SEC*, Mayer Brown, Sept. 3, 2009.

funds and other alternative investment funds that will lead to marketing restrictions for hedge funds with non-E.U. managers.<sup>63</sup> The most significant effect will be marketing restrictions in Europe for hedge funds based in the U.S. that do not have an authorized fund manager.<sup>64</sup> The proposed regulations indicate that it will be very difficult for non-E.U. fund managers to become authorized.<sup>65</sup> This proposed directive comes in the wake of the European Parliament's call for reform of the European financial system.<sup>66</sup>

Not all European countries share the same view regarding the proposed regulatory changes. Britain has recently made significant efforts to soften the severe regulations called for by the European directive.<sup>67</sup> Britain, the location of eighty percent of Europe's \$300 billion hedge fund industry, currently has support from most of the European parliamentarians to alter the directive advocated for by France and Germany.<sup>68</sup> The European Parliament recognizes the need for making changes to the directive, especially in light of a study published by the U.K.'s Financial Services Authority indicating that the directive would cost European private equity and hedge fund sectors up to 3.2 billion Euros in initial compliance costs and an additional 311 million Euros per year.<sup>69</sup> Although Britain seems to be ahead in its lobbying, opinions may shift as Spain will take over the leadership of the European Union.<sup>70</sup> Elena Salgado, Spain's Finance Minister, supports implementing the directive as is, stating that greater transparency obligations and consumer protection are necessary.<sup>71</sup> The European Parliament has commenced discussions of the Directive, and the approval process is expected to take between six to twelve months.<sup>72</sup>

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<sup>63</sup> Covington, *supra* note 3, at 2.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> Elena Moya, *EU Hedge Fund Directive 'Could Be Softened', says Liberal Democratic Chair*, THE GUARDIAN, Sept. 24, 2009, <http://www.guardian.co.uk/business/2009/sep/24/eu-hedge-fund-directive-bowles>.

<sup>68</sup> *Id.*

<sup>69</sup> Moya, *EU Hedge Fund*, *supra* note 67; Private Investment Funds Update, Proskauer Rose, Oct. 2009, at 4.

<sup>70</sup> Elena Moya, *Hedge Funds Are Not for Hedging, Says Spain's Finance Minister*, THE GUARDIAN, Sept. 10, 2009, <http://www.guardian.co.uk/business/2009/sep/10/hedge-funds-europe>.

<sup>71</sup> *Id.*

<sup>72</sup> Proskauer Rose, *supra* note 69, at 4.

### E. Conclusion

In light of the current financial crisis, regulatory reform that will affect private equity firms and hedge funds is imminent and yet, shrouded in uncertainty. The Obama Administration and Congress are targeting private funds that may contribute to systemic risk because of their high leverage, among other factors.<sup>73</sup> Imposing registration requirements on hedge funds, private equity firms and their managers could greatly increase operating costs.<sup>74</sup> Concerns about cost have been expressed by private funds around the world as Europe faces financial regulatory reform directives as well.<sup>75</sup> However, U.S. private equity firms may luck out. If the Senate Committee's Discussion Draft is enacted, private equity fund managers could still retain their exempt status, as they would be among the few to "dodge the registration bullet."<sup>76</sup> Only time will tell how the regulatory changes in the U.S. and Europe will shape the financial services industry.

Andreea Sabin<sup>77</sup>

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<sup>73</sup> TREASURY REPORT, *supra* note 38, at 37.

<sup>74</sup> Davis Polk Summary, *supra* note 47, at 13.

<sup>75</sup> Proskauer Rose, *supra* note 69, at 4.

<sup>76</sup> Client Update, *Will Private Equity Dodge the Registration Bullet?*, Debevoise & Plimpton LLP, Nov. 12, 2009.

<sup>77</sup> Student, Boston University School of Law (J.D. 2011).

#### IV. *Government Sponsored Enterprises*

##### A. **Overview**

Government Sponsored Enterprises (“GSEs”) are private companies which receive specific benefits from the government and are limited to a particular field of business.<sup>1</sup> GSEs are for-profit corporations with stockholders but are exempt from reporting some securities transactions to the Securities and Exchange Commission (“SEC”).<sup>2</sup> There is also an implied understanding that GSEs carry the full faith and credit of the U.S. Treasury and, as a result, they are given below-market interest rates.<sup>3</sup> This business model creates a moral hazard; profit-driven businesses can take risks knowing taxpayer dollars will be used to cover losses.<sup>4</sup> Additionally, the GSEs are exempt from regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934 (“Acts of 1933 and 1934”).<sup>5</sup> Exemption from these Acts allows them to operate important parts of their businesses in the shadows, out of the sight of regulators, investors and the public.<sup>6</sup>

In return for these benefits, GSEs can operate only in a specific market.<sup>7</sup> Fannie Mae and Freddie Mac, the two largest GSEs, were both created to facilitate home loans, and from 1968 to 2007 they more than doubled in size every five years.<sup>8</sup> As of March 2009, Fannie and Freddie guaranteed or owned “about half of the \$10.6 trillion in outstanding home loan debt.”<sup>9</sup> In 2008, these two

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<sup>1</sup> CONGRESSIONAL RESEARCH SERVICE. RS21663, GOVERNMENT SPONSORED ENTERPRISES (GSEs): AN INSTITUTIONAL OVERVIEW (2007), 2, 5.

<sup>2</sup> Press Release, Rep. Markey, Markey, Putnam Offer Tougher Rules for Federal Mortgage Corporations (March 10, 2009).

<sup>3</sup> U.S. Congressional Research Service. Government Sponsored Enterprises, at 2.

<sup>4</sup> *Id.* at 3-5.

<sup>5</sup> Congressman Adam H. Putnam, *The Fannie Mae and Freddie Mac Full Disclosure Act: Handout*, [http://www.adamputnam.house.gov/putnam/fannie\\_freddie\\_handout.pdf](http://www.adamputnam.house.gov/putnam/fannie_freddie_handout.pdf) (last visited Sept. 24, 2009).

<sup>6</sup> Press Release, Rep. Markey, *supra* note 2, at 1.

<sup>7</sup> CONGRESSIONAL RESEARCH SERVICE. RS21663, *supra* note 1 at 2.

<sup>8</sup> *Id.* at 5.

<sup>9</sup> Press Release, Rep. Markey, *supra* note 2, at 1.

companies purchased or guaranteed nearly seventy-five percent of new mortgages.<sup>10</sup>

There are currently seven GSEs.<sup>11</sup> Three are investor owned (Fannie Mae, Freddie Mac, and Farmer Mac), two are borrower owned (the Federal Home Loan Bank System and the Farm Credit System) and the remaining two are “funding shells” (the Financing Corporation and the Resolution Funding Corporation).<sup>12</sup> Because of their size and relevance to the current financial crisis, this article will focus on Fannie Mae and Freddie Mac.

### **B. Fannie Mae, Freddie Mac and their Current Relevance**

In August 2008, Fannie Mae and Freddie Mac stocks plummeted to less than ten percent of their value from a year earlier.<sup>13</sup> On September 7, 2008 Fannie Mae and Freddie Mac were put into government conservatorship.<sup>14</sup> As a result, the government guaranteed \$400 billion in taxpayer money to pay off the two companies’ potential losses.<sup>15</sup> This action was necessary to avoid a more severe economic crisis; Fannie Mae and Freddie Mac were too large and served too important a function to be allowed to fail.<sup>16</sup>

### **C. Warnings and Limited Reaction**

There had been warning signs and calls for increased regulation long before Fannie and Freddie were placed in conservatorship.<sup>17</sup> In a joint securities report published in 1992, the

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<sup>10</sup> Press Release, Tim Geithner, Sec’y, U.S. Dep’t of the Treasury, Statement by Secretary Tim Geithner on Treasury’s Commitment to Fannie Mae and Freddie Mac, at 1 (Feb. 18, 2009).

<sup>11</sup> CONGRESSIONAL RESEARCH SERVICE, RS21663 *supra* note 1 at 3, n.8.

<sup>12</sup> *Id.*

<sup>13</sup> Rep. Adam H. Putnam, *Fannie Mae & Freddie Mac History*, [http://www.house.gov/putnam/fannie\\_freddie\\_timeline/pdf](http://www.house.gov/putnam/fannie_freddie_timeline/pdf) (last visited Sept. 24, 2009).

<sup>14</sup> Press Release, Henry M. Paulson, Jr., Sec’y, U.S. Dep’t of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008).

<sup>15</sup> Geithner, *supra* note 10, at 1.

<sup>16</sup> *Id.*

<sup>17</sup> *Fannie Mae & Freddie Mac History*, *supra* note 13, at 1-3.

Treasury Department, the SEC and the Federal Reserve told Congress that the GSEs' conduct in the securities market amounted to "misconduct," and concluded that "the exemptions under the federal securities laws for equity and unsecured debt securities of GSEs should be eliminated."<sup>18</sup>

In 1999 the New York Times reported that by expanding lending to the subprime market "Fannie Mae is taking on significantly more risk . . . [and] may run into trouble in an economic downturn, prompting a government rescue."<sup>19</sup> The motive for subprime lending was twofold. First, Fannie Mae pursued increased profits through riskier loans while taxpayers bore the risk, illustrating the inherent moral hazard of the hybrid GSE structure. Second, the GSEs had "been under increasing pressure from the Clinton Administration to expand mortgage loans among low and moderate income people," which made up the subprime market.<sup>20</sup> This illustrates another problem with the hybrid GSE structure: politically motivated governmental demands beget unwise policies, which can lead to financial ruin.

In 2003, Freddie Mac admitted to several years of inaccurate earnings reports totaling almost five billion dollars, and the SEC found that Freddie Mac violated Generally Accepted Accounting Principles ("GAAP") in its financial reporting.<sup>21</sup> In 2004, a similar story unfolded at Fannie Mae: it had at least seven years of inaccurate reports totaling \$6.3 billion, again in violation of GAAP.<sup>22</sup>

Congressman Christopher Shays introduced the Uniform Securities Disclosure Act in 2002 and the Leave No Securities Behind Act in 2003; both acts were defeated.<sup>23</sup> Both of these bills would have eliminated the securities and registration exemptions for GSEs.<sup>24</sup> In 2003, the Office of Federal Housing Enterprise Oversight

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<sup>18</sup> DEP'T OF THE TREASURY, SEC. AND EXCH. COMM'N, FED. RESERVE SYS., JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET, at 33-34 (1992).

<sup>19</sup> Steven A. Holmes, *Fannie Mae Eases Credit to Aid Mortgage Lending*, N.Y. TIMES, Sept. 30, 1999, at C2.

<sup>20</sup> *Id.*

<sup>21</sup> *Fannie Mae & Freddie Mac History*, *supra* note 13, at 2.

<sup>22</sup> *Id.*; Press Release, Donald T. Nicolaisen, Chief Accountant, Sec. and Exch. Comm'n, Office of the Chief Accountant Issues Statement on Fannie Mae Accounting (Dec. 15, 2004).

<sup>23</sup> *Fannie Mae & Freddie Mac History*, *supra* note 13, at 1-2.

<sup>24</sup> *Id.*



recommended that securities exemptions be eliminated “to enhance transparency of America’s public companies.”<sup>25</sup>

These and other efforts over the next few years led to some limited increases in regulation.<sup>26</sup> In 2003, Fannie and Freddie agreed to release some mortgage-backed securities (“MBS”) information, but would not agree to have their MBSs registered.<sup>27</sup> As the economy unraveled in 2008, Congress passed the Housing and Economic Recovery Act of 2008.<sup>28</sup> After seeing the combined effect of GSEs’ shadow security dealings, their “inherent conflict and flawed business model” and the subprime mortgage crisis, Fannie and Freddie Congress relieved Fannie and Freddie of their equity security exemption.<sup>29</sup> Furthermore, at the time Fannie and Freddie were put into government conservatorship, Treasury Secretary Paulson stated that “to address systemic risk, in 2010 their portfolios will begin to be gradually reduced at the rate of ten percent per year, largely through natural run off, eventually stabilizing at a lower, less risky size.”<sup>30</sup> Increasing securities transparency and reducing the size of GSEs were steps towards stability; however, they were not intended to be the last steps.<sup>31</sup>

#### **D. Proposals for the Future of Fannie and Freddie**

At the conclusion of Secretary Paulson’s conservatorship announcement, he urged policymakers to reform the GSE model, “There is a consensus today that these enterprises pose a systemic risk and they cannot continue in their current form . . . . We will make a grave error if we don’t use this time out to permanently address the structural issues presented by the GSEs.”<sup>32</sup>

In September 2009, the Government Accountability Office (“GAO”) issued a report to Congress listing the options for

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<sup>25</sup> Press Release, Armando Falcon, Jr., Dir. Office of Fed. Hous. Enter. Oversight, OFHEO Proposes Securities Disclosure Regulation for Fannie Mae and Freddie Mac, at 1 (Jan. 21, 2003).

<sup>26</sup> *Fannie Mae & Freddie Mac History*, *supra* note 13, at 1-3.

<sup>27</sup> *Id.* at 2.

<sup>28</sup> Housing and Economic Recovery Act of 2008.

<sup>29</sup> Paulson, *supra* note 14, at 2.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 2-4.

<sup>32</sup> *Id.* at 4.

restructuring Fannie and Freddie.<sup>33</sup> The three proposed options were to: (1) increase regulation but keep GSEs in their same basic structure, (2) create a government agency to fill the role of GSEs, or (3) let the private market fill the role of GSEs and create a government mortgage insurer to ensure stability.<sup>34</sup>

### 1. Increase Regulation

This option maintains the current hybrid nature of privately run companies with government backing.<sup>35</sup> This option's strength and weakness is its limitedness; because it seeks to change things within the current basic structure it will both be easier to reach a consensus on new regulations and have limited impact. However, many in the industry, including former Secretary Paulson, maintain that the hybrid GSE structure with added regulation best fulfills the mission of home mortgage liquidity.<sup>36</sup> The GAO highlights five policies for Congress to consider in deciding how to increase GSE stability.<sup>37</sup> Many of these policies can be used in conjunction with each other, each is not meant to be exclusionary.

The first proposed policy is to reduce or even eliminate mortgage portfolios.<sup>38</sup> This is a strongly supported regulation; however, there is some support for allowing limited mortgage portfolios to help maintain service to rural and multifamily mortgages.<sup>39</sup> These properties are difficult to service through MBS for a variety of reasons; for instance, they offer less diversification and less predictable repayment time frames.<sup>40</sup>

The second proposed policy is to break Fannie and Freddie into approximately ten smaller GSEs.<sup>41</sup> Of course, simply breaking

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<sup>33</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES' LONG-TERM STRUCTURES (2009).

<sup>34</sup> *Id.* at 29-36.

<sup>35</sup> CONGRESSIONAL RESEARCH SERVICE. RS21663, *supra* note 1 at 1.

<sup>36</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 31, 34.

<sup>37</sup> *Id.* at 31-34.

<sup>38</sup> *Id.* at 31-32.

<sup>39</sup> *Id.* at 29, 31, 32

<sup>40</sup> *Id.* at 32.

<sup>41</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES' LONG-TERM STRUCTURES (2009) at 32.

up the GSEs while keeping their current structure will not solve the problem; the inherent weaknesses of the current model will be transferred to each of the smaller corporations. However, implementing this option in addition to increasing regulation would eliminate a systemic threat should one or more of the newly formed GSEs fail.<sup>42</sup> Having more GSEs may also increase competition, and in turn benefit those who purchase mortgages.<sup>43</sup>

The third proposed policy is to limit executive compensation.<sup>44</sup> Tying executive bonuses to corporate performance was part of the cause for the inaccurate earnings reports mentioned earlier.<sup>45</sup> Eliminating a powerful incentive to manipulate earnings reports should increase GSE transparency and stability.

The fourth proposed policy is to transform GSEs into cooperatives owned by lenders. The idea is that “by having lenders assume some of the risks associated with the enterprises’ activities, mortgage underwriting standards could be enhanced.”<sup>46</sup> However, the recent loss of confidence in Fannie and Freddie could make it difficult to find banks willing to invest in a cooperative.<sup>47</sup>

The fifth proposed policy is to regulate GSEs like public utilities.<sup>48</sup> Utilities are regulated differently from other entities because their position in the economy is unique: a few corporations dominate an important market sector.<sup>49</sup> GSEs have similar characteristics and thus could be regulated in a similar manner.<sup>50</sup> In addition to other regulation, former Secretary Paulson supports this method in combination with eliminating mortgage portfolios.<sup>51</sup>

Congressman Adam H. Putnam supports increasing GSE regulation.<sup>52</sup> He and Congressman Ed Markey co-sponsored the Fannie Mae and Freddie Mac Full Disclosure Act, which would

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<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 33.

<sup>47</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES' LONG-TERM STRUCTURES (2009) at 33.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 33-34.

<sup>51</sup> *Id.* at 34.

<sup>52</sup> *The Fannie Mae and Freddie Mac Full Disclosure Act: Handout, supra* note 5, at 1.

eliminate the GSE exemptions from the Acts of 1933 and 1934.<sup>53</sup> The need for the Act was explained in a press release made on March 10, 2009; ““There are many factors that were involved in our current economic meltdown, . . . and one of them was a failure to require enough transparency and accountability from Fannie and Freddie. This legislation pulls the blinds up on the windows and lets some much needed regulatory sunshine into the rooms.”<sup>54</sup>

While such increased regulation would certainly increase the transparency and reduce the risks of GSEs, some argue that this does not go far enough.<sup>55</sup> Supporters of this notion view a business model that demands profits while passing risk to the government as inherently unstable.<sup>56</sup> This leads back to the two remaining restructuring options given by the GAO.

## 2. Nationalization

Another proposal made by the GAO is to convert GSEs into a government controlled agency.<sup>57</sup> This would remove the profit-seeking characteristic of GSEs which, in turn, eliminates a motive for risky lending and profit misrepresentation.<sup>58</sup> This option would also abolish the exemptions under the Acts of 1933 and 1934 and lead to more transparency.<sup>59</sup>

The GAO put forward three options for structuring a government agency. The first two options call for the agency to phase out retained mortgage portfolios and instead concentrate on MBS.<sup>60</sup> One version focuses on responsible lending and increased coordination with lenders.<sup>61</sup> The second would more accurately base premiums on risk and pass off low-income borrowers to the Federal

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<sup>53</sup> *Id.*

<sup>54</sup> Press Release, Rep. Adam H. Putnam, Putnam, Markey Offer Tougher Rules for Federal Mortgage Corporations (March 10, 2009).

<sup>55</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 29.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 29-30.

<sup>61</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC: ANALYSIS OF OPTIONS FOR REVISING THE HOUSING ENTERPRISES' LONG-TERM STRUCTURES (2009) at 29-30.

Housing Administration.<sup>62</sup> The third would have the agency supply down payments “directly to targeted borrowers.”<sup>63</sup>

Robert Kuttner, co-founder and co-editor of *The American Prospect*, argues that Fannie and Freddie could be better run by the government than the free market.<sup>64</sup> Kuttner states that before the GSEs attained their current hybrid structure, the government filled the role of buying banks’ approved mortgages and that this system “worked beautifully until it was privatized.”<sup>65</sup> Kuttner notes that when Fannie and Freddie were run by the government, they operated for the public’s interest, however when Fannie and Freddie were privatized they operated for the insiders’ interest.<sup>66</sup> A government-run system could ensure high homeownership rates, reestablish reasonable loan standards, and keep mortgage lenders from bankruptcy.<sup>67</sup>

The GAO stated that government control of GSEs creates a presumed inability to attract and keep human resources, increased bureaucracy and a lack of market responsiveness that often plagues government agencies.<sup>68</sup> To overcome these problems, while still solving the hybrid problem, GSEs could be fully privatized.<sup>69</sup>

### 3. Privatization

Privatized GSEs would likely have several advantages over governmental agencies including efficiency, incentive to meet market demands and more competitive salaries.<sup>70</sup> Also, these private companies would be without government guarantees and would therefore be less prone to excessive risk-taking.<sup>71</sup> As with the governmental agency option and with the Full Disclosure Act,

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<sup>62</sup> *Id.* at 30.

<sup>63</sup> *Id.* at 30-31.

<sup>64</sup> Robert Kuttner, *Little Orphan Fannie*, THE HUFFINGTON POST, Sept. 8, 2008, [http://www.huffingtonpost.com/robert-kuttner/little-orphan-fannie\\_b\\_124841.html](http://www.huffingtonpost.com/robert-kuttner/little-orphan-fannie_b_124841.html).

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> U.S. GOV’T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 30.

<sup>69</sup> *Id.* at 34.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

privatization would eliminate the Acts of 1933 and 1934 exemptions.<sup>72</sup>

Privatization could be implemented in a variety of ways.<sup>73</sup> First, GSEs could be terminated, leaving existing private-sector institutions to fill the void.<sup>74</sup> This would constitute privatization through termination.<sup>75</sup> Second, GSEs could be transformed into fully private corporations without government backing.<sup>76</sup> Under this option it would be vital for investors to understand that these companies have no federal debt guarantee.<sup>77</sup> Federal Reserve Chairman Ben Bernanke has mentioned that this could be done by splintering the GSEs into several new, smaller companies.<sup>78</sup> Either form would require a federal insurer to keep the market fluid during economic downturns.<sup>79</sup>

Another option, discussed by Bernanke and Paulson, is the use of covered bonds, which “are debt obligations issued by financial institutions and secured by a pool of high-quality mortgages or other assets.”<sup>80</sup> Covered bonds fund most mortgages for European banks, but these bonds must become less expensive to compete in the United States.<sup>81</sup> If this obstacle is overcome, covered bonds offer a less risky approach to securitization and mortgage portfolios.<sup>82</sup> Covered bonds are reported on balance sheets and thereby incentivize responsible lending.<sup>83</sup> Additionally, the loans that make up the bond are closely watched, and are replaced if their stability waivers.<sup>84</sup>

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<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 35-36.

<sup>74</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 35.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 35-36.

<sup>77</sup> *Id.* at 35.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 35-36.

<sup>80</sup> *Id.* at 36.

<sup>81</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 36.

<sup>82</sup> Heidi Crebo-Rediker and Douglas Rediker, *Covered Bonds Can Rebuild America*, FORBES.COM, July 28, 2008, [http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx\\_hcr\\_dr\\_0728bonds.html](http://www.forbes.com/2008/07/28/covered-bonds-infrastructure-oped-cx_hcr_dr_0728bonds.html).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

The late Bill Seidman, former FDIC chairman, advocated breaking the GSEs into smaller units and then selling them to private companies.<sup>85</sup> This would combine the advantages of smaller companies, as described in the regulation section, and those of privatization. Seidman argued that securitization markets have reduced the need for GSEs.<sup>86</sup> This plan would result in higher interest rates on mortgages, but the government could directly subsidize homeowners if it chose, as mentioned under the governmental agency section.<sup>87</sup>

### E. Conclusion

GSEs are massive financial organizations that control trillions of dollars worth of home mortgage debt.<sup>88</sup> Parts of these companies operate in the dark which has resulted in abuse.<sup>89</sup> GSEs are advantaged by a perceived federal guarantee and allowed to grow, at the taxpayers' expense, to the point that their failure would result in systemic damage.<sup>90</sup> The recent financial crisis and the conservatorship of Fannie Mae and Freddie Mac have shown us that the traditional GSE business model and regulations need to be rethought.<sup>91</sup> Congress must consider whether to keep the GSE structure intact and increase regulation, replace the current system with a government agency or transition to full privatization.<sup>92</sup>

Daniel Butler<sup>93</sup>

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<sup>85</sup> John Spence, *Former FDIC Chief Urges Breakup of Fannie, Freddie*, MARKET WATCH, Aug. 21, 2008, available at <http://www.marketwatch.com/story/former-fdic-chairman-seidman-advocates-gse-bailout-privatization>.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Press Release, Rep. Markey, *supra* note 2, at 1.

<sup>89</sup> *Id.*; JOINT REPORT ON THE GOVERNMENT SECURITIES MARKET, *supra* note 18 at 33-34.

<sup>90</sup> CONGRESSIONAL RESEARCH SERVICE. RS21663, *supra* note 1 at 2, 5-6.

<sup>91</sup> Paulson, *supra* note 14, at 4.

<sup>92</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, FANNIE MAE AND FREDDIE MAC, at 29-36.

<sup>93</sup> Student, Boston University School of Law (J.D. 2011).

## V. *Structured Investment Vehicles*

### A. Introduction

In 1988, Citigroup created the first structured investment vehicle (SIV).<sup>1</sup> The basic concept was to issue short-term debt and use the proceeds to invest in higher-yielding long-term assets.<sup>2</sup> Specifically, SIVs issue short-term debt in the form of commercial paper.<sup>3</sup> Commercial paper are securities issued by large banks and corporations to raise money for short periods of time.<sup>4</sup> SIVs use the proceeds from commercial paper sales to finance long-term investments, such as mortgage-backed bonds, bank debt and other structured credit.<sup>5</sup> Therefore, SIVs contain an inherent maturity mismatch because short-term loans are being used to finance long-term investments.<sup>6</sup> This maturity mismatch necessarily introduces an element of risk although that risk is largely concealed as long as the SIV contains top-rated assets and the commercial paper market is stable, which was true from 1988 until 2007.<sup>7</sup>

In addition to the inherent maturity mismatch, SIVs have several other attributes that make them particularly risky. SIVs are characteristically opaque because investors are denied access to information about what assets are actually held by the SIV.<sup>8</sup> Investors are forced to rely on credit rating agencies (CRAs) to

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<sup>1</sup> Grace Wong, *Super SIV 101*, CNNMONEY.COM, <http://money.cnn.com/galleries/2007/news/0710/gallery.superfund>.

<sup>2</sup> *Id.*

<sup>3</sup> Grace Wong, *Why the credit crunch may deepen*, CNNMONEY.COM, Sept. 13, 2007, [http://money.cnn.com/2007/09/13/markets/credit\\_crunch/index.htm](http://money.cnn.com/2007/09/13/markets/credit_crunch/index.htm).

<sup>4</sup> *Commercial paper said to get sweeter*, CNNMONEY.COM, Sept. 10, 2007, [http://money.cnn.com/2007/09/10/markets/banks\\_paper/index.htm](http://money.cnn.com/2007/09/10/markets/banks_paper/index.htm).

<sup>5</sup> Anousha Sakoui, *Extent of Sigma fall-out becomes clear*, FT.COM, June 17, 2008, <http://www.ft.com/cms/s/0/5c727dbe-bcbd-11dd-af5a-0000779fd18c.html>.

<sup>6</sup> Gillian Tett & Anousha Sakoui, *New hope for restructuring SIVs*, FT.COM, June 17, 2008, <http://www.ft.com/cms/s/0/b01b7bd0-3c95-11dd-b958-0000779fd2ac.html>.

<sup>7</sup> *Id.*

<sup>8</sup> See Michael Hiltzik, *CalPERS appears to be a willing victim*, LATIMES.COM, July 27, 2009, <http://www.latimes.com/business/la-fi-hiltzik27-2009jul27,0,2776614.column>.



assess the risk of any particular SIV.<sup>9</sup> CRAs use complex risk models to assess the risk posed by SIVs; we now know that many of the assumptions made by the models were flawed.<sup>10</sup> The bigger problem with CRAs, however, was that the SIV promoters, and not the investors, paid the CRAs for their ratings.<sup>11</sup> For example, in 2005, Moody's was paid \$715 million, or 41% of its revenue, by SIV promoters for rating their SIVs.<sup>12</sup> As a result, CRAs were incentivized to provide higher-than-accurate ratings to appease SIV promoters, and if a CRA provided low ratings, the SIV promoter would take their business to another CRA that was willing to provide a high rating.<sup>13</sup>

Generally, SIVs were created by banks, however some SIVs were created by hedge funds and investment firms.<sup>14</sup> Non-bank SIVs were considerably more risky because non-bank SIVs were more likely than bank SIVs to lack a back-up source of funding, which could be important in the event that the commercial paper market dried up.<sup>15</sup> SIVs that were established by banks were risky in their own ways. Most banks created SIVs as off-the-book entities, which kept them lightly regulated.<sup>16</sup> Regulators were unable to easily gauge the risk of any particular SIV.<sup>17</sup>

SIVs were lucrative despite these risks. SIV promoters had no problem creating demand for the complex securities packages because the returns were higher than traditional investments and their ratings were just as high.<sup>18</sup> Banks, investment funds and hedge funds quickly followed Citigroup's lead and created their own SIVs

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<sup>9</sup> *See Id.*

<sup>10</sup> Lloyd Blankfein, Chairman and Chief Executive Officer, Goldman Sachs, Speech to the Council of Institutional Investors (Apr. 7, 2009), <http://www.marketwatch.com/story/text-goldman-sachs-ceo-lloyd>.

<sup>11</sup> Hiltzik, *supra* note 8.

<sup>12</sup> *Id.*

<sup>13</sup> *See Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *See Id.*

<sup>16</sup> Paul Eavis, *Even 'safe' funds play with fire*, CNNMONEY.COM, Oct. 19, 2007, [http://money.cnn.com/2007/10/19/magazines/fortune/eavis\\_boa.fortune/](http://money.cnn.com/2007/10/19/magazines/fortune/eavis_boa.fortune/).

<sup>17</sup> *See Id.*

<sup>18</sup> *See* Bethany McLean, *It's Enron all over again*, CNNMONEY.COM, Nov. 14, 2007, [http://money.cnn.com/2007/11/13/news/companies/bulldog\\_enron.fortune/index.htm](http://money.cnn.com/2007/11/13/news/companies/bulldog_enron.fortune/index.htm).

supported by commercial paper sales.<sup>19</sup> By 2007, SIVs had grown into a \$400 billion industry.<sup>20</sup> At its peak, the amount of outstanding commercial paper exceeded \$1 trillion with the majority of it maturing within one to four days.<sup>21</sup>

In retrospect, it is clear that the overall exposure of consumers, banks and other financial firms to SIVs was extensive because of the interconnectedness of the market.<sup>22</sup> Banks and financial firms that were not setting up SIVs were often buying securities issued by the SIVs.<sup>23</sup> Even money market funds, traditionally thought of as very conservative investments, had exposure to SIVs because money market sponsors invested in SIVs to increase returns.<sup>24</sup> One large Bank of America money market fund had over \$600 million of exposure to Cheyne Finance, an SIV managed by a London-based hedge fund.<sup>25</sup>

### B. The Market Crash and its Effect on SIVs

Although for many years SIVs were highly successful, as soon as market conditions began to change, the inherent problems of the SIV structure—the maturity mismatch, the dependence on a stable commercial paper market and faulty risk assessment—finally caught up to them. In the spring of 2007, rising defaults on home loans made to borrowers with weak credit raised concerns about mortgage-backed investments.<sup>26</sup> Panic spread through the market and investors stopped buying mortgage-backed securities, including the commercial paper issued by SIVs.<sup>27</sup> Instead, investors chose safer investments like Treasuries.<sup>28</sup> Without money from commercial paper

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<sup>19</sup> Wong, *supra* note 1.

<sup>20</sup> Anousha Sakoui & Paul J. Davies, *Ernst & Young on standby for Sigma*, FT.COM, Oct. 2, 2008, <http://www.ft.com/cms/s/0/9bab1388-90bc-11dd-8abb-0000779fd18c.html>.

<sup>21</sup> Glenn Hutchins, *After the Panic of '08*, CNNMONEY.COM, Mar. 16, 2009, <http://money.cnn.com/2009/03/16/news/economy/panic08.fortune.htm>

<sup>22</sup> See Eavis, *supra* note 16.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Wong, *supra* note 1.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

sales, SIVs lacked the funds needed to finance their long-term asset investments and SIV promoters began to panic.<sup>29</sup>

Concern about a widespread SIV meltdown grew and on October 15, 2007, Citigroup, J.P. Morgan Chase and Co. and Bank of America announced a plan to create a “superfund” called the Master Liquidity Enhancement Conduit, which would issue short-term notes and use the proceeds to buy mortgage-based assets from SIVs.<sup>30</sup> The goal of the plan was to make the sale of assets more orderly and to prevent another wave of panic.<sup>31</sup> Investors, however, were skeptical of the “superfund,” which was essentially just another SIV, and Wall Street banks ultimately refused to cooperate.<sup>32</sup> Some SIVs were able to tap bank credit lines<sup>33</sup> and others were able to replace short-term debt with repurchase agreements with banks.<sup>34</sup> However, despite restructuring efforts, over the next year, one by one every SIV ultimately collapsed.<sup>35</sup> Sigma Finance, one of the oldest and largest SIVs, was the last to fail.<sup>36</sup> Sigma Finance ceased trading on October 1, 2008.<sup>37</sup>

### C. SIV-Related Litigation

Less than a year after the collapse of the last SIV, the first SIV-related lawsuit was filed.<sup>38</sup> In July 2009, the California Public Employees Retirement System (CalPERS) filed suit in connection with investment losses they believe were caused by “wildly inaccurate” ratings of SIVs by credit ratings agencies.<sup>39</sup> CalPERS, a pension fund that provides retirement benefits to 1.6 million public

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<sup>29</sup> *Id.*

<sup>30</sup> Grace Wong, *Wall Street superfund: Not so super*, CNNMONEY.COM, Oct. 22, 2007, [http://money.cnn.com/2007/10/22/markets/super\\_fund/index.htm](http://money.cnn.com/2007/10/22/markets/super_fund/index.htm).

<sup>31</sup> Wong, *supra* note 1.

<sup>32</sup> Wong, *Wall Street superfund: Not so super*, *supra* note 30.

<sup>33</sup> Wong, *supra* note 1.

<sup>34</sup> Paul J Davies & Anousha Sakoui, *Sigma collapse marks end of SIV era*, FT.COM, Oct. 1, 2008, <http://www.ft.com/cms/s/0/18fbc5c-8fe4-11dd-9890-0000779fd18c.html>.

<sup>35</sup> *See Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *See* Leslie Wayne, *Calpers Sues Over Ratings of Securities*, NYTIMES.COM, July 14, 2009, <http://www.nytimes.com/2009/07/15/business/15calpers.html>.

<sup>39</sup> *Id.*

employees in California, bought \$1.3 billion of SIVs in 2006.<sup>40</sup> After the market crashed in 2007, the SIVs were liquidated at a fraction of their original value and CalPERS lost over \$1 billion.<sup>41</sup>

CalPERS claims that in giving the SIVs the agencies' highest credit rating, the three top rating agencies—Moody's Investors Service, Standard & Poor's and Fitch—"made negligent misrepresentation" to the pension fund.<sup>42</sup> The suit even went as far as to claim that rating agencies were actively involved in creating the SIVs, saying that that the rating agencies would help the arrangers in structuring the SIVs so that they could rate them as high as possible.<sup>43</sup> Specifically at issue is a structured investment vehicle called Cheyne Finance, which was rated as "investment grade" shortly before its 2007 collapse.<sup>44</sup> Cheyne Finance was set up by a hedge fund and a few investment firms.<sup>45</sup> As a non-bank SIV, Cheyne Finance had no back-up source of liquidity.<sup>46</sup>

The rating agencies, in response to the charges, argue that their ratings are mere opinions and are protected by the First Amendment.<sup>47</sup> On September 4, 2009, Shira Scheindlin, the Southern District of New York judge presiding over the case, ruled that First Amendment protections should not extend to ratings made to a limited group of investors.<sup>48</sup> The decision is likely to lead to more lawsuits against credit rating agencies by unhappy investors.<sup>49</sup>

The case raises important questions about who should bear the responsibility for investment losses due to failed SIVs. SIV promoters denied investors information about what assets were contained within the SIVs but investors chose to put money in SIVs

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<sup>40</sup> *Id.*

<sup>41</sup> Hiltzik, *supra* note 8.

<sup>42</sup> Wayne, *supra* note 38.

<sup>43</sup> Colin Barr, *Business as usual for Moody's and S&P*, CNNMONEY.COM, Oct. 9, 2009, <http://money.cnn.com/2009/10/09/news/economy/ratings.reform.fortune.htm>.

<sup>44</sup> *Report: Court Ruling Limits Credit Rating Firms' First Amendment Protection*, FOXBUSINESS.COM, Sept. 4, 2009, <http://www.foxbusiness.com/story/markets/industries/finance/report-court-ruling-limits-credit-rating-firms-amendment-protection/>.

<sup>45</sup> Hiltzik, *supra* note 8.

<sup>46</sup> *See Id.*

<sup>47</sup> Barr, *supra* note 43.

<sup>48</sup> *Report: Court Ruling Limits Credit Rating Firms' First Amendment Protection*, *supra* note 44.

<sup>49</sup> *See Id.*

knowing that the defining characteristic of these vehicles was their lack of transparency, that they could never know exactly what assets were inside.<sup>50</sup> Investors like CalPERS always had the choice between SIVs and more transparent investment vehicles but chose SIVs because they offered higher returns, along with higher risk.

Likewise, credit rating agencies may have provided inaccurate ratings that made SIVs appear to have higher quality assets than they actually did, but the investors, again, knew that the ratings agencies were funded by the SIV promoters and thus had reason to be skeptical the ratings.<sup>51</sup> In fact, according to some financial analysts, rating agencies have a history of poor performance and faulty ratings.<sup>52</sup> Those analysts claim that the same rating agencies that failed SIV investors and contributed to the crash in 2007 were the ones that failed to flag the problems at Enron and WorldCom in the downturn at the start of the decade.<sup>53</sup> There were financial institutions that for these very reasons chose not to get involved with SIVs and other risky SIV-like structures.<sup>54</sup> Banks like Wells Fargo took smaller returns in exchange for safer investments and are now stronger because of it.<sup>55</sup>

#### D. Proposals for Reform

SIVs were part of a larger project by financiers to create a credit industry outside the world of traditional banking, a so-called shadow banking system.<sup>56</sup> Many saw the collapse of Sigma as marking an end to that project and as a lesson that investment structures like SIVs should be avoided in the future.<sup>57</sup> Others believe that the shadow banking system is necessary, despite the risks, because without the shadow banking system, banks would get too

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<sup>50</sup> See Hiltzik, *supra* note 8.

<sup>51</sup> *See Id.*

<sup>52</sup> See Barr, *supra* note 43.

<sup>53</sup> *Id.*

<sup>54</sup> See Adam Lashinsky, *Riders on the storm*, CNNMONEY.COM, Apr. 20, 2009, [http://money.cnn.com/2009/04/19/news/companies/lashinsky\\_wells\\_fortune/index.htm](http://money.cnn.com/2009/04/19/news/companies/lashinsky_wells_fortune/index.htm).

<sup>55</sup> *Id.*

<sup>56</sup> Paul J Davies et al., *Sigma collapse ends shadow bank project*, FT.COM, Oct. 1, 2008, <http://www.ft.com/cms/s/0/19db6e24-8fff-11dd-9890-0000779fd18c.html>.

<sup>57</sup> *See Id.*

big.<sup>58</sup> The best solution may be not to try to eliminate the shadow banking system all together but to try to make the shadow system smaller, better regulated and less opaque.<sup>59</sup>

Given the role of CRAs in the collapse of SIVs, one of the major goals of future reform is to improve CRA practices. Rating agencies claim that they have made positive changes to their agencies in response to the current economic crisis.<sup>60</sup> Standard & Poor's claims it has adopted new rules for preventing conflicts of interests and Moody's claims to have made efforts to improve transparency.<sup>61</sup> Despite these claims, many are skeptical that for-profit rating agencies can provide unbiased assessments of credit-worthiness.<sup>62</sup>

In the summer of 2009, the Obama administration called for new rules that would strengthen the SEC's oversight of rating agencies.<sup>63</sup> Such reform efforts are aimed at preventing risky SIV-like structures from receiving high credit ratings in the future. However, many plans under discussion as of late 2009 do little to address two of CRAs' major structural problems.<sup>64</sup> The first is the inherent conflict of interest that exists because credit agencies are paid by promoters rather than investors.<sup>65</sup> The second is that ratings by these agencies are widely used for investing decisions and capital requirements but are never subjected to meaningful scrutiny.<sup>66</sup> Congress passed the Credit Rating Agency Reform Act in 2006. Though the Act gave the SEC some power to regulate CRAs, it specifically prohibited the SEC from regulating the CRAs' rating methodologies and analytical methods.<sup>67</sup>

Another way regulators are trying to prevent the return of SIV-like vehicles is through new accounting rules for off-the-book

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<sup>58</sup> Theo Francis, *Smaller "Shadow" System Means Bigger Banks*, BUSINESSWEEK.COM, Sept. 16, 2009, [http://www.businessweek.com/blogs/money\\_politics/archives/2009/09/smaller\\_shadow.html](http://www.businessweek.com/blogs/money_politics/archives/2009/09/smaller_shadow.html).

<sup>59</sup> *Id.*

<sup>60</sup> Barr, *supra* note 43.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> Barr, *supra* note 43.

<sup>67</sup> Ian Katz & Davis Scheer, *SEC Faulted for Lax Oversight of Credit-Rating Firms*, WASHINGTONPOST.COM, Aug. 29, 2009, <http://www.washingtonpost.com/wpdyn/content/article/2009/08/28/AR2009082803700.html>.

vehicles.<sup>68</sup> The Financial Accounting Standards Board (FASB) first tried to tighten the rules for off-balance-sheet vehicles following the Enron accounting scandal in 2001, but banks and others found ways to get around the rules.<sup>69</sup> The new rules, proposed by FASB in 2008, would make it more difficult and expensive for banks and other firms to use off-balance-sheet vehicles to sell-off or securitize assets.<sup>70</sup> If adopted, the rule changes could have a significant impact.<sup>71</sup> When federal regulators stress-tested the country's nineteen largest financial institutions in the spring of 2009, they concluded that the new accounting rules could shift \$900 billion in assets onto bank balance sheets.<sup>72</sup> The nation's biggest banks and real estate interests are leading lobbying efforts against the implementation of the new rules.<sup>73</sup> In October 2009, the American Bankers Association announced that banks would be forced to reduce lending if they are not allowed to keep off-balance sheet entities.<sup>74</sup>

### E. Conclusion

Although there may be no easy solutions to the problems presented by SIV-like investment vehicles, there are many proposals for how to change current CRA practices and how to improve regulation of off-balance-sheet entities like SIVs.<sup>75</sup> The right solution may just take time and, more importantly, compromise between investors, financial firms and CRAs.

Sarah Foster<sup>76</sup>

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<sup>68</sup> Matthew Cowley & David Reilly, *FASB Delays New Rules On Off-the-Book Vehicles*, WSJ.COM, July 31, 2008, <http://online.wsj.com/article/SB121745512133798467.html>.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> See John Carney, *Banks Threaten to Stop Lending If They're Not Allowed to Keep Off-Balance Sheet Entities*, BUSINESSINSIDER.COM, Oct. 13, 2009, <http://www.businessinsider.com/banks-fight-on-capitol-hill-to-keep-toxic-assets-off-balance-sheet-2009-10>.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See Barr, *supra* note 43.

<sup>76</sup> Student, Boston University School of Law (J.D. 2011).

**VI. *TALF and Revenue Procedure 2009-45: New Hope for the Commercial Mortgage-Backed Securities Market?***

**A. Introduction**

Commercial Mortgage-Backed Securities (CMBS) had become the most common source of Commercial Real Estate (CRE) lending in the last two decades. To create CMBS, lenders place pools of various single commercial and multifamily loans of different sizes and property types into a single trust.<sup>1</sup> The trust issues a series of bonds of varying yield, duration and payment priority.<sup>2</sup> Nationally recognized rating agencies (Moody's Investors Services, Standard & Poor's, Fitch Ratings, DBRS, Inc. and Realpoint LLC) assess the varying risk and yield profiles of the different securities (or tranches).<sup>3</sup> They then assign a credit rating to each, ranging from AAA-rated securities with a high priority of repayment (and thus lower risk and lower yield) to B-rated and unrated securities with a lower priority of repayment (and thus higher risk and higher yield).<sup>4</sup> Securities investors purchase the CMBS based on their desired credit rating, yield and duration.<sup>5</sup>

The CMBS gained prominence in the years following the savings and loan crisis of the late 1980s and early 1990s.<sup>6</sup> The severe drop in commercial property values created big losses for thrift institutions, which then were one of the main sources of CRE lending.<sup>7</sup> In 1989, the Congress created the Resolution Trust Corporation (RTC) to bail-out the distressed thrift industry.<sup>8</sup> The job of the RTC was to acquire and quickly liquidate insolvent thrifts'

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<sup>1</sup> Commercial Mortgage Securities Association, *The Role of Commercial Mortgage Backed Securities (CMBS) and Commercial Real Estate Collateralized Debt Obligations (CRE CDOs) in the U.S. Real Estate Finance Market* 1, [http://www.cmsaglobal.org/uploadedFiles/CMSA\\_Site\\_Home/Industry\\_Resources/Research/Industry\\_Overview/CMBS%20Summary\(1\).pdf](http://www.cmsaglobal.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Research/Industry_Overview/CMBS%20Summary(1).pdf) (last visited Nov. 12, 2009).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> Joseph F. DeMichele & William J. Adams, *THE HANDBOOK OF COMMERCIAL MORTGAGE-BACKED SECURITIES* 73, 74 (Frank J. Fabozzi & David P. Jacob eds., 2d ed. 1999).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*



assets, the majority of which consisted of commercial mortgage loans.<sup>9</sup> To finance these activities, the RTC began to employ CMBS, highly diversified pools of loans, which attracted many investors.<sup>10</sup> When the RTC finished liquidating insolvent thrift institutions in 1993, other issuers (insurance companies, pension funds and commercial banks) stepped in to continue the growth of the profitable CMBS market.<sup>11</sup>

In the years that followed, CMBS became a part of balanced investment portfolios, along with other asset-backed securities, such as municipal and corporate debt.<sup>12</sup> The CMBS market grew from \$41.6 billion in 1990, representing 3.8% of commercial and multifamily mortgage debt outstanding, to \$907 billion as of the third quarter 2007, representing 28% of mortgages outstanding.<sup>13</sup>

### **B. Collapse of the CMBS Market**

CMBS lending had so weaved itself into the fabric of the debt market that, unsurprisingly, the latter's collapse in 2007 and subsequent CRE troubles led to the downturn in the CMBS market. As noted in the 2009 report of the Real Estate Roundtable, real estate transactions decreased by sixty-eight percent in 2008, and CMBS issuance fell from \$230 billion in 2007 to \$12 billion in 2008.<sup>14</sup>

Among the many reasons cited for the CMBS downturn, one is that potential CMBS purchasers are wary to buy CMBS even for a fraction of their value, and when they do, they demand that a higher level of risk be priced into all CMBS tranches.<sup>15</sup> This distrust of the market stems from the overall drop in commercial property values.<sup>16</sup> Many borrowers are unable to refinance their mortgages, which results in losses not only to property owners, but also to CMBS

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> Commercial Mortgage Securities Association, *supra* note 1, at 2.

<sup>13</sup> *Id.*

<sup>14</sup> Bill Streeter, *Execs of Major CRE Firms Paint Mixed Picture*, A.B.A. BANKING J., Mar. 2009, at 5.

<sup>15</sup> Jennifer Popovec, *The Big Comedown*, RETAIL TRAFFIC (Sept. 1, 2007), [http://retailtrafficmag.com/finance/lending/retail\\_treasuries\\_cmbs\\_loans/](http://retailtrafficmag.com/finance/lending/retail_treasuries_cmbs_loans/).

<sup>16</sup> See generally Lingling Wei & Peter Grant, *Commercial Real Estate Lurks as Next Potential Mortgage Crisis*, WALL ST. J. AUG. 31, 2009, at A2.

purchasers.<sup>17</sup> According to Deutsche Bank, some \$153 billion in CMBS loans are due in 2012, and about \$100 billion of that will be difficult to refinance.<sup>18</sup> This is discouraging news because refinancing helps avoid defaults, and lack thereof leads to monetary losses.

Another reason cited for the downturn in the CMBS market is the bad underwriting practices on the part of CMBS lenders. In the past, CMBS lenders would originate loans without considering the risks or disregarding those risks.<sup>19</sup> Loose credit lending relied on the assumption that occupancy and rents of commercial properties would continue to rise.<sup>20</sup> When those rents and values plummeted after the real estate market crash, it led to a growing number of properties that were unable to generate enough cash to make principal and interest payments.<sup>21</sup> This led to an overall lull in the CMBS market and resulted in further losses.

### C. Government Rescue Programs

The federal government has stepped-in to help ease the mortgage crisis by taking two important steps. First, the Federal Reserve implemented the Troubled Asset Relief Program (TARP) in November 2008. The prominent initiative under the program is the Term Asset-Backed Securities Loan Facility (TALF), which was expanded in May 2009 to provide non-recourse funding to any eligible CMBS borrower with eligible collateral.<sup>22</sup> Second, the Internal Revenue Service (IRS) adopted the Revenue Procedure 2009-45 tax rule in September 2009 that allows commercial real estate borrowers to modify their securitized loans that are on the brink of default without triggering tax penalties.<sup>23</sup>

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<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> Popovec, *supra* note 15.

<sup>20</sup> Wei & Grant, *supra* note 16.

<sup>21</sup> *Id.*

<sup>22</sup> Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (Oct. 30, 2009), [http://www.newyorkfed.org/markets/talf\\_faq.html#1](http://www.newyorkfed.org/markets/talf_faq.html#1).

<sup>23</sup> Xenia Jowyk & Scott Sherwood, *Real Estate Roundtable Welcomes IRS Action Allowing CMBS Loan Modifications 1* (Sept. 15, 2009), [http://www.rer.org/atf/cf/%7B42ee8980-837f-4af0-a738-d43f0925666b%7D/2009\\_09\\_15\\_REMIC\\_RULES.PDF](http://www.rer.org/atf/cf/%7B42ee8980-837f-4af0-a738-d43f0925666b%7D/2009_09_15_REMIC_RULES.PDF).

### 1. Term Asset-Backed Securities Loan Facility (TALF) Program

Originally, TALF began as a program to restart securitizations in small business loans, as well as in auto, credit card and student borrowing.<sup>24</sup> In May 2009, it was expanded to include CMBS issued or modified on or after January 1, 2009. It was further extended to Legacy CMBS to reinvigorate credit markets, encourage trading in assets backed by CMBS and set CMBS pricing levels.<sup>25</sup> That, in turn, should help borrowers refinance existing mortgages on better terms to avoid defaults, as well as finance new purchases of commercial real estate.<sup>26</sup> Despite these good intentions, TALF has been criticized for its numerous shortcomings.

First, a number of TALF eligibility requirements are problematic. For example, eligible CMBS must be rated in the highest long-term investment grade category by at least two eligible rating agencies.<sup>27</sup> Securities that have been placed on review or watch for downgrade are not eligible.<sup>28</sup> Yet, Standard & Poor's notes that a large number of CMBS will be downgraded under its new rating procedure.<sup>29</sup> Accordingly, many CMBS will not be able to take advantage of TALF financing.

Second, the Federal Reserve Bank of New York (FRBNY) has broad discretion to disqualify any CMBS as TALF financing collateral based on its subjective risk assessment.<sup>30</sup> As TALF is likely to undergo numerous revisions and adjustments, and since these adjustments are subject to arbitrary FRBNY action, the process by

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<sup>24</sup> John Dedyo et al., *Fed Expands TALF to Include Legacy CMBS*, THE METROPOLITAN CORP. COUNS. 18, 18 (July 2009), available at <http://www.metrocorp.counsel.com/pdf/2009/July/18.pdf>.

<sup>25</sup> *Id.*

<sup>26</sup> *Commercial Real Estate: Hearing Before the J. Econ. Comm.*, 111th Cong. 4 (2009) (statement of Jon D. Greenlee, Assoc. Dir. of Div. of Banking Supervision and Regulation).

<sup>27</sup> MetWest, *TALF: Introduction of Commercial Mortgage-Backed Securities (CMBS)* 1 (June 16, 2009), available at [http://www.mwamllc.com/documents/MetWest\\_TALF\\_Introduction\\_of\\_CMBS\\_6-09\\_000.pdf](http://www.mwamllc.com/documents/MetWest_TALF_Introduction_of_CMBS_6-09_000.pdf).

<sup>28</sup> *Id.*

<sup>29</sup> Peter K. McKee, Jr. et al., *Ups and Downs for Legacy CMBS: TALF Expands, but S&P Signals Downgrades* (May 29, 2009), [http://www.andrewskurth.com/assets/attachments/9225\\_TALF\\_Print\\_E-Alert-FINAL.pdf](http://www.andrewskurth.com/assets/attachments/9225_TALF_Print_E-Alert-FINAL.pdf).

<sup>30</sup> Dedyo et al., *supra* note 24.

which the FRBNY may reject CMBS from TALF participation leaves much to uncertainty.<sup>31</sup> As a result, many issuers and investors may be wary of “unforeseen complications” and spontaneous changes in the program and thus unwilling to participate in TALF.<sup>32</sup> This, in turn, would lead to underutilization of the program and the failure to achieve its full benefits.<sup>33</sup>

Third, investors may be further discouraged from participation in TALF because of its restrictions on the sale of CMBS and high loan interest rate.<sup>34</sup> If strong financial players can obtain lower loan interests from other lenders and are “locked in” to their CMBS for a number of years, TALF ceases to be attractive.<sup>35</sup>

Fourth, the FRBNY requires CMBS loan pool diversification with respect to each pool’s loan sizes, geographic location, property types, and borrower sponsorship.<sup>36</sup> This requirement may render many Legacy CMBS ineligible, because they are mostly subject to single sponsorship and are often similar in other respects, such as their geographic location.<sup>37</sup> Thus, whereas new-issuance CMBS may accommodate the diversification requirement, Legacy CMBS may not be able to take advantage of TALF.

Lastly, while the Federal Reserve expects TALF to benefit the taxpayers, many disagree.<sup>38</sup> With government financing most of the CMBS cost, there is a disproportionate risk-benefit ratio favoring the investors at the taxpayers’ expense.<sup>39</sup> If CMBS increase in value, the investors reap the full benefit, and if CMBS value plummets, the investors could default on their TALF loans, leaving the taxpayers to

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<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> Congressional Oversight Panel, *May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF* 1 (May 7, 2009), <http://cop.senate.gov/documents/cop-050709-report-execsummary.pdf>.

<sup>35</sup> *Id.*

<sup>36</sup> Akin Gump Strauss Hauer & Feld LLP, *Client Alert: Federal Reserve Extends Maturity of Certain TALF Loans* 3 (May 4, 2009), <http://www.akingump.com> (follow “Publications” hyperlink; search “TALF”).

<sup>37</sup> Erica Berg et al., *PaulHastings Stay Current: Legacy CMBS TALF: Something New for Something Old* 3 (May 2009), [http://www.paulhastings.com/assets/publications/1320.pdf?wt.mc\\_ID=1320.pdf](http://www.paulhastings.com/assets/publications/1320.pdf?wt.mc_ID=1320.pdf).

<sup>38</sup> William C. Dudley, President and Chief Exec. Officer, Fed. Reserve Bank of NY, *A Preliminary Assessment of the TALF* (June 4, 2009), *available at* <http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html>.

<sup>39</sup> Congressional Oversight Panel, *supra* note 34.

absorb any remaining losses.<sup>40</sup> This renders TALF unpopular even among those not directly involved in the CMBS market.

## 2. Revenue Procedure 2009-45 Rule

Another recent and dramatic step taken by the federal government to rescue the ailing CMBS market was the Revenue Procedure 2009-45 tax rule. Adopted by the IRS on September 15, 2009, the new tax rule allows commercial real estate borrowers to modify their securitized loans without incurring severe tax penalties.<sup>41</sup> Previous tax rules imposed these penalties for any changes made within commercial mortgage pools after the securitization startup date.<sup>42</sup> Modifications such as loan principal forgiveness, lowering the interest rate and extending the maturity date were considered “significant” for federal taxation purposes and resulted in additional taxes to the pool, since modified loans were treated as new debt instruments.<sup>43</sup> Before the current economic crisis, however, there was little need for such modifications, as loan refinancing was more readily available, and borrowers could meet their debt obligations without resorting to changing the terms of the original agreement.<sup>44</sup> The credit crisis made such modifications necessary to stave off loan defaults.<sup>45</sup> Therefore, the new rule no longer treats these modifications as “significant” if they are occasioned by a default or a reasonable possibility of a default, thus obviating tax penalties.<sup>46</sup>

The new tax rule has a number of shortcomings. First, it does not override internal Pooling and Servicing agreements between the CMBS pool and the CMBS purchaser.<sup>47</sup> Such agreements may place

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<sup>40</sup> *Id.*

<sup>41</sup> Jowyk & Sherwood, *supra* note 23.

<sup>42</sup> *Id.*

<sup>43</sup> See generally Rev. Proc. 2009-45, available at <http://www.irs.gov/pub/irs-drop/rp-09-45.pdf>.

<sup>44</sup> *Id.* at 2.

<sup>45</sup> Elaine Misonzhnik, *New IRS Regulations Might Contain CMBS Defaults, but Won't End the Commercial Real Estate Crisis*, RETAIL TRAFFIC (Sept. 22, 2009), <http://retailtrafficmag.com/finance/lending/0922-irs-regulations-contain-damage/>.

<sup>46</sup> Rev. Proc. 2009-45, *supra* note 44, at 6.

<sup>47</sup> Jim Butler, *Insights on the New CMBS Rules—Implications for Troubled Loans Today* (Sept. 17, 2009), <http://www.hotelnewsresource.com/pdf/dyn/41211.pdf>.

restrictions on loan modifications in a pool, making easy access to term adjustments a moot point.<sup>48</sup> Second, it does not solve the problem of conflicting interests of different tranches of CMBS holders.<sup>49</sup> While AAA-rated securities tend to be short-term investments and are expected to be repaid in full at maturity date, the AA- and A-rated securities are longer-term and bear the most penalties upon default.<sup>50</sup> Therefore, more modifications mean more losses to highest rated CMBS and more gains to the lower rated securities, creating internal tension.<sup>51</sup>

Third, the “pretend and extend” strategy of CMBS lenders, whereby they prefer to give the borrowers an opportunity to meet their debt obligations at a later date or according to new terms instead of seizing and liquidating the defaulted borrowers’ assets, may not be prudent.<sup>52</sup> The borrower’s asset value will likely continue to decline, and holding on to depreciating assets will result in greater losses to the lenders.<sup>53</sup> The bottom line is that the new tax rule does not solve the problem, but allows for modifications that may stave off loan defaults until the economic market recovers and refinancing becomes more readily available.<sup>54</sup> To some, this is not an effective measure, since market recovery is not as imminent as was once hoped.

#### D. CMBS Market Outlook

According to the best financial analysts, the CMBS market projections appear bleak. Deutsche Bank estimates total losses on the outstanding CMBS will be in the nine-twelve percent range, total losses on the 2005-2008 vintages will be 11.6-15.3%, and total losses on the 2007 vintage will exceed twenty-one percent.<sup>55</sup> How well the large CMBS investors will bear the losses depends on the numerous individual loan structures specific to each pool, the specific market

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<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> Misonzhnik, *supra* note 46.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Butler, *supra* note 48.

<sup>54</sup> Misonzhnik, *supra* note 46.

<sup>55</sup> Richard Parkus & Jing An, *Deutsche Bank CMBS Research: The Future Refinancing Crisis in Commercial Real Estate, Part II: Extensions and Requirements* (July 15, 2009), <http://fredericksburg.com/blogs/blogfiles/billf/CRE.pdf>.

and property type of the loan collateral, and other factors, such as supply-demand response rate and extent of the recession.<sup>56</sup> Major financial strategists are skeptical about the CMBS market bouncing back any time soon, predicting real troubles ahead in 2010 through 2013.<sup>57</sup> They have faith in TALF, but believe that overall the road to recovery will be long and winding.<sup>58</sup>

### E. Conclusion

Since their inception in the 1990s, CMBS had become the most prominent source of CRE lending in the United States. The debt market collapse of 2008 left CMBS lenders and borrowers in dire financial straits and effectively shut down CMBS lending, which in turn amplified the economic downturn. The two recently adopted government measures—TALF and the new IRS tax rule—bring new hope to the distressed CMBS market, but both have numerous flaws that need to be addressed. TALF aims to promote CMBS liquidity by allowing CMBS purchasers to obtain low-cost financing. The concern is that many CMBS in need of TALF funds may be ineligible under the program's procedures, which will render TALF inadequate as a rescue measure. The new IRS tax rule allows CRE borrowers to modify securitized loans without incurring large tax penalties. Critics claim, however, that the new rule does not address some of the systemic problems that will preclude many CMBS from being modified. Whatever the criticism, the two initiatives are at least a start in helping invigorate CMBS market.

Yevgeniya Drobitskaya<sup>59</sup>

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<sup>56</sup> George J. Pappadopoulos, *The Impact of Recession on CMBS*, THE RMA J. (June 2001), <http://findarticles.com/p/search/?qa=George%20Pappadopoulos>.

<sup>57</sup> Posting of Alex Finkelstein, *Blumberg and Maguire See Nothing But Gloom Ahead for Commercial Real Estate Markets* (May 19, 2009), <http://www.realestatechannel.com/us-markets/commercial-real-estate-1/phillip-blumberg-blumberg-partners-us-commercial-real-estate-cmbs-talf-property-values-alex-finkelstein-827.php>.

<sup>58</sup> *Id.*

<sup>59</sup> Student, Boston University School of Law (J.D. 2011).

## **VII. *Regulation of Over-the-Counter Derivatives: The Ultimate Lesson of Regulatory Reform***

### **A. Introduction**

In light of the collapse of AIG, Lehman Brothers, Bear Stearns and other financial behemoths, Congress is considering legislation to regulate the Over-the-Counter (“OTC”) derivatives market—a shadowy marketplace where the world’s biggest financial players make trillion dollar bets on the values of various financial instruments. As Congress begins to debate the regulation of this complicated marketplace, it must remain cognizant of reasoned dissent. All too often, the voices of reasoned dissenters are muffled by the overwhelming weight of complacency. Effective reform requires a reasoned inquiry and an acknowledgement of the logical implications of both action and inaction. In the late 1990s, Congress rejected an opportunity to explore the logic of one dissident regulator, Brooksley Born, who warned Congress of the “explosive growth in the OTC market.”<sup>1</sup> As a result of this neglect, federal regulators ignored a rapidly growing systemic risk and allowed unmonitored financial institutions to squander much of America’s wealth. In 2009, as Congress reconsiders the issue of OTC derivative regulation, it should heed the lesson of the late 1990s and remember the reasoned dissent of Brooksley Born.

### **B. Background**

Derivatives, which include futures, options, swaps and many hybrid instruments, are financial instruments that derive their value from an underlying asset, such as physical commodities, financial instruments, indexes, foreign currencies or spreads between the values of such assets.<sup>2</sup> A swap is a type of derivative whereby two parties agree on an exchange of cash flows based on differences or changes in the value or level of the underlying asset.<sup>3</sup> Unlike exchange-traded derivatives, which are bought and sold on regulated

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<sup>1</sup> Over-the-Counter Derivatives, 63 Fed. Reg. 26114 (proposed May 12, 1998) (to be codified at 17 C.F.R. pt.34, 35), at 26119.

<sup>2</sup> *Id.* at 26115.

<sup>3</sup> Report of the President’s Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, at 4 (Nov. 1999).



exchanges such as the New York Mercantile Exchange (“NYMEX”) or the Intercontinental Exchange (“ICE”), an overwhelming majority of these contracts are traded over-the-counter, meaning they are negotiated directly between two principles and are often customized to the individual needs of the parties involved.<sup>4</sup> Swaps and derivatives have become an increasingly important piece of the financial puzzle as businesses and investors use these financial instruments to shift and manage risk as well as to provide investment opportunities for capital markets.<sup>5</sup>

The Commodity Exchange Act (“CEA”) provided the Commodity Futures Trading Commission (“CFTC”) with exclusive authority over contracts in “commodities” for “future delivery.”<sup>6</sup> Although the CEA’s language provides for relatively broad regulatory authority, the CFTC has never clarified whether OTC derivatives could be construed to be subject to the CEA.<sup>7</sup> As a result of this ambiguity, Congress and the CFTC have had to continually reassure the financial industry of the evolving regulatory status of these financial instruments. In 1989, the CFTC approved a policy statement concerning swap transactions, which confirmed, albeit informally, that the CFTC was exempting from oversight most non-standardized swap agreements between highly capitalized financial participants not traded on regulated exchanges.<sup>8</sup> In 1992, Congress passed the Futures Trading Practices Act (“FTPA”), which allowed the CFTC to formally confirm this exemption of swap transactions.<sup>9</sup> The FTPA did not go as far as announcing that swap agreements are not futures contracts, but it did reassure the financial industry that the CFTC would not meddle in the OTC derivative market.<sup>10</sup>

While very little changed in the regulatory treatment of OTC products between 1998 and 2009, the OTC derivatives market changed dramatically. By the close of 1998, the notional value of the global OTC derivatives market was around \$80 trillion.<sup>11</sup> The “notional” amount represents the amount upon which payments to the parties to a derivatives transaction are based and is the most

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<sup>4</sup> *Id.* at 5.

<sup>5</sup> Over-the-Counter Derivatives, *supra* note 1, at 26115.

<sup>6</sup> President’s Working Group, *supra* note 3, at 6-7.

<sup>7</sup> *Id.* at 7.

<sup>8</sup> *Id.* at 10.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 10-11

<sup>11</sup> *Id.* at 4.

commonly used measure of outstanding derivatives transactions.<sup>12</sup> As of June 2008, the notional value of the global OTC derivatives market was over \$680 trillion, a nearly 900 percent increase over ten years.<sup>13</sup> Meanwhile, the oversight and regulatory authority over these products has been stagnant. Congress did not take measures to address the growing risks in the OTC derivatives market until the Commodity Futures Modernization Act (“CFMA”) in 2000 and, even then, the legislation merely clarified that nearly all OTC products would continue to be exempt from regulation.<sup>14</sup> Although the authors of the CFMA promoted the Act as legislation that would “promote innovation, competition, efficiency, and transparency in OTC derivatives markets,” the Act nevertheless failed to provide any significant regulatory power to federal authorities over these opaque markets.<sup>15</sup> In actuality, the CFMA provided for a series of regulatory exclusions for dealers and OTC products, thereby reducing market transparency.<sup>16</sup>

### C. Hushing Dissent

In July of 1998, Alan Greenspan, then Chairman of the Federal Reserve Board, addressed Congress to quell concerns over the status of the rapidly growing OTC derivatives market. Greenspan told the Senate Committee on Agriculture that he saw “no reason to question the underlying stability of the OTC markets, or the overall effectiveness of private market discipline . . .”<sup>17</sup> A proponent of minimal regulation, Greenspan assured Congress that “risks in financial markets, including derivatives markets, are being regulated by private parties.”<sup>18</sup> On Capitol Hill, Greenspan was regarded as “an

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<sup>12</sup> Over-the-Counter Derivatives, *supra* note 1, at 26115

<sup>13</sup> Bank for International Settlements (BIS) Quarterly Review, *Semiannual Over-the-Counter (OTC) Derivatives Markets Statistics*, Table 19 (June 2009).

<sup>14</sup> Peter Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1.

<sup>15</sup> President’s Working Group, *supra* note 3, at 1; Goodman, *supra* note 14.

<sup>16</sup> Anthony Faiola, Ellen Nakashima and Jill Drew, *What Went Wrong?*, WASH. POST, Oct. 15, 2008.

<sup>17</sup> *Regulation of Over the Counter (OTC) Derivatives and Derivatives Markets: Before the S. Comm. on Agriculture*, 105th Cong. (1998) (statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System).

<sup>18</sup> Goodman, *supra* note 14.

oracle” and “the greatest chairman in the history of the Federal Reserve Bank.”<sup>19</sup> His confidence in the market was, for many legislators, a sufficient proxy for a more thorough and independent analysis of economic concerns.<sup>20</sup> Although there were many reasons for skepticism, such as the increased concentration of market risk in just a few investment banks, Greenspan’s assurances were sufficient for most legislators on Capitol Hill.<sup>21</sup>

At odds with Greenspan’s laissez-faire regulatory philosophy was fellow regulator and then Chairwoman of the CFTC, Brooksley Born.<sup>22</sup> Born was concerned by the “complexity of the derivatives marketplace, the fact that dealer activity tends to be concentrated in a relatively small number of large entities, the lack of transparency, and systemic risk.”<sup>23</sup> Born broached the issue of OTC derivative regulation in a meeting with Greenspan, Treasury Secretary Robert Rubin and SEC Chairman Arthur Levitt in May of 1998.<sup>24</sup> After receiving a cold reception from her fellow regulators, Born took the initiative to publish a concept release later that month seeking further comment on the regulation of OTC derivatives.<sup>25</sup> Rather than propose specific rules for the regulation of the OTC derivatives market, this concept release merely posed seventy-five questions, addressed to market participants, regarding the integrity of the existing regulatory framework and ways to improve it.<sup>26</sup> The concept release sought to “stimulate public discussion and to elicit informed analysis” of the OTC derivatives market and to identify points of common concern.<sup>27</sup>

The concept release received an immediate response, although not the sort sought by Born. Greenspan, Rubin and Levitt published a rare joint statement of the Fed, Treasury and SEC disparaging the concept release for “casting a shadow of regulatory uncertainty over an otherwise thriving market.”<sup>28</sup> On July 30, 1998, less than three months after the CFTC’s concept release, Greenspan,

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> Over-the-Counter Derivatives, *supra* note 1, at 26125.

<sup>24</sup> Goodman, *supra* note 14.

<sup>25</sup> *Id.*

<sup>26</sup> *See generally* Over-the-Counter Derivatives, *supra* note 1.

<sup>27</sup> *Id.* at 26116.

<sup>28</sup> Faiola, *supra* note 16.

Levitt and Larry Summers, then Treasury Deputy Secretary, addressed the Senate Committee on Agriculture in order to further rebuke Born and the CFTC's concept release.<sup>29</sup> Although Born's concerns derived from unprecedented growth in the OTC markets and a number of bank insolvencies related to unchecked risk-taking in the OTC market, Greenspan, Levitt and Summers reiterated their belief that the markets could regulate themselves.<sup>30</sup> Defending the merits of self-regulation, Summers emphasized that, "the parties to these kinds of contract are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies . . . ."<sup>31</sup>

Not only did these three men share their disagreement with Born, but they also came equipped with figurative shackles for her—a legislative proposal for Congress to temporarily eliminate Born's authority to promulgate rules and regulations under her existing authority.<sup>32</sup> "Such legislation," Mr. Summer's announced, "was necessary to avoid disruption and dislocation in the market."<sup>33</sup> While a seemingly harsh response to a fellow regulator's attempt to seek public comment on an issue of concern for the CFTC, Summers disparaged Born's concept release, calling it "highly problematic" and a "matter of serious concern."<sup>34</sup> According to Summers, the threat to financial stability was not the rapidly growing and increasingly opaque OTC derivatives market; it was the unjustified inquiry by an overzealous regulator such as Brooksley Born.<sup>35</sup>

On its face, though, Born's approach was relatively cautious: "The Commission is not entering into this process with preconceived results in mind."<sup>36</sup> The release emphasized that "any proposed changes will be carefully designed to avoid unduly burdensome or duplicative regulation that might adversely affect the continued vitality of the market" and that the concept release did not "alter the

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<sup>29</sup> *Id.*

<sup>30</sup> Greenspan, *supra* note 17.

<sup>31</sup> *Regulation of Over the Counter (OTC) Derivatives and Derivatives Markets: Before the S. Comm. on Agriculture*, 105th Cong. (1998) (statement of Larry Summers, Deputy Secretary of the U.S. Department of the Treasury).

<sup>32</sup> Faiola, *supra* note 16.

<sup>33</sup> Summers, *supra* note 31.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Over-the-Counter Derivatives*, *supra* note 1, at 26114.

current status of any instrument or transaction under the CEA.”<sup>37</sup> Nevertheless, the concept release generated ire and indignation from her counterparts in the Clinton Administration.<sup>38</sup> Born was deemed to be a dangerous regulator, whose public scrutiny of the OTC derivatives market would inhibit confidence, innovation and economic growth.<sup>39</sup>

As a result of her public rebuke, Born soon stepped down from her position at the CFTC.<sup>40</sup> Meanwhile, Greenspan, Rubin, Summers and Levitt worked with Congress to push through a comprehensive piece of legislation, the CFMA, that provided legal certainty for the OTC derivatives market by eliminating most of the CFTC’s authority to regulate such transactions.<sup>41</sup> Congress made clear that neither the CFTC, nor the Federal government, would interfere with the OTC derivatives market.<sup>42</sup>

#### **D. The Collapse of Long-Term Capital Management**

Shortly after Born’s public rebuke by Greenspan, Levitt and Summers in July of 1998, American financial regulators saw the first glimpses of an impending crisis. The hedge fund Long-Term Capital Management (“LTCM”) was in dire straits and federal regulators struggled to determine how best to manage the failure of such a colossal financial institution.<sup>43</sup> LTCM had borrowed extraordinary amounts of money, leveraging its \$4.8 billion of capital at a ratio of twenty-five to one.<sup>44</sup> When LTCM began to shed money in the summer of 1998, it held positions in the OTC derivatives market amounting to a notional value of \$1.5 trillion.<sup>45</sup> When LTCM began to falter due in part to its gratuitous risk-taking in the unregulated OTC derivatives market, regulators realized that the implications of a

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<sup>37</sup> *Id.* at 26116.

<sup>38</sup> Goodman, *supra* note 14.

<sup>39</sup> Faiola, *supra* note 16.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> David Barboza and Jeff Gerth, *On Regulating Derivatives: Long-Term Capital Bailout Prompts Call for Action*, N.Y. TIMES, Dec. 15, 1998, at C1.

<sup>44</sup> Report of the President’s Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, at 12 (Apr. 28, 1999).

<sup>45</sup> *Id.* at 28.

failure of this magnitude would have ramifications beyond those felt in LTCM's corporate offices.<sup>46</sup> Most worrisome was the build-up of risk "on the shoulders of these few financial institutions that dominate the market."<sup>47</sup> As Warren Buffett warned in a letter to his Berkshire Hathaway shareholders, "large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers . . . . The troubles of one could quickly infect the others."<sup>48</sup> As a result of this systemic risk, the Federal Reserve Bank stepped-in and arranged for thirteen financial firms to come to LTCM's rescue by immediately pumping it with nearly \$4 billion in liquidity.<sup>49</sup> In response to the LTCM crisis, Ms. Born applauded the Federal Reserve Bank's prompt action to find creditors and counterparties for LTCM's liabilities, but also offered a warning stating, "[n]ext time, we may not be as fortunate."<sup>50</sup> Despite the fact that LTCM's failure exposed a major weakness in the U.S. federal regulatory scheme, Congress still did not broach the issue of OTC derivatives regulation.<sup>51</sup>

#### E. A Decade of Silence is Broken

In 2008, ten years after Greenspan's public rebuke of Born for her inquiry into the regulation of OTC derivatives, America experienced the worst financial crisis in nearly a century.<sup>52</sup> America's largest financial institutions collapsed under the weight of their financial obligations, triggered by collapsing mortgage values and a rapid increase in demands for collateral on their credit default swaps.<sup>53</sup> Faced with the threat of systemic failure, the federal government dug deep into its pockets to bailout institutions such as

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<sup>46</sup> *Id.* at 13.

<sup>47</sup> Barboza, *supra* note 43.

<sup>48</sup> Goodman, *supra* note 14.

<sup>49</sup> President's Working Group, *supra* note 44, at 14.

<sup>50</sup> Brooksley Born, *International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission*, 21 *Nw. J. Int'l L. & Bus.* 607, 639 (2001).

<sup>51</sup> Faiola, *supra* note 16.

<sup>52</sup> Reuters, *Three Top Economists Agree 2009 Worst Financial Crisis Since Great Depression*, Feb. 27, 2009.

<sup>53</sup> Jerome Madden, *A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*, 5 *Bus. L. Brief (Am. U.)* 15, 17 (Fall 2008).

AIG, who teetered on the edge of defaulting on \$440 billion in OTC swaps.<sup>54</sup> Critics point to a number of factors that played a part in the collapse of the American financial system, but an overwhelming factor was the “mega-catastrophic risk” posed by the unregulated OTC derivatives market.<sup>55</sup> Although the risks have remained the same between 1998 and 2009, one important factor has changed: the size of the OTC market. In 1998, Mr. Summers rebuked Ms. Born for meddling in a “vast, increasingly global” OTC derivatives market with a “notional value of around \$26 trillion.”<sup>56</sup> As of June 2009, the notional value of the global OTC derivatives market exceeds \$600 trillion, an increase by nearly twenty-four times over a ten-year span.<sup>57</sup>

In response to the financial crisis, the Obama Administration has drafted legislative language to overhaul the financial regulatory system and reign in the OTC derivatives that have been evading regulators for a quarter century.<sup>58</sup> The proposal articulates the same concerns voiced by Born and the CFTC more than ten years ago and proposes many of the same remedies offered in her concept release.<sup>59</sup> On October 15, 2009, the House Financial Services Committee approved the Treasury’s legislation, which will be considered by the full House of Representatives.<sup>60</sup>

The Administration’s proposal, submitted to Congress on August 11, 2009, provides for a two-pronged approach: one prong focuses on the derivatives dealers, the other on the derivatives markets.<sup>61</sup> Similar to Born’s concept from 1998, this proposal provides for capital and margin requirements, mandatory reporting of volumes and positions and segregation of margin accounts for

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<sup>54</sup> *Id.* at 18.

<sup>55</sup> BBC News, *Buffett Warns on Investment “Time Bomb,”* (Apr. 3, 2003).

<sup>56</sup> Summers, *supra* note 31.

<sup>57</sup> Bank of International Settlements, *supra* note 13

<sup>58</sup> Press Release, U.S. Department of the Treasury, *Administration’s Regulatory Reform Agenda Reaches New Milestone: Final Piece of Legislative Language Delivered to Capitol Hill* (Aug. 11, 2009).

<sup>59</sup> *See generally*, Over-the-Counter Derivatives, *supra* note 1.

<sup>60</sup> Press Release, House Committee on Financial Services, *Financial Services Committee Approves Legislation to Regulate Derivatives* (Oct. 15, 2009).

<sup>61</sup> *Derivatives Market Legislation: Hearing on H.R. 977 Before the H. Comm. on Agriculture*, 111th Cong. (2009) (statement of Gary Gensler, Chairman of the Commodity Futures Trading Commission).

individual transactions.<sup>62</sup> By subjecting derivatives dealers to strict requirements, federal regulators can ensure that regulations apply to all contracts, whether standardized or customized.<sup>63</sup> The Treasury proposal also requires all “standardized” contracts to go through central counterparty clearing which will limit the risk of counterparty default and ensure that counterparties have sufficient capital and margins relative to their risks.<sup>64</sup> If passed, this legislation will provide transparency in an otherwise opaque market and will help to ensure that Federal regulators have a window into the shadowy markets that brought down LTCM in 1998, AIG in 2008 and formed a large part of the current global financial crisis.

#### F. Conclusion

In a 1999 President’s Working Group report evaluating the LTCM failure, a report endorsed by Greenspan, Rubin, Levitt and Born, the report acknowledged that, “none of [LTCM’s] investors, creditors or counterparties provided an effective check on its overall activities.”<sup>65</sup> Despite this acknowledgement, federal regulators chose to leave this market unregulated, going as far as heralding the passage of the CFMA in 2000. While it is easy in hindsight to acknowledge that the proponents of self-regulation may have been mistaken in their confidence in private party discipline, there is a more important lesson for regulators and legislators to take from the public rebuke of Brooksley Born: prudential regulation requires reason and courage. While Born’s vocal dissent was unpopular and earned her the resentment of her regulatory peers, her concerns were well-reasoned and fundamentally sound. Today, it is clear that Born’s dissent is vindicated by an economy that collapsed under the weight of unhindered risk-taking in the OTC market. However, until Congress provides a platform for those dissident voices so that they may address the underlying systemic risks in our economy, it will remain unclear whether Congress and the federal regulatory system have learned a lesson from the financial crisis of 2009.

Jonathan Urban<sup>66</sup>

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<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> President’s Working Group, *supra* note 44.

<sup>66</sup> Student, Boston University School of Law (J.D. 2011).



## VIII. *Currency Swaps*

### A. **Introduction**

As derivative financial instruments, currency swaps can both reduce and create credit risk for the involved parties.<sup>1</sup> These parties include central banks, financial institutions and corporations. Each of these entities swaps currencies to achieve different goals. Central banks swap currencies to improve liquidity,<sup>2</sup> financial institutions swap currencies to hedge against foreign exchange risk,<sup>3</sup> and corporations swap currencies to access foreign markets.<sup>4</sup> These goals were hindered by the recession beginning in 2007. In response, legislation has been proposed to protect against currency swap risk.<sup>5</sup>

Even with new regulation, the general operation of currency swaps may remain the same. To swap currencies, two parties exchange an amount of one currency for its equivalent value in another currency.<sup>6</sup> Similar to lending, currency swaps have either fixed or floating interest rates applied to each currency's principal,

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<sup>1</sup> Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 531 (1998); *Financial Regulatory Overhaul*, 111th Cong. (2009) (testimony of Gary Gensler, Chairman of the Commodity Futures Trading Commission).

<sup>2</sup> *Latin American Geopolitics: The Dragon in the Backyard*, ECONOMIST 33, August 15, 2009 (stating that China is swapping currencies to improve yuan liquidity); Jack Healy, *Muted Signs of Life in the Credit Markets*, N.Y. TIMES, Apr. 7, 2009, at B1 (stating that the United States Federal Reserve improved liquidity by swapping currencies with the central banks in Britain, Japan, and Europe).

<sup>3</sup> Riva Froymovich, *Swaps Flag Return to Normal*, WALL ST. J., July 17, 2009, at C2.

<sup>4</sup> *Swisscom Brings the First Swiss Franc Corporate Since June*, EUROWEEK, August 21, 2009; See Guatam Goswami & Milind M. Shrikhande, *Economic Exposure and Currency Swaps*, J. APPL. FIN., October 1, 2007, at 62.

<sup>5</sup> *Financial Regulatory Overhaul: Hearing Before the H. Comm. Financial Services*, 111th Cong. (2009) (testimony of Scott Sleyster, Chief Investment Officer of Prudential Financial).

<sup>6</sup> Froymovich, *supra* note 3, at C2.

depending on the type of currency swap.<sup>7</sup> Currency swaps, like all other derivatives, have some inherent risk because the parties involved rely on the agreement to negate all foreign exchange rate fluctuations.<sup>8</sup> However, currency swaps have little risk if they are made by well capitalized and well managed institutions, are fully secured and typically mature in three months or fewer.<sup>9</sup> Moreover, currency swaps are often used to hedge against risk, rather than create risk.<sup>10</sup>

Before swaps existed, the following scenario might occur: Don, a United States importer, may hesitate to import because he fears that the dollar's value may fall, making imports more expensive. Eric, a European exporter to the United States, may hesitate to produce because he fears the dollar's value may rise, yielding smaller profits for exporting to the United States. If Don and Eric swap currencies at mutually beneficial interest rates, then they can ameliorate their respective foreign currency exchange rate fears.<sup>11</sup> Don would swap dollars for euros hedging against the risk that the dollar's value will rise and Eric would swap euros for dollars hedging against the risk that the dollar's value would fall.<sup>12</sup> This currency swap makes trade and production more efficient.<sup>13</sup>

Currency swaps are periodic payments rather than lump sums.<sup>14</sup> If Don wants to swap his United States dollars for Eric's euros, each period Don will pay Eric a portion of the principal and an agreed upon interest rate, fixed or floating, in dollars.<sup>15</sup> When Don pays Eric dollars, Eric pays Don euros, effectively swapping

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<sup>7</sup> Ed Jonathan Law & John Smullen, *A Dictionary of Finance and Banking*, Sept. 25, 2009, <http://www.oxfordreference.com/views/ENTRY.html?subview=Main&entry=t20.e901>.

<sup>8</sup> Sebastian Mallaby, *Geithner on the High Wire; A Rescue Plan Has to Reduce Risk, Not Just Regulate It*, WASH. POST, March 27, 2009, at A17.

<sup>9</sup> Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Richmond 2009 Credit Markets Symposium: The Federal Reserve's Balance Sheet (Apr. 3, 2009), <http://www.federalreserve.gov/newsevents/speech/bernanke20090403a.htm>.

<sup>10</sup> Mallaby, *supra* note 8, at A17.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> See Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV'T L. REV. 217, 237 (2009).

<sup>15</sup> *See id.*

currencies. Eric also pays a principal plus an interest rate, just like Don.<sup>16</sup> The currency swap is a traditional currency swap if interest rates are fixed, it is a basis swap if the interest rates are floating, and it is a cross currency interest rate swap if one interest rate is fixed and the other is floating.<sup>17</sup>

IBM and the World Bank agreed to the first currency swap in 1981, exchanging U.S. dollars for Swiss francs and Deutsche marks.<sup>18</sup> As currency swaps increased in volume, bankers realized that standard terms should be adopted to save time and resources.<sup>19</sup> In the mid 1980s, the International Swaps and Derivatives Association (“ISDA”) standardized currency swap terms and documents.<sup>20</sup> This increased the efficiency of currency swaps because it forced all participating parties to use prepared forms for their swap agreement.<sup>21</sup> Additionally, it reduced the number of disputes because parties swapping currencies had a standard template and accepted definitions that they had to follow.<sup>22</sup>

In 2009, the number of currency swaps has increased due to efforts to stimulate the global economy<sup>23</sup> and bolster trade.<sup>24</sup> Many central banks are using currency swaps to increase asset liquidity; by improving liquidity banks stabilize and expand transactional activity.<sup>25</sup> Currency swaps can also help a nation improve its global trade position. The swap increases the market’s supply of that particular currency, which may increase the likelihood that transactions will be conducted in that currency. This increase in demand

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<sup>16</sup> *See id.*

<sup>17</sup> Law & Smullen, *supra* note 7.

<sup>18</sup> Jon Lanchester, *Outsmarted: High Finance v. Human Nature*, THE NEW YORKER, June 1, 2009, available at [http://www.newyorker.com/arts/critics/books/2009/06/01/090601crbo\\_books\\_lanchester?currentPage=1](http://www.newyorker.com/arts/critics/books/2009/06/01/090601crbo_books_lanchester?currentPage=1).

<sup>19</sup> Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 752-53 (2008).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> Healy, *supra* note 2, at B1.

<sup>24</sup> *See Time to Join China as It Challenges the Dollar*, THE NATION (THAILAND), June 22, 2009 (stating that China is making trading more attractive by raising the international supply of yuan).

<sup>25</sup> Healy, *supra* note 2, at B1.

will more than offset the increase in the currency's supply, either keeping the value of the currency steady or increasing its value.<sup>26</sup>

### **B. The Currency Swaps Market's Reaction to the Current Economic Crisis**

Aggregate currency swaps reduced in number and monetary size during the recent economic crisis.<sup>27</sup> Additionally, the lengths of currency swaps were reduced to further decrease currency swap risk.<sup>28</sup> By reducing the length of the swap, the parties hoped they would be subject to less interest rate and exchange rate fluctuation.<sup>29</sup> The current crisis reduced the length of most currency swaps from three months to less than a week.<sup>30</sup> While the shortening of swap periods decreased credit risk, it also decreased the attractiveness of swap participation.<sup>31</sup>

As recently as the first quarter of 2009, the currency swap market was still constrained for a number of reasons.<sup>32</sup> The subprime mortgage crisis tightened credit markets which reduced the overall number of transactions.<sup>33</sup> The government intervened with measures aimed at increasing domestic production, which reduced the need for currency swaps.<sup>34</sup> General credit uneasiness reduced the length of currency swaps, limiting the overall benefit of the swaps.<sup>35</sup> Corporations reduced currency swap agreements because they were too costly as access to a foreign market may not be worth the fixed costs attributable to fees from currency swaps.<sup>36</sup>

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<sup>26</sup> *Time to Join China as It Challenges the Dollar*, *supra* note 24.

<sup>27</sup> Bernanke, *supra* note 9.

<sup>28</sup> See Froymovich, *supra* note 3, at C2.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> Philip Alexander, *Crisis Shakes Up the Competitive Landscape: New Platforms for the New Times*, *THE BANKER*, Oct. 1, 2009.

<sup>32</sup> See Froymovich, *supra* note 3, at C2.

<sup>33</sup> Samuel, *supra* note 14, at 224.

<sup>34</sup> See Andrew Batson, *China Seeks an End to U.S. Trade Spat*, *WALL ST. J.*, Sept. 16, 2009, at A5 (stating that the G20 met in response to the economic crisis, and that trade restriction increases were discussed).

<sup>35</sup> Sudeep Reddy, *As It Starts Programs, Fed Weighs How to Stop Them*, *WALL ST. J.*, March 23, 2009, at A4.

<sup>36</sup> *Swisscom Brings the First Swiss Franc Corporate Since June*, *supra* note 4.

The number of currency swaps has increased in 2009.<sup>37</sup> Many countries, notably the U.S.<sup>38</sup> and China,<sup>39</sup> have entered into currency swap agreements. The banks that reduced currency swaps because of tight credit markets are swapping currencies now that credit is available.<sup>40</sup> Corporations can increase how frequently they swap currencies because of the resurgence of currency swaps.<sup>41</sup>

### **C. The Way Back: Central Banks Stimulate While Others Raise Revenue**

Currency swaps can and will contribute to global recovery. The increased liquidity from currency swaps enables more credit activity and international trade.<sup>42</sup> Between May and June 2009 absolute swap market value rose about twelve percent, due largely to the credit markets loosening up.<sup>43</sup> Central banks are “shoring up liquidity in commercial banks” through their currency swaps.<sup>44</sup> Foreign and domestic financial institutions, in turn, are using that extra liquidity to increase business and raise revenue.<sup>45</sup> Although banks are currently hesitant to lend, increased liquidity will help corporations tap into new markets when lending resumes.<sup>46</sup>

#### **1. Central Banks Increase Currency Swaps**

Central banks are increasing their use of currency swaps to improve liquidity.<sup>47</sup> When central banks swap currencies, liquidity is

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<sup>37</sup> Froymovich, *supra* note 3, at C2.

<sup>38</sup> Healy, *supra* note 2, at B1

<sup>39</sup> *Time to Join China as It Challenges the Dollar*, *supra* note 24.

<sup>40</sup> Froymovich, *supra* note 3, at C2.

<sup>41</sup> Bernanke, *supra* note 9.

<sup>42</sup> See Edmund L. Andrews, *Bernanke Defends Steps Taken to Contain Crisis*, N.Y. TIMES, Feb. 19, 2009, at B3; *Time to Join China as It Challenges the Dollar*, *supra* note 24; see Juan Forero & Joshua Partlow, *Latin America Appears to Warm to IMF; Economic Crisis Forces Many Countries to Turn to Once-Shunned Organization*, WASH. POST, Apr. 28, 2009 at A13.

<sup>43</sup> Froymovich, *supra* note 3, at C2.

<sup>44</sup> Healy, *supra* note 2, at B1.

<sup>45</sup> Bernanke, *supra* note 9.

<sup>46</sup> *Swisscom Brings the First Swiss Franc Corporate Since June*, *supra* note 4; See Goswami & Shrikhande, *supra* note 4, at 62.

<sup>47</sup> Andrews, *supra* note 41, at B3.

increased because domestic financial institutions, when conducting international transactions, can draw on foreign currency in order to conduct deals and hedge against risk.<sup>48</sup> In April 2009, the United States, Japan, Britain and Europe swapped \$287 billion worth of currencies.<sup>49</sup> Additionally, the European Central Bank agreed to bilateral currency swaps with Hungary and Denmark.<sup>50</sup> China entered into separate currency swap agreements with various countries worth, in total, \$27.5 billion.<sup>51</sup> At least one foreign finance minister is asking the International Monetary Fund (“IMF”) to make hard currency available to troubled countries through currency swaps.<sup>52</sup> These nations are swapping currencies to both lower credit risks and increase liquidity for their domestic financial institutions.<sup>53</sup>

## 2. China’s Use of Currency Swaps to Challenge the Dollar with the Yuan

China has and continues to swap currencies with a number of other nations.<sup>54</sup> One reason that China is swapping currencies is to strengthen its case for the yuan to be the world’s reserve currency, a strategy which appears to be making progress.<sup>55</sup> China is targeting its trade partners with currency swaps to increase the amount of yuan in the world.<sup>56</sup> China and Argentina entered into a currency swap arrangement worth \$10 billion that enables Argentina to place

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<sup>48</sup> Healy, *supra* note 2, at B1.

<sup>49</sup> *Id.*

<sup>50</sup> Ulrich Volz, *Sovereign Debt Risk Looms Large This Year*, WALL ST. J., Jan. 30, 2009, at A13.

<sup>51</sup> *Time to Join China as It Challenges the Dollar*, *supra* note 24.

<sup>52</sup> Bob Davis, *IMF Mulls a Global Bank Tax*, THE WALL ST. J., Oct. 3, 2009, at A8.

<sup>53</sup> *See id.*

<sup>54</sup> *Latin American Geopolitics: The Dragon in the Backyard*, *supra* note 2 (China is increasing trade with Latin America, increasing the amount of yuan in the area); *Time to Join China as It Challenges the Dollar*, *supra* note 24 (China swaps currency with Argentina, Belarus, Brazil, Hong Kong, Indonesia, Malaysia and South Korea); Robert Zoellick, President, World Bank, *Will The U.S. Dollar Remain the Main Reserve Currency?* (Sept. 30, 2009) (China is moving toward gradual internationalization of its currency by making trade easier with currency swaps).

<sup>55</sup> *Latin American Geopolitics: The Dragon in the Backyard*, *supra* note 2, at 33.

<sup>56</sup> *Time to Join China as It Challenges the Dollar*, *supra* note 24.

Chinese import orders in yuan, not dollars.<sup>57</sup> Additionally, China made swaps with Indonesia (worth \$14.6 billion) and with Belarus (worth \$2.9 billion).<sup>58</sup> These swaps strengthen the yuan's position because more trade is transacted in yuan. This helps Chinese exporters because when demand for the yuan increases, its value also increases.<sup>59</sup> Moreover, China is thus able to recoup its losses due to the dollar's 2009 devaluation.<sup>60</sup> China holds an abundance of U.S.' debt denominated in dollars, so diversifying its foreign currency portfolio with Argentinean pesos, Indonesian rupiahs and Belarusian rubles reduces China's exposure to the dollar's fluctuation.<sup>61</sup>

The U.S. is rightfully worried about the yuan replacing the dollar as the world's reserve currency because it would further reduce the dollar's value. The benefit of a reserve currency is that foreign countries often conduct transactions using the global reserve currency. If the dollar loses status as reserve currency, demand contracts and value decreases.

However, the dollar will probably not lose reserve currency status in the near future.<sup>62</sup> Despite China's ability to successfully swap currencies and diversify its foreign currency assets, the U.S. has to sit idly by for the dollar to be replaced.<sup>63</sup> The U.S. trade deficit and potential dollar inflation are arguments China hopes will persuade the IMF to adopt the yuan as the world's reserve currency.<sup>64</sup> However, the deficit narrowed in October 2009, and Federal Reserve Chairman Ben Bernanke is striving to extend this deficit reduction.<sup>65</sup> Additionally, despite low interest rates, severe inflation will not occur because of the "slack" in the economy and the Federal Reserve's ability to increase interest rates when the economy rebounds.<sup>66</sup>

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<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> Zoellick, *supra* note 54.

<sup>63</sup> *See id.*

<sup>64</sup> *Id.*

<sup>65</sup> Paul Evans, *Bernanke Remarks Give Dollar a Lift*, WALL ST. J., Oct. 10, 2009, at B7.

<sup>66</sup> Jon Hilsenrath, *Fed Reviews Two Programs as Markets Look More Stable*, WALL ST. J., Aug. 6, 2009 at A2.

### 3. Corporations' and Financial Institutions' Use of Currency Swaps

Corporations and financial institutions are entering into more currency swap agreements as the 2007 to 2009 recession winds down.<sup>67</sup> Globally, currency swaps give corporations a natural edge over corporations who do not swap currencies.<sup>68</sup> If a corporation's transactions consist of foreign earnings and obligations, then it would usually worry about that currency's fluctuations affecting its bottom line.<sup>69</sup> Corporations can avoid this problem with currency swaps. By swapping currencies, they quickly and frequently transfer foreign earnings into domestic currency, thus locking in their profit.<sup>70</sup>

Corporations are increasing their currency swaps in 2009.<sup>71</sup> Because they involve credit, currency swaps can add risk to simple foreign currency investment but with careful counterparty credit risk analysis and fair interest rates, that risk is reduced.<sup>72</sup> Chinese companies are increasing currency swaps to settle trade deals in yuan, rather than dollars.<sup>73</sup> This would have saved them money if they did it before the dollar's value fell.<sup>74</sup> Other corporations are entering into currency swap agreements because they want to enter new markets or need to realize their profits from foreign earnings.<sup>75</sup> Further, some corporations are using currency swaps as a tool to reduce costs.<sup>76</sup> These corporations reduce costs by investing in the currency swaps, not to trade or speculate, but rather to manage currency and interest rate risks.<sup>77</sup>

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<sup>67</sup> Froymovich, *supra* note 3, at C2.

<sup>68</sup> S. Murlidharan, *Currency Swap*, BUSINESS LINE, Oct. 5, 2009, available at 2009 WLNR 19568089.

<sup>69</sup> *See id.*

<sup>70</sup> *See id.*

<sup>71</sup> *Swisscom Brings the First Swiss Franc Corporate Since June*, *supra* note 4.

<sup>72</sup> *Id.*

<sup>73</sup> Denis McMahon, *Beijing Aims to Expand Foreign Trade in Yuan*, WALL ST. J., Apr. 11, 2009, at A6.

<sup>74</sup> *Id.*

<sup>75</sup> *Swisscom Brings the First Swiss Franc Corporate Since June*, *supra* note 4; *See* Murlidharan, *supra* note 68.

<sup>76</sup> *Derivatives Market Legislation: Before the H. Comm. on Agriculture*, 111th Cong. (2009) (testimony of Glenn English, Chief Executive Officer of the National Rural Electric Cooperatives Association).

<sup>77</sup> *Id.*



Financial institutions are increasing their foreign currency activity, particularly their currency swap agreements.<sup>78</sup> In currency swap agreements, a financial institution might act as an intermediary and charge a nominal fee for its service.<sup>79</sup> Also, a financial institution might swap currencies to negate their foreign investment risk stemming from exchange rate fluctuation.<sup>80</sup> This trend is increasing because credit markets continue to loosen up from 2008's contraction.<sup>81</sup> Banks are therefore entering into currency swaps for two reasons: to broker transactions as intermediaries for corporations<sup>82</sup> and to hedge against risk.<sup>83</sup>

#### 4. Proposed Regulation That May Affect Currency Swaps

As of October 2009, the House Financial Services Committee is considering several bills that would dramatically change banking and finance.<sup>84</sup> Currency swaps sometimes reduce risk, but they are inherently risky and can create risk if used improperly.<sup>85</sup> Currency swaps are derivative financial instruments, and they are regulated along with similar over the counter derivatives such as credit default swaps, collateralized debt obligations and other risky financial instruments that derive value from an asset.<sup>86</sup> While ISDA increased efficiency and reduced transaction costs by standardizing the terms for currency swap agreements, it did not provide regulation or prevent the currency swaps' contribution to the financial crisis.<sup>87</sup>

It is uncertain what forms of regulation the Obama Administration would impose on currency swaps. Proposals include increased capital requirements to ensure solvency and mandated

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<sup>78</sup> Alexander, *supra* note 31.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> See Murlidharan, *supra* note 68.

<sup>83</sup> Alexander, *supra* note 31.

<sup>84</sup> Sleyster, *supra* note 5.

<sup>85</sup> Gensler, *supra* note 1.

<sup>86</sup> *Over-the-Counter Derivatives Regulation: Hearing Before the Subcomm. On Securities, Insurance, and Investment of the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (testimony of Christopher Whalen, Managing Director of Institutional Risk Analytics).

<sup>87</sup> See Kim, *supra* note 19.

business conduct standards to strengthen market integrity.<sup>88</sup> Additionally, regulators may require the posting and collecting of margin collateral to reduce the risk of either party's failure to perform.<sup>89</sup> Finally, one of the most popular proposals requires the use of third party clearinghouses to clear trades, which would eliminate the bank's risk of a counterparty's failure to perform because the clearinghouse would bear all of the risk for clearing the trade.<sup>90</sup>

However, some argue that clearinghouses would be ineffective.<sup>91</sup> In October 2009, Scott Sleyster, the Chief Investment Officer of Prudential, argues against clearinghouses for over the counter derivatives.<sup>92</sup> Regarding currency swaps, Mr. Sleyster argues that federal clearinghouses would not have the flexibility in posting investment securities as collateral that is currently available with the over the counter market.<sup>93</sup> Additionally, Mr. Sleyster suggests that clearinghouses set up to reduce risk from currency rate fluctuations would be unnecessary because the swaps already protect against fluctuations through previously determined interest rates.<sup>94</sup> Thus, it is argued that clearinghouses would not decrease foreign currency risk and would reduce the benefits of currency swaps.

#### D. Conclusion

While the volume of currency swaps is increasing in 2009, it is still down from its 2007 level.<sup>95</sup> As of April 2009, currency swaps were down \$310 billion from their 2006 level of \$11 trillion.<sup>96</sup> However, the current increase in currency swaps will continue as the economy improves. Currency swaps are relatively safe instruments and their use can improve liquidity. Additionally, currency swaps can be a considerable source of revenue for financial institutions. Finally, currency swaps are an important instrument in global trade. Currency swap use will help the global economy to recover. It is important to

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<sup>88</sup> Gensler, *supra* note 1.

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> Sleyster, *supra* note 5.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> Bernanke, *supra* note 9.

<sup>96</sup> *Id.*; Goswami & Shrikhande, *supra* note 4, at 62.

remain cautious in the regulation of currency swaps so that swaps are not limited in number or size, which could stunt economic growth.

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## **IX. Credit Rating Agencies**

### **A. Introduction**

Credit Rating Agencies (CRAs) play a significant role in the modern securities market. CRAs determine the, “[c]redit worthiness of financial instruments and publicly traded companies.”<sup>1</sup> These determinations can increase investor confidence, shape a corporation’s financial situation and structure and improve the overall fluidity of the securities market. CRAs fulfill these functions through their use of a grading system that rates security investments for potential investors. Because no government agency performs this function, CRAs have become the de facto regulators of many important aspects of the financial market.<sup>2</sup> The recent financial crisis, however, has called into question the exact role of CRAs. A lack of transparency, conflict in the issuer-payment model and the absence of competition among CRAs led to a call for greater understanding and regulation of CRAs by investors and government officials.<sup>3</sup> While the future role and function of CRAs have not been defined, it is clear that there will be changes in the structure and relationship between the financial market and CRAs.

### **B. A History of Credit Rating Agencies**

CRAs were created during the nineteenth century to combat problems arising from the expansion of railroads across the U.S. The capital required by the railroads for this expansion exceeded the amount that they could raise from banks or private investors. To raise funds, railroads sold corporate bonds to the general public.<sup>4</sup> Investors required “better, cheaper and more readily available information

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<sup>1</sup> Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 238 N.Y. Law Journal, Nov. 5, 2007, [http://www.maglaw.com/publications/data/00144/\\_res/id=sa\\_File1/07011070002Morvillo.pdf](http://www.maglaw.com/publications/data/00144/_res/id=sa_File1/07011070002Morvillo.pdf).

<sup>2</sup> Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., Apr. 27, 2008, at 36.

<sup>3</sup> Gautam Setty & Randall Dodd, *Credit Rating Agencies: Their Impact on Capital Flows to Developing Countries*, FINANCIAL POLICY FORUM, Apr. 14, 2003 at 1, 7, 17, <http://www.financialpolicy.org/FPFSPR6.pdf>.

<sup>4</sup> *Id.* at 1.

about these debtors and debt securities,”<sup>5</sup> to make decisions about which corporate bonds to purchase.

In 1909 the Moody’s issued the first credit ratings.<sup>6</sup> Prior to Moody’s, banks played a significant role in shaping the views of potential investors.<sup>7</sup> Banks vouched for the quality of corporate bonds; the public relied on the banks’ opinions due to their reputations; at the same time, banks become more involved with these corporations, acquiring inside information about the firms.<sup>8</sup> Investors did not have the ability to get the same information as banks, resulting in the dissemination of asymmetrical information.<sup>9</sup>

By the 1920’s a few small and well respected CRAs had formed.<sup>10</sup> During the 1930’s the power and legitimacy of CRAs expanded as the government gave them a regulatory role. CRAs ratings were used to determine which bonds banks could carry on their books and which they could carry at cost.<sup>11</sup> The regulatory role of CRAs further expanded in 1973, with an SEC rule that allowed the SEC to label certain CRAs as Nationally Recognized Statistical Rating Organizations (“NRSROs”).<sup>12</sup> However, the Credit Rating Agency Reform Act of 2006 abolished “the [SEC’s] authority to designate credit-rating agencies as [NRSROs]” and allowed other CRAs that met certain standards to also become NRSROs.<sup>13</sup>

### C. The Function and Purpose of CRAs

The fundamental purpose of CRAs is to independently assess the credit risk of a security and relay this information to potential investors. This purpose is fulfilled through the use of a rating or grading system. The rating system reflects the likelihood that the

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<sup>5</sup> *Id.*

<sup>6</sup> Ratings, Rating Agencies, and the Global Financial System 20 (Richard M. Levich et al. eds., Kluwer Academic Publishers) (2002).

<sup>7</sup> Setty & Dodd, *supra* note 3 at 2.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Levich, *supra* note 6 at 5.

<sup>11</sup> John C. Coffee Jr., Gatekeepers: The Professions and Corporate Governance 289 (Oxford University Press) (2006).

<sup>12</sup> *Id.*

<sup>13</sup> Marie Leone, *Bush Signs Agency Reform Act*, CFO, Oct. 2, 2006, <http://cfosreact.com/article.cfm/7991492>.

issuer of the security will be able to repay the debt.<sup>14</sup> Each CRA has its own factors and methods for grading securities, but they all result in either a high or low rating for that security. The higher the rating the less likely it is that a company will default on a repayment to the investor.<sup>15</sup> The CRAs' ratings are not only valuable to individual investors but also to companies that manage large investment portfolios.

CRA grading also has a significant effect on the issuer of the securities. Companies rely on high ratings to create confidence in the strength of their securities and influence investors to purchase these securities, resulting in increased capital for the company.<sup>16</sup> The higher the company's securities rate, the greater chance it will have to raise capital via investors.<sup>17</sup>

Another purpose of CRAs is to reduce asymmetry of information in the financial market.<sup>18</sup> One way CRAs do this is by providing an independent source of information for investors. This information also "police[s] the conflicts of interest between the asset managers and their clients whose money the managers invest."<sup>19</sup> Asset managers might want to invest in high risk securities of which investors may not approve. "The use of ratings by investment policies can limit the risk in the asset manager's investments at a low monitoring cost and thus benefit the investors."<sup>20</sup>

The last major function of CRAs is regulation. Following the developments of the 1970s, the "[SEC] began subjecting broker-dealers to minimum capital requirements based on the credit quality of the positions held in their portfolios, following the lead of banking and insurance regulators requiring 'investment grade' instruments."<sup>21</sup> The SEC created NRSROs to serve as underwriters of securities and as sources of credible information for investors.<sup>22</sup> The NRSROs were the regulators of this sector of the financial market and were subject to limited oversight.

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<sup>14</sup> Setty & Dodd, *supra* note 3 at 1.

<sup>15</sup> Sack & Juris, *supra* note 1.

<sup>16</sup> Setty & Dodd, *supra* note 3 at 1.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 2.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Sack & Juris, *supra* note 1.

<sup>22</sup> *Id.*

#### D. NRSROs

While there are numerous CRAs, the NRSROs that dominate the financial market are Moody's Investor Services ("Moody's"), Standard & Poor's ("S&P"), and Fitch Ratings ("Fitch"). Each has its own criteria and system for rating securities. Moody's rating system works on a scale of AAA to C, with AAA being the highest rating and C the lowest.<sup>23</sup> These ratings are "intended to be measures of expected loss, and therefore incorporate elements of both probability of default and severity of loss in the event of default."<sup>24</sup>

The ratings system of S&P is a measurement of a company's claims paying ability, also known as its "financial capacity to meet its insurance obligations."<sup>25</sup> S&P establishes their grade by looking at a company's "industry-specific risk, management factors, operating performance and capitalization."<sup>26</sup> The scale of S&P's grading system ranges from AAA to CCC. AAA indicates that an investment has high financial security and a high level of safety.<sup>27</sup> CCC indicates that an investment has low financial security and a "questionable ability" to meet its obligations.<sup>28</sup>

Fitch's rating system is based on assigning an Issuer Default Rating ("IDR"). IDR is a measurement of companies' "relative vulnerability to default on financial obligations."<sup>29</sup> Fitch's rating scale ranges from AAA to C. AAA represents a security with the "lowest expectation of default risk" and indicates that a company has a very strong capacity to repay its financial commitments even in the event of unforeseen adverse events.<sup>30</sup> C represents a security with a very high risk and indicates it is "imminent or inevitable" that a company will default on its financial obligations.<sup>31</sup>

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<sup>23</sup> MOODY'S RATING SYMBOLS & DEFINITIONS, at 2, Aug. 2003, [http://www.rbcpa.com/Moody's\\_ratings\\_and\\_definitions.pdf](http://www.rbcpa.com/Moody's_ratings_and_definitions.pdf)

<sup>24</sup> *Id.* at i.

<sup>25</sup> *Standard and Poor's Rating*, ImmediateAnnuities.com, <http://www.immediateannuities.com/ratings/sp.htm>.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> FITCHRATINGS.COM, [http://www.fitchratings.com/creditdesk/public/ratings\\_defintions/index.cfm?rd\\_file=ltr](http://www.fitchratings.com/creditdesk/public/ratings_defintions/index.cfm?rd_file=ltr).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

## **E. Flaws in the CRA System**

### **1. Lack of Competition**

Though the Credit Rating Agency Reform Act of 2006 opened the door for other CRAs to become NRSROs, Moody's, S&P, and Fitch still dominate the securities market.<sup>32</sup> This domination has led to questions about the accountability, reliability and accuracy of the information that these three CRAs provide. If the credit rating market was more competitive there would be greater accuracy in ratings, lower fees and less likelihood of destructive forms of competition.<sup>33</sup> When there is more competition, there is greater incentive for each CRA to be as accurate as possible, have more competitive fees and practice sound policy.<sup>34</sup> In the current securities market, however, Moody's, S&P and Fitch occupy such a dominant position that the benefits of a competitive securities market are not possible.

### **2. Issuer-Payment Model**

Under the current system, the issuer pays for the CRAs rating. As a result, CRAs collect "fees from the investment banks whose securities they rate."<sup>35</sup> This payment model can foster conflicts of interest because the issuer is paying for its rating. Consequently, a CRA may be influenced to give a better rating to a security than it should because the CRAs want future business. This calls into question the legitimacy of the CRA ratings.

### **3. Lack of Liability**

NRSROs are shielded from most liability under §11 of the 1933 Securities Act or the First Amendment.<sup>36</sup> NRSROs are not shielded from liability from fraud, but they "are not held even to a negligence standard' for much of their work."<sup>37</sup> Instead, a party must

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<sup>32</sup> Sack & Juris, *supra* note 1.

<sup>33</sup> Setty & Dodd, *supra* note 3 at 7-8.

<sup>34</sup> *Id.*

<sup>35</sup> Micheal Hirsh, *Drop Moody's Into the Volcano*, NEWSWEEK.COM, Sept. 30, 2009, <http://www.newsweek.com/id/216486/page/1>.

<sup>36</sup> Sack & Juris, *supra* note 1; Hirsh, *supra* note 35 at 1.

<sup>37</sup> Sack & Juris, *supra* note 1.



show that an NRSRO acted with “actual malice,” knowledge of falsity, or reckless disregard in performance of their rating function.<sup>38</sup> In *Jefferson County Sch. Dist. v. Moody’s Investors Services, Inc.*, the 10<sup>th</sup> Circuit Court of Appeals held that the ratings by Moody’s were an opinion and that it was protected under the First Amendment.<sup>39</sup> This lack of liability can lead to inaccurate, negligent, and unreliable ratings by NRSROs because it is very difficult for investors to hold them accountable.

#### 4. Lack of Regulation

NRSROs are only subject to minimal regulation by the SEC. SEC regulation is primarily limited to setting the criteria for becoming an NRSRO.<sup>40</sup> NRSROs rate the securities and set the standards for sectors of the financial market, such as the mortgage industry.<sup>41</sup> However, there was no agency or entity evaluating the merit and value of the ratings being issued by the NRSROs. NRSROs served as regulators of the securities market while issuing ratings for which they were paid.<sup>42</sup> This lack of regulation led to an absence of accountability by the NRSROs.

#### F. NRSOs’ Role in the Collapse of the Financial Market

The NRSROs overvaluing of securities, specifically mortgage-backed securities, played a major role in the financial collapse. NRSROs evaluated “bonds issued by the investment vehicle created to house them” rather than mortgages held by banks.<sup>43</sup> The mortgages were held by a special purpose vehicle (“SPV”), a ghost corporation that had no real assets.<sup>44</sup> The monthly mortgage payments went to the SPV and the SPV would finance itself through the sale of bonds.<sup>45</sup> The SPV, “float[ed] 12 classes of

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<sup>38</sup> *Id.*

<sup>39</sup> 175 F.3d 848, 855 (10th Cir. 1999).

<sup>40</sup> Sack & Juris, *supra* note 1.

<sup>41</sup> Lowenstein, *supra* note 2 at 1.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 3.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

bonds, from triple-A to a lowly Ba1.”<sup>46</sup> “The highest-rated bonds had first priority on the cash received from mortgage holders until they were fully paid, then the next tier of bonds and so on.”<sup>47</sup> By segregating payments in this way, the triple A rating of the bonds at the top was maintained at the expense of the payments on the lower tier bonds.<sup>48</sup>

In 2007, the SPVs or Controlled Debt Obligation (CDO) trusts setup by the banks collapsed. Many of these trusts bought bonds “collateralized with subprime mortgages.”<sup>49</sup> Subprime mortgages are loans given at a higher interest rate to homebuyers with a riskier credit history.<sup>50</sup> When the subprime market collapsed and these mortgages went into default, the trusts were left with subprime assets.<sup>51</sup> Banks could no longer flip the short-term, high-risk assets and thus had massive debt on their balances sheets.<sup>52</sup> Investors who purchased banks securities, based on the overinflated ratings of the NRSROs, took large losses when the assets of the SPVs were revalued at the proper level.<sup>53</sup> If the NRSROs provided accurate rating, investors would have known the actual level of risk inherent in these investments. Instead, the SPV were allowed to “float” their bonds and inflate their overall credit rating.

### G. The Fallout

The role of CRAs in the collapse of the financial market led to a call for increased regulation. One potential source of regulation is the SEC. The SEC proposed an amendment to its rules that would require CRAs to “disclose more of their ratings history, and creators of financial products will have to share data with all credit raters.”<sup>54</sup> Under the Securities Act of 1933 these proposals would amend

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<sup>46</sup> *Id.*

<sup>47</sup> Lowenstein, *supra* note 2 at 1.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> Peter Eavis, *CDOs Explained*, CNNMONEY.COM, Nov. 26, 2007, [http://money.cnn.com/2007/11/24/magazines/fortune/eavis\\_cdo.fortune/index.htm](http://money.cnn.com/2007/11/24/magazines/fortune/eavis_cdo.fortune/index.htm).

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> Karey Wutkowski, *SEC rules take aim at credit rating agencies*, REUTERS.COM, Sept. 17, 2009, <http://www.reuters.com/article/ousivMolt/idUSTRE58G76Q20090917>.

Regulation S-K, Form S-3 and Form S-4 of the Securities Act of 1933.<sup>55</sup> Under the Securities Exchange Act of 1934 they would amend Rule 13a-11, Rule 15d-11, Form 8-K, and Form 20-F.<sup>56</sup>

Congress has also initiated steps to increase regulation of the CRAs. House Financial Services Capital Markets Subcommittee Chairman Paul Kanjorski drafted a bill that would increase the regulation of CRAs.<sup>57</sup> The bill would, “empower federal securities regulators to review credit-rating methodologies, crack down on conflicts, and give investors a better shot at winning lawsuits against ratings firms.”<sup>58</sup> Kanjorski’s bill calls for joint-and-several liability for all rating agencies registered with the SEC when “legal action against one rating agency results in a monetary judgment where the investor isn’t able to recover the full amount from that rater.”<sup>59</sup> Kanjorski believes that increased liability will cause all CRAs to be more accurate in their ratings.<sup>60</sup> The three big credit rating agencies, Republicans in Congress and others oppose this plan.<sup>61</sup> They argue that collective liability will lead to a decrease in accuracy because one CRA would be liable for the accuracy of another CRA’s rating, without having any control over that rating.<sup>62</sup> They argue this reduces the incentive for CRAs to be more accurate in their own ratings.<sup>63</sup> Other members of Congress, such as Brad Sherman, have proposed an alternative whereby the SEC would choose a CRA security rating at random and would provide a second, independent rating of that security.<sup>64</sup>

Attorney Generals Andrew Cuomo of New York, Jerry Brown of California, and Richard Blumenthal of Connecticut have

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<sup>55</sup> SEC, 17 C.F.R. pt. 229, 239, 240, 249, 274 (2009).

<sup>56</sup> *Id.*

<sup>57</sup> Sarah N. Lynch, *Rep Kanjorski Circulates Draft Bill on Credit Rating Agencies*, WSJ.COM, Sept. 25, 2009, <http://online.wsj.com/article/BT-CO-20090925-713340.html>.

<sup>58</sup> *Id.*

<sup>59</sup> Ronald D. Orol, *Legislator eyes expanded liabilities for credit rating agencies*, MARKETWATCH.COM, Sept. 30, 2009, <http://www.marketwatch.com/story/legislator-eyes-expanded-liabilities-for-raters-2009-09-30>.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

also moved to investigate the actions of the CRAs.<sup>65</sup> Brown is looking to see if S&P, Moody's and Fitch "acted improperly during the credit boom by assigning super-safe, triple-A ratings to structured products that later turned out to be extremely risky, and in some cases, worthless."<sup>66</sup> He has subpoenaed information regarding whether the NRSROs, "failed to conduct adequate due diligence, whether they had compromised their standards and safeguards for profits, and whether they had conspired with the companies whose products they rated to the detriment of investors."<sup>67</sup>

## H. The Future of CRAs

Each proposal for the regulation of CRAs asks what policy will best achieve more accurate ratings, increased transparency of information, better managing of conflicts of interest and greater government regulation.<sup>68</sup> Some commentators call for increased competition among CRAs, arguing that increased competition would lead to a higher quality of rating.<sup>69</sup> However, a counter argument is that increased competition would actually lead to less accurate ratings.<sup>70</sup> A new CRA would likely offer overly high ratings to attract issuers and thus the quality and accuracy of ratings would go down.<sup>71</sup> Other commentators believe that the issuer-payment model should be changed to an investor-payment model, believing this change will remove the conflict of interest problem between companies and CRAs.<sup>72</sup> However, this solution may not be practical because paying for ratings is expensive and investors would likely be unwilling or unable to pay to play.<sup>73</sup> Finally, some suggest that CRAs should be removed from their regulatory post.<sup>74</sup> Under this plan, there would be

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<sup>65</sup> Cyrus Sanati, *California Investigates Credit Rating Agencies*, NYTIMES.COM, Sept. 17, 2009, <http://dealbook.blogs.nytimes.com/2009/09/17/california-investigates-credit-rating-agencies/>.

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> Jonathan Katz et al, *Credit Rating Agencies*, WORLDBANK.ORG, Oct. 2009, 1, 5, <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf>.

<sup>69</sup> *Id.* at 6.

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> Jonathan Katz et al, *Credit Rating Agencies*, WORLDBANK.ORG, Oct. 2009, 6, <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf>.

a reduced reliance on CRA ratings and they would play a lesser role in regulating the market place.<sup>75</sup> The problem with this plan is that there is no agency or body to fill the void that would be left by removing CRAs from their regulatory role.<sup>76</sup>

### I. Conclusion

In the end, it seems unlikely that any significant reform will occur in the relationship between CRAs and the financial market. Greater transparency and increased regulation by the SEC may lead to an increase in accuracy of ratings, however, the problems of the issuer-payment model, lack of competition and CRAs as regulators still remain. As yet, no true solution to these problems has been offered that can also retain the benefits of the role that CRAs play in the market. CRAs play such a vital role in the securities market that any change in the system may lead to more turmoil in an already unstable marketplace. It seems most likely that the role of CRAs will remain largely the same with a few minor changes meant to appease those who want greater transparency in the CRA system.

Joseph DeCampo<sup>77</sup>

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> Student, Boston University School of Law (J.D. 2011).

X. ***Reforms of Collateralized Debt Obligations: Enforcement, Accounting and Regulatory Proposals***

A. **Introduction**

In early 2008, collateralized debt obligations (“CDOs”) were traded in a market worth over \$2 trillion.<sup>1</sup> However, the primary market of new CDO issuances shut down in 2008, following a string of credit downgrades.<sup>2</sup> Presently, CDOs are largely unregulated, but pending reforms in enforcement, accounting and regulation seek to address the specific problems that led to the market’s shutdown.

In enforcement, the U.S. Securities and Exchange Commission (“SEC”) recently announced that it will reorganize its Enforcement Division into five units, one of which will specifically handle securities like CDOs.<sup>3</sup> In accounting, a debate rages on about whether to adhere to fair value accounting of CDOs because of the role it may have played in the shutdown of the market.<sup>4</sup> Also, the Financial Accounting Standards Board (“FASB”) recently released its Statement of Financial Accounting Standards No. 166 (“FAS 166”), which will ultimately result in the elimination of Qualified Special Purpose Entities (“QSPEs”), causing the assets, liabilities, gains and losses from many balance sheet CDOs to flood back to their originators.<sup>5</sup> In regulation, the International Organization of Securities Commissions (“IOSCO”) released a thoughtful proposal for international CDO regulation.<sup>6</sup>

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<sup>1</sup> Jody Shenn, *CDO Market is Almost Frozen*, *J.P. Morgan, Merrill Says*, BLOOMBERG NEWS, Feb. 5, 2008, <http://www.bloomberg.com/apps/news?sid=aCk0Qr1f2Eew&pid=20601087>.

<sup>2</sup> *Id.*

<sup>3</sup> John Herzfeld & Phyllis Diamond, *Khuzami Unveils Broad Reorganization of Enforcement Div’n, New Subpoena Powers*, 41 SEC. REG. & L. REP. 1473 (2009).

<sup>4</sup> See generally Eric B. Poer, *Analysis: “Inactive” Market Presents Challenges for Fair Value Accounting*, SEC. L. DAILY, Feb. 12, 2009.

<sup>5</sup> *Accounting Principles: New FASB Guidance Likely to Balloon Balance Sheets*, *Credit Suisse Says*, SEC. L. DAILY, June 19, 2009.

<sup>6</sup> TECHNICAL COMMITTEE OF THE INT’L ORG. OF SEC. COMMISSIONS, UNREGULATED FINANCIAL MARKETS AND PRODUCTS CONSULTATION REPORT 5 (2009).

## B. Definition

A collateralized debt obligation is a type of asset-backed security.<sup>7</sup> The underlying assets vary but are typically a portfolio of income streams—mortgages, credit default swaps (“CDSs”) or other CDOs—that are split into tranches, rated by a credit rating agency, and sold to investors.<sup>8</sup> There are several types of CDOs.

A balance sheet CDO is a type of cash CDO that is backed by tangible income streams like mortgages, high-yield bonds, and leveraged loans among others.<sup>9</sup> To create a balance sheet CDO, an originating firm takes a collection of securities and transfers the assets and liabilities to a special purpose vehicle (“SPV”).<sup>10</sup> Per FAS 140, the transfer is often done through a “true sale” to a special type of SPV called a QSPE, meaning that the originator no longer has access to the securities; they are removed from the originator’s balance sheets, and there is no obligation to repay in the event of bankruptcy.<sup>11</sup> Next, the rights to collect the income streams are split into tiered, risk-based tranches; each tranche has a specific subordination, credit rating and rate of return.<sup>12</sup> Finally, a credit rating agency examines each tranche and assigns a rating.<sup>13</sup> Because the QSPE’s assets are distinct from the originator’s the QSPE is rated independently.<sup>14</sup>

An arbitrage CDO is another type of cash CDO.<sup>15</sup> Here, an asset manager—not an originating firm—transfers its assets to an SPV.<sup>16</sup> Like a balance sheet CDO, the SPV is split into tranches, rated, and sold to investors.<sup>17</sup> However, the asset manager actively manages the portfolio, and because the transfer is to an SPV, it is not

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<sup>7</sup> See generally Barry Jay Epstein & Elaine Vullmahn, *Efforts to Bail Out the U.S. Economy Could Impede Legitimate Uses of Securitization*, 7-8 MEALEY’S EMERG. SEC. LITIG. 30 (2009).

<sup>8</sup> See generally *id.*

<sup>9</sup> See generally SIVAN MAHADEVAN, ET AL., MORGAN STANLEY STRUCTURED CREDIT INSIGHTS: INSTRUMENTS, VALUATIONS, AND STRATEGIES 8 (4th ed. 2008).

<sup>10</sup> Epstein & Vullmahn, *supra* note 7.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> See generally Mahadevan, et al., *supra* note 9, at 10.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

removed from the manager's balance sheet.<sup>18</sup> Arbitrage CDOs have become increasingly popular in recent years; in 2007, about 90% of cash CDOs were arbitrage CDOs.<sup>19</sup>

Synthetic CDOs are a special type of CDO, where the underlying assets are CDSs.<sup>20</sup> That is, similar to cash CDOs, an originator or asset manager transfers CDSs to an SPV or QSPE, and it is divided into tranches, rated, and sold to investors.<sup>21</sup> Investors receive an income stream from the originator, but in the event of a default—a contingent liability—the investors must cover the loss by paying a lump sum to the originator. This structure somewhat resembles an insurance policy because it allows originators to mitigate or hedge credit risks.<sup>22</sup> However, synthetic CDOs entail the risk that illiquid investors will not be able to fully pay in the event of a contingent liability. Most synthetic CDOs mitigate this problem by requiring funding, which means that upon entry, investors must pay into a reserve fund maintained by the SPV or QSPE.<sup>23</sup> Despite the differences between these types of CDOs, their risks and role in the shutdown of the primary market are substantially similar.

### C. The Shutdown of the CDO Market

The CDO market, worth over \$2 trillion in 2008, shut down early that year following a series of downgrades by credit rating agencies.<sup>24</sup> A number of factors may have been responsible. First, the CDO market was overexposed to subprime mortgages, which were a popular underlying asset.<sup>25</sup> Instead of keeping quality mortgages as long-term assets, banks had an incentive to churn subprime mortgages into CDOs, thereby removing them from their balance sheets and earning underwriting fees.<sup>26</sup> After the housing bubble

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> Jan Job de Vries Robbe, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 10:1 (Steven L. Schwarcz ed., 3d ed. 2007).

<sup>21</sup> See generally Mahadevan, et al., *supra* note 9, at 16.

<sup>22</sup> Robbe, *supra* note 20, at § 10:4.

<sup>23</sup> Mahadevan, et al., *supra* note 9, at 18-19.

<sup>24</sup> Shenn, *supra* note 1.

<sup>25</sup> See generally Lisbeth Freeman, Note, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 586 (2009).

<sup>26</sup> *Id.* at 589.



burst, homeowners defaulted on subprime mortgages, and the properties were insufficient collateral.<sup>27</sup>

Second, credit rating agencies had a fundamental conflict of interest with CDO originators.<sup>28</sup> Rating a CDO is a difficult procedure. The ratings agency must examine all the underlying assets, possibly hundreds in total, and if the CDO contains holdings from other CDOs, their assets must be recursively examined to properly assign a rating. Due to the complexity of rating CDO tranches, originators paid credit rating agencies large fees; at the market's peak, about half of credit rating agency revenue was generated by CDO valuations.<sup>29</sup> Because CDO ratings generated such a high volume of business, credit rating agencies actually counseled originators on how to structure CDOs in order to inflate ratings.<sup>30</sup> Overvalued credit ratings may have led to a false sense of confidence and security in the CDO market, particularly if investors did not personally understand the risks of each tranche in their holdings.

Third, once a downturn in the CDO market began in early 2008, fair value accounting (mark-to-market) gave investors an incentive to sell their holdings at greatly depressed prices, leading to the shutdown of the primary market. In late 2007, FAS 157 defined fair value accounting of CDOs in a way that gave great weight to their market prices.<sup>31</sup> Consequently, to value a CDO tranche, one would look to the current trading price.<sup>32</sup> When the market began to decline, investors were faced with the decision to either cut their losses by selling CDO holdings at greatly depressed prices—incurring an actual loss—or to accept write-downs from fair value accounting.<sup>33</sup> For example, once trading prices lowered to sixty percent, fair value accounting gave investors an incentive to sell their holdings at sixty percent value; if not, they feared that the trading price would lower even further, and they would incur additional losses.<sup>34</sup> Ironically, losses from depressed trading prices may have

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<sup>27</sup> Robert O'Harrow, Jr. & Brady Dennis, *Financial Crisis: Credit Woes Sent AIG Spiraling: The Company Faced an Avalanche of Collateral Calls It Didn't Foresee and Couldn't Escape*, L.A. TIMES, Jan. 2, 2009, at C1.

<sup>28</sup> See generally Freeman, *supra* note 25, at 600.

<sup>29</sup> *Id.* at 601.

<sup>30</sup> *Id.* at 602.

<sup>31</sup> Poer, *supra* note 4.

<sup>32</sup> *Id.*

<sup>33</sup> See generally *id.*

<sup>34</sup> See generally *id.*

remained unrealized if investors held CDOs to term, but fair value accounting gave them an incentive to sell their holdings at greatly depressed trading prices, in turn realizing actual losses and undermining the market.<sup>35</sup>

Fourth, the Basel II Accord created a bubble for highly-rated CDOs. Under Basel II, which has been adopted by numerous foreign countries, investors are allowed to use their own internal risk models in calculating capital requirements.<sup>36</sup> Because AAA-rated CDOs supposedly pose less risk than securities with lower ratings, the ability to package poorly-rated securities into AAA-rated CDOs allowed international investors to skirt capital restrictions; investors claimed that because their CDO holdings were highly rated, they posed less risk and therefore should have less adverse effect on capital requirements.<sup>37</sup> However, the bubble for highly-rated CDOs quickly ended following credit downgrades in early 2008.<sup>38</sup>

Fifth, the market was flooded with low-quality CDOs. The creation of a CDO allows its originator to remove the assets from their balance sheets, earning an underwriting fee in the process. This creates an incentive to churn unwanted assets into CDOs.<sup>39</sup> Sixth, a general lack of regulation or enforcement may have contributed to the end of new CDO issuances.

Generally, the end of the CDO primary market accounted for a substantial amount of the losses and write-downs during the start of the 2007-09 global credit crisis.<sup>40</sup> For this reason, the vast majority of current discourse regarding CDOs focuses on addressing the factors responsible for the market's shut down through proposed reforms in enforcement, accounting, and regulation.

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<sup>35</sup> *See id.*

<sup>36</sup> *See generally* *Basel II: An Introduction to the New Capital Adequacy Rules*, OUT-LAW, Sept. 2008, <http://www.out-law.com/page-7096>.

<sup>37</sup> *See id.*

<sup>38</sup> *See* Shenn, *supra* note 1.

<sup>39</sup> Freeman, *supra* note 24, at 589.

<sup>40</sup> *See generally* FATEN SABRY, ET AL., NERA ECONOMIC CONSULTING, AN UPDATE ON THE CREDIT CRISIS LITIGATION: A TURN TOWARDS STRUCTURED PRODUCTS AND ASSET MANAGEMENT FIRMS 8 (2009).

#### **D. Enforcement Reforms: SEC Crackdown and Specialization**

The SEC is planning to ramp up enforcement efforts of complex securities, and CDOs are a prime target. On April 27, 2009, SEC Chairman Mary Schapiro announced a Department of Enforcement crackdown, which includes fifty new cases involving CDOs and CDSs.<sup>41</sup> Yet, Schapiro noted that the SEC lacks the resources to properly log, investigate, and track incoming tips.<sup>42</sup> Her comment may underscore the SEC's historical inability to comprehensively investigate and enforce private markets of complex securities, such as CDOs.

More significantly, during an August 5, 2009 speech to the New York City Bar Association, SEC Enforcement Director Robert Khuzami announced a reorganization of the Enforcement Division into five specialized units.<sup>43</sup> A senior SEC official speculated that the reorganization will be complete by the end of the year.<sup>44</sup> One of the new units, called the Structured and New Products Unit, will specifically handle instruments like CDOs.<sup>45</sup> Khuzami hopes that this specialization will prevent investigators from being "misled by . . . complexity."<sup>46</sup> In order to promote efficiency and "proactive decisionmaking," Khuzami plans to relocate skilled personnel to investigative roles, where they will be given great autonomy over their caseload.<sup>47</sup> Moreover, Khuzami plans to delegate his subpoena powers to senior supervisors of each unit, effectively giving each unit subpoena power.<sup>48</sup> The effect of these changes is still uncertain. The SEC has historically been "behind the curve" on enforcing complex securities, according to some critics.<sup>49</sup> Additionally, the new subpoena powers may not go far enough; some advocate that the subpoena should be "self-enforcing," so that failure to comply is

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<sup>41</sup> Malini Manickavasagam, *Schapiro Details Current Enforcement Effort Against Hedge Funds, Other Opaque Markets*, 41 SEC. REG. & L. REP. 804 (2009).

<sup>42</sup> *Id.*

<sup>43</sup> Herzfeld & Diamond, *supra* note 3.

<sup>44</sup> Yin Wilczek, *SEC Enforcement: Specialized Units Should be in Place by Beginning of New Year, SEC Official Says*, SEC. L. DAILY, Sept. 24, 2009.

<sup>45</sup> Herzfeld & Diamond, *supra* note 3.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> Wilczek, *supra* note 44.

grounds for contempt without an administrative proceeding.<sup>50</sup> Nonetheless, these measures represent a significant change in CDO enforcement.

### **E. Accounting Reforms: Fair Value and QSPEs Under Attack**

An ongoing debate rages about whether to adhere to strict fair value accounting because of the role it may have played in the shutdown of the CDO market. Many believe that fair value accounting forced investors to sell CDO holdings at a loss in order to avoid write-downs as the market declined.<sup>51</sup> Some commentators argue that this practice fully undermined the market and caused investors to realize losses that may have remained unrealized if CDOs were held to term.<sup>52</sup> In response, FAS 157-3, released in October 2008, clarified that fair value should be used, but alternative methods are appropriate in an inactive market.<sup>53</sup> That is, CDO assets should be valued using fair value methods, but if trading prices are depressed—indicated by greatly decreased trading volume and widening of bid-ask spreads—a “safety valve” method like amortized cost is appropriate.<sup>54</sup> For example, if trading prices are depressed to twenty percent but only six percent of one’s CDOs are in default, then the value of one’s holdings is ninety-four percent, not twenty percent.<sup>55</sup>

Still, there is an active debate over whether to adhere to strict fair value accounting. A January 15 Group of Thirty report cited criticisms of fair value accounting in a collapsed market.<sup>56</sup> During a meeting of the Financial Crisis Advisory Group on April 20, 2008, FASB Chairman Robert Herz underscored that fair value methods are only appropriate where there is a functioning, liquid market.<sup>57</sup>

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<sup>50</sup> *Id.*

<sup>51</sup> *See* notes 31-35.

<sup>52</sup> *Id.*

<sup>53</sup> Poer, *supra* note 4.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> Timothy Lucas, *Accounting Principles: Fair Value Controversy to Color Major Accounting Issues in 2009*, SEC. L. DAILY, Jan. 29, 2009.

<sup>57</sup> Stephen Bouvier, *Accounting Principles: Advisory Group on Fair Value Accounting Reveals Scale of Task During Credit Crisis*, SEC. L. DAILY, Apr. 22, 2009.

Yet, a December 30, 2008 SEC report notes that criticisms of fair value accounting are valid in a collapsed market but generally recommends retaining fair value accounting in most cases.<sup>58</sup> The debate over fair value accounting of CDOs is far from over.

Similarly, many criticize that FAS 140 gave originators an incentive to rid themselves of unwanted assets by turning the assets into balance sheet CDOs.<sup>59</sup> FAS 140 allows originators to remove unwanted assets and liabilities from their balance sheets if transferred to a QSPE in a “true sale” during the formation of a balance sheet CDO.<sup>60</sup> In response, FASB released FAS 166 on June 12, which overturns FAS 140 by eliminating QSPEs, effective January 1, 2010.<sup>61</sup> In short, FAS 166 makes it difficult for financial firms to remove assets from their balance sheets when creating a CDO.<sup>62</sup> Surprisingly, this change is retroactive; on January 1, originators’ balance sheets will be flooded with assets, liabilities, gains, and losses from unwanted assets they previously transferred to QSPEs.<sup>63</sup> A recent Credit Suisse report notes that this issue is still developing, and as a result, great uncertainty remains as to how this surge of assets will be represented on balance sheets or how to remove assets in the future.<sup>64</sup> In this way, the elimination of QSPEs and adherence to strict fair value accounting represents significant accounting reforms for CDOs.

#### **F. Regulatory Reforms: Proposals, Internal and External**

IOSCO, an international committee comprised of ninety-five percent of the world’s securities regulators, recently released a thoughtful proposal for regulation of currently unregulated instruments, and CDOs were a major point of discussion.<sup>65</sup> The first proposal is to (i) correct perverse incentives by requiring originators

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<sup>58</sup> Lucas, *supra* note 56.

<sup>59</sup> See notes 26, 39.

<sup>60</sup> See notes 26, 39.

<sup>61</sup> *Accounting Principles: New FASB Guidance Likely to Balloon Balance Sheets*, Credit Suisse Says, *supra* note 5.

<sup>62</sup> See generally *id.*

<sup>63</sup> See *id.*

<sup>64</sup> *Id.*

<sup>65</sup> TECHNICAL COMMITTEE OF THE INT’L ORG. OF SEC. COMMISSIONS, *supra* note 6, at 5.

to retain long-term holdings, (ii) increase transparency by releasing documents and disclosures of originators' risk practices, (iii) require independent verification of valuations, and (iv) mandate continual product maintenance and upkeep reports.<sup>66</sup> Second, increase risk awareness and management by (i) requiring greater disclosure of the underlying asset pool and underwriting procedures, (ii) increasing suitability requirements and redefining the meaning of "sophisticated investor," and (iii) encouraging the development of alternate risk-assessment procedures for buyers.<sup>67</sup> Finally, the report notes a lack of regulatory oversight of important players in the CDO market, like credit rating agencies.<sup>68</sup> Therefore, IOSCO generally recommends that jurisdictions assess the scope of their regulatory reach in order to determine whether other regulatory enhancements are necessary.<sup>69</sup> Ultimately, however, despite its call for broad reform, IOSCO's proposals have yet to receive significant attention from regulators.

### G. Conclusion

In all, the shutdown of the CDO market spurned a great deal of public discourse. However, there is relatively little discussion of general, far-reaching issues such as the merits of an unregulated CDO market. Instead, the reforms largely seek to address specific causes of the market's shutdown. For this reason, the reforms center on markedly fragmented issues in enforcement, accounting, and regulation. In this way, the future viability of a primary market of CDO issuances may depend upon whether these various fragmented reforms can adequately correct a larger, systemic market failure.

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<sup>66</sup> *Id.* at 19.

<sup>67</sup> *Id.* at 23-24.

<sup>68</sup> *Id.* at 24.

<sup>69</sup> *Id.*

<sup>70</sup> Student, Boston University School of Law (J.D. 2011).

## XI. *Dark Pool Liquidity*

### A. Introduction

Dark Pool Liquidity is a type of Alternative-Trading System (“ATS”) exchange in which liquid assets are bought and sold in such a way that transactions are not displayed on the public market.<sup>1</sup> The price and identity of the trading companies are not revealed, allowing traders to keep transactions confidential.<sup>2</sup> Confidentiality is important for large-block traders of liquid assets because these traders’ strategies are closely monitored by competitors; dark pool trading also provides a cost savings benefit.<sup>3</sup> The practice of dark pool liquidity originated in the 1980s; at the time, these exchanges were known as “securities crossing networks,” and were mainly popular among hedge funds.<sup>4</sup> As the market share of dark pools increases, government regulation becomes more likely. In response, dark pools consolidate like public traders, this decreases some of their confidentiality and thus their attractiveness.<sup>5</sup>

Seth Merrin, founder of Liquidnet (one of the largest independently owned dark pool electronic marketplaces in the U.S.), has commented that buyers, more cautious about investing in a volatile market, make it difficult for new brokers to build dark pool networks.<sup>6</sup> Merrin predicts that those dark pool models that do survive will consolidate—this has to do not only with a slow economy, but also because many newer dark pools have not developed adequate security measures against gaming (where public traders monitor prices to discover hidden dark pools), which is

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<sup>1</sup> Jeremy Grant, *Dark pool trio forms European alliance*, FINANCIAL TIMES, May 7 2009, [http://www.ft.com/cms/s/0/7f84eb7c-3b2d11deba9100144feabdc0.html?ftcamp\\_rss&nclick\\_check=1](http://www.ft.com/cms/s/0/7f84eb7c-3b2d11deba9100144feabdc0.html?ftcamp_rss&nclick_check=1).

<sup>2</sup> David Bogoslaw, *Big Traders Dive Into Dark Pools*, BUSINESS WEEK, Oct. 3, 2007, [http://www.businessweek.com/investor/content/oct2007/pi2007102\\_394204.htm](http://www.businessweek.com/investor/content/oct2007/pi2007102_394204.htm).

<sup>3</sup> *Id.*

<sup>4</sup> Nick Rockel, *Dark Pool Surge shows signs of slowdown*, ABSOLUTE RETURN & ALPHA, June 16, 2009.

<sup>5</sup> Sang Lee, *Dark Pools 2009: Not So Dark Anymore*, ADVANCED TRADING, Oct. 5, 2009, <http://www.advancedtrading.com/crossingnetworks/showArticle.jhtml?articleID=220301072>.

<sup>6</sup> *Merrin Sets Sites on Expansion*, WALL STREET LETTER, Feb. 16, 2009 (LEXIS, ALL NEWS).

essential for stability.<sup>7</sup> Liquidnet, facing competition, has launched a new service called H2O Blocks, which “brings reserve liquidity sitting in algorithms to buy-side traders’ desks,” providing traders with another source of liquidity.<sup>8</sup> Moreover, adverse selection, where well-informed traders quickly push prices on less-informed counterparties, also increases the risk of dark pool transactions.<sup>9</sup> Nonetheless, studies in 2009 estimate that dark pool liquidity encompasses around 10% of daily equity trading in the U.S., and in 2010 that number is expected to rise to 15%.<sup>10</sup> There are currently over sixty operating dark pool liquidity brokers worldwide.<sup>11</sup> Dark pool liquidity has increased in popularity abroad, especially in Europe. The process of starting up dark pools in Europe produces different risks that investors contemplate before investing in international dark pooling.<sup>12</sup>

### B. Strategy and Dark Pool Trading

Gaming and adverse selection create policy problems like price discovery and fairness. Adverse selection, for example, actually produces price discovery problems for traders inside dark pools, because counterparties with more experience can adversely shift prices.<sup>13</sup> Gaming results when either public traders or well-informed dark pool traders try to acquire dark pools of liquidity because of the large volume of shares they would receive relative to the cost.<sup>14</sup> For example, Liquidnet typically charges traders at two cents per share;

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<sup>7</sup> *Id.*

<sup>8</sup> Nina Mehta, *Liquidnet to Sellside: Send Blocks*, TRADERS MAGAZINE, May 2009, [http://www.tradersmagazine.com/issues/20\\_294/-103712-1.html](http://www.tradersmagazine.com/issues/20_294/-103712-1.html).

<sup>9</sup> James Ramage, *Joint Study Tackles Dark Aggregators*, TRADERS MAGAZINE, Aug. 21, 2009, <http://www.tradersmagazine.com/news/pipeline-alliancebernstein-dark-pool-aggregator-algorithm-adverse-selection-104291-1.html>.

<sup>10</sup> Rockel, *supra*, note 4.

<sup>11</sup> *Id.*

<sup>12</sup> See Josephine Moulds, *LSE's stock has fallen but it is building a platform for success*, THE DAILY TELEGRAPH (U.K.), Sept. 24, 2009, <http://www.telegraph.co.uk/finance/markets/questor/6227852/LSEs-stock-has-fallen-but-it-is-building-a-platform-for-success.html>; see also Merrin, *supra* note 6 (commenting on Liquidnet's liquidity pools in Europe).

<sup>13</sup> Ramage, *supra* note 9.

<sup>14</sup> Ramage, *supra* note 9.



when the average volume of shares for a dark pool trader is very high, traders enjoy a significant amount of savings using dark pool liquidity.<sup>15</sup> Public exchange traders argue that gaming is necessary to rectify the price discovery unfairness that dark pool traders enjoy, but dark pool traders respond that so-called “liquidity mapping algorithms,” that detect where dark pools lurk, eliminate confidentiality.<sup>16</sup> Many scholars argue that these unintended consequences of the dark pool market stem from the recent wave of market fragmentation which has “driven liquidity underground.”<sup>17</sup> This makes dark pool trading popular for large-block traders, but public traders are attempting to push these underground markets to the surface.<sup>18</sup>

### 1. Gaming

Gaming is a phenomenon whereby a public buyer monitors reported prices and strategically buys shares that are suspected to contain dark pools of liquidity.<sup>19</sup> Buyers accomplish this by using high-speed algorithms to create an unattractive “lit market.”<sup>20</sup> However, dark pool liquidity is particularly difficult to track, so this strategy of using algorithms to ping pools with “small sell orders in an effort to discover if a large buy order is resting” underneath, remains a risky one.<sup>21</sup> If successful, however, buyside public traders can manipulate prices against sellers in dark pools.<sup>22</sup> Furthermore, algorithms can track liquidity transactions across dark pools, detecting anomalies to find hidden liquid assets.<sup>23</sup> Dark pool brokers

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<sup>15</sup> Bogoslaw, *supra* note 2.

<sup>16</sup> Jeff Brown, *Liquidity Mapping: Jump into the Dark Pool*, 5 WALL STREET & TECH., July 1, 2009 at 30.

<sup>17</sup> Lawrence Leibowitz, Group Executive Vice President & Head of U.S. Mkts. & Global Tech. for NYSE Euronext, Address at the Annual Secs. Indus. & Fin. Mkts. Ass’n Mkt. Structure Conference (May, 2009), in TRADERS MAGAZINE, Aug. 1, 2009, at 14.

<sup>18</sup> Brown, *supra* note 16.

<sup>19</sup> Alexandra Zendrian, *Don’t Be Afraid of the Dark Pools*, FORBES, May 18, 2009, <http://www.forbes.com/2009/05/18/dark-pools-trading-intelligent-investing-exchanges.html>.

<sup>20</sup> Grant, *supra* note 1.

<sup>21</sup> Rockel, *supra* note 4.

<sup>22</sup> *Fair Game?* THE TRADE MAGAZINE, Apr.-June 2008, No. 16, available at <http://www.thetradenews.com/fairgame>.

<sup>23</sup> Brown, *supra* note 16.

operating independent networks, such as Liquidnet, have internal monitoring programs—if a member attempts to “ping” shares from the inside, brokers remove the member from the network.<sup>24</sup> BIDS Trading uses a Scorecard system whereby members whose trade patterns are evidence of gaming are removed from the consortium.<sup>25</sup> Gaming has the potential to change the way brokers have traditionally monitored prices, from a “quote-centric” routing system, to a liquidity mapping model to keep up with the incredibly fast exchanges associated with dark pooling.<sup>26</sup>

## 2. Adverse Selection

Adverse Selection occurs where a dark pool trader is effectively misled by another dark pool trader; that is, one with more experience and knowledge about either the direction of the traded stock, or about the relative liquidity of each party misleads another dark pool trader who does not have access to this information.<sup>27</sup> Advanced traders manipulate “natural adverse selection,” where falling stocks fill more quickly than rising stocks; because there are more buyers of rising stocks, it takes longer for these buyers to fill orders.<sup>28</sup> Traders prevent releasing “indications of intent” (“IOIs”), expressions of intent to trade a security “sent by a broker to a specific set of counterparties,” because if released to the public, adverse selection is likely.<sup>29</sup> Pipeline Trading is one example of a dark pool trader using preventive measures to retain its confidentiality. Pipeline has released an “Algorithm-Switching Engine that uses real-time market changes to change buy-side strategies, allowing new buyers to counteract the sophisticated counterparties engaging in adverse selection.”<sup>30</sup> The policy problems created by adverse selection are

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<sup>24</sup> Rockel, *supra* note 4.

<sup>25</sup> Bogoslaw, *supra* note 2.

<sup>26</sup> Brown, *supra* note 16.

<sup>27</sup> Ramage, *supra* note 9.

<sup>28</sup> *How Long to Leave an Order in the Dark?* THE TRADE NEWS, Feb. 19, 2009, <http://www.thetradenews.com/trading-venues/dark-pools/2809>.

<sup>29</sup> *Neovest Announces Actionable Indications of Interest*, COMPUTER BUSINESS REVIEW ONLINE, Apr. 24, 2007, [http://www.cbronline.com/news/neovest\\_unveils\\_ioi\\_trading\\_service](http://www.cbronline.com/news/neovest_unveils_ioi_trading_service).

<sup>30</sup> Henri Waelbroeck, *Opportunistic Trading*, in 2009 Electronic & Algo Trading Report, INST. INV. NEWS, Sept. 2009, [www.pipelinetrading.com/resources/ALGO-Waelbroeck-Eprint.pdf](http://www.pipelinetrading.com/resources/ALGO-Waelbroeck-Eprint.pdf).

many, but most prominent are the discouragement of investment in dark pools by “uninformed traders,” who are generally not the “high-frequency traders” (“HFTs”) that are experienced with dark pools.<sup>31</sup>

### C. Government Regulation of Dark Pool Liquidity

Government oversight of dark pool liquidity has been scant since its inception.<sup>32</sup> However, increased government regulation may occur in the next few years, as worries about a deregulated economy continue to rise.<sup>33</sup> Proponents of government regulation of dark pool liquidity generally point to fairness concerns, where public price discovery is distorted over time because of dark pool liquidity.<sup>34</sup> In addition, market disaggregation through high speed transactions (for example, dark pool liquidity) has, in the view of many policymakers, contributed to the economic recession due to a lack of government oversight.<sup>35</sup>

#### 1. Regulation NMS

One of the major attempts to overhaul the private equity market (which includes dark pool liquidity) was unfolded in Regulation NMS. Regulation NMS was introduced under the Securities and Exchange Act of 1934, in an effort to increase fairness and transparency in the securities market.<sup>36</sup> Regulation NMS mandates that public traders publish the “national best bid or offer” (“NBBO”) for each security, but does *not* mandate dark pool traders to publish quotes.<sup>37</sup> As a result, the number of ATSS like dark pools, fearful of adverse selection because of Regulation NMS’s disclosure

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<sup>31</sup> Ramage, *supra* note 9.

<sup>32</sup> Sarah N. Lynch, *Schumer and NYSE Chief Ask SEC to Regulate Dark Pools*, WALL ST. J., Oct. 21, 2009, <http://online.wsj.com/article/SB125606283321896991.html>.

<sup>33</sup> Leibowitz, *supra* note 17.

<sup>34</sup> Kaufman, *On Eve of Anniversary of Lehman Collapse, Calls for Forward Looking Approach To Financial Regulation*, FED. INFO. & NEWS DISPATCH, INC., Sept. 14, 2009, 2009 WLNR 18116665.

<sup>35</sup> Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks to Economic Club of New York (Feb. 17, 2009), in WALL ST. J., Feb. 17, 2009, <http://online.wsj.com/public/resources/documents/EconClub.PDF>.

<sup>36</sup> 17 C.F.R. § 242.600 (2005).

<sup>37</sup> Zohar Hod, et al., *Shining a light on dark liquidity*, IBM Global Business Services, Jan. 2007, [http://www.935.ibm.com/services/us/gbs/bus/pdf/dark\\_liquiditybcw01629-usen-00.pdf](http://www.935.ibm.com/services/us/gbs/bus/pdf/dark_liquiditybcw01629-usen-00.pdf).

requirements, increased after Regulation NMS passed in 2005.<sup>38</sup> While public traders individually might not be concerned with the economic reality of what they are buying, the government tried to account for this system failure by passing Regulation NMS.<sup>39</sup> Thus, Regulation NMS intended to rectify the economic fictions created by private equity, but it actually enhanced ATS models, decreasing market transparency.<sup>40</sup> Regulation NMS, by requiring disclosure of the lowest-priced seller on exchanges, forced large-block public traders underground to avoid disclosure, increasing transactions in dark pool liquidity.<sup>41</sup>

## 2. Regulatory Reform

Senators Kaufman (D, DE) and Schumer (D, NY) have been on the forefront among those advocating for the SEC to reform and increase regulation over dark pool liquidity in 2009. First, after the SEC unanimously voted to propose reporting requirements for dark pools (though none have been specifically proposed), Sen. Schumer introduced drafts of legislation which included the “real-time reporting of trade information.”<sup>42</sup> Schumer’s recommendations for real-time reporting may prove cumbersome for dark pool traders, as trades are completed within milliseconds.<sup>43</sup> Second, Sen. Kaufman alluded to the traditional preference in the U.S. for liquidity over fairness, and argued that a return to fairness principles is necessary to ease market fragmentation, a volatile market and the burden on public securities traders.<sup>44</sup> Kaufman, in his speech to the U.S. Senate on the eve of the anniversary of the Lehman Brothers collapse, remarked that institutional investors participating in dark pool liquidity networks “violate the spirit of rules that require fair and

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<sup>38</sup> Leibowitz, *supra* note 17.

<sup>39</sup> Bogoslaw, *supra* note 2.

<sup>40</sup> *Id.*

<sup>41</sup> Leibowitz, *supra* note 17.

<sup>42</sup> Press Release, Sen. Charles E. Schumer, Schumer Calls on Federal Authority to Level the Playing Field for Dark Pools, Exchanges (Oct. 20, 2009).

<sup>43</sup> Brown, *supra* note 16.

<sup>44</sup> Interview by Betty Liu with Sen. Ted Kaufman, Bloomberg TV, (Aug. 25, 2009), *available at*

<http://www.allbusiness.com/legal/banking-law-finance-regulation/12786136-1.html>.

non-discriminatory access to quotations.”<sup>45</sup> Kaufman compared Regulation NMS’s requirement of a “best execution of trade” to monitor transactions to a telescope, regulating only visible, slower trades, where high-frequency traders perform transactions in milliseconds, more like a microscope.<sup>46</sup> In fact, speed is crucial for dark pool traders, primarily to avoid adverse selection (see above) by completing transactions before shares are made available for public scrutiny.<sup>47</sup> Dark pools average around ten milliseconds to complete an order, and others move at a microsecond-pace.<sup>48</sup>

Chairman Schapiro explained the details of the SEC’s review of dark pool liquidity transactions by reiterating the common concern that dark pools distort the public price discovery process, and also raised concerns about information access.<sup>49</sup> Subsequent to the SEC’s vote to propose new rules on dark pools, Schapiro said that IOI’s exchanged within dark pools create a “two-tiered market” because only private pools can access this information, resulting in unfair and inefficient trading.<sup>50</sup> Of course, opacity is the primary objective of dark pool traders.<sup>51</sup> If SEC reform is sweeping enough (for now, this seems unlikely because no bills have been proposed, but is certainly possible), dark pools will dissolve, either due to the economic recession or to increased government regulation.<sup>52</sup>

The Financial Industry Regulatory Authority (“FINRA”) has taken an interest in dark pool liquidity as well, particularly in maintaining the integrity of IOIs.<sup>53</sup> FINRA issued Regulatory Notice 09-28 to its members, warning that “natural” IOIs must be “truthful,

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<sup>45</sup> Kaufman, *supra* note 35.

<sup>46</sup> *Id.*

<sup>47</sup> Grant, *supra* note 1.

<sup>48</sup> Rockel, *supra* note 4.

<sup>49</sup> Peter Elstob, *SEC’s Schapiro on dark pools, rating agencies, and why she supports global accounting standards*, COMPLINET, Oct. 9, 2009, <http://www.complinet.com/news/article/articleTeaser/?articleId=125528>.

<sup>50</sup> SEC Chairman Mary L. Schapiro, Statement on Dark Pool Regulation Before the Commission Open Meeting, U.S. SEC & EXCH. COMM’N, Oct. 21, 2009, <http://sec.gov/news/speech/2009/spch102109mls.htm>.

<sup>51</sup> Lee, *supra* note 5.

<sup>52</sup> Merrin, *supra* note 6.

<sup>53</sup> Nina Mehta, *FINRA Warns Brokers to Send Truthful IOIs*, TRADERS MAGAZINE, May 29, 2009, <http://www.tradersmagazine.com/news/finra-truthful-IOIs-103831-1.html> (commenting on the tension between the need for accurate IOI’s on the buy-side, and the need for efficient transactions on the sell-side).

accurate, and not misleading” regarding trading volume and representation.<sup>54</sup> This issue alludes to dark pools, where actors issue IOIs that do not reflect an accurate trade volume (the volume traded is higher than the amount reported, to retain the privacy of large-block trading).<sup>55</sup>

#### **D. Future Considerations: Dark Pool Liquidity Abroad**

Finding demand in the U.S. for dark pool liquidity, more firms are investing in dark pools (usually independently run) abroad, particularly in Europe.<sup>56</sup> Some privacy obstacles to establishing dark pools in Europe include the lack of a uniform tracking mechanism, making defragmentation a more pressing concern for investors.<sup>57</sup> In May 2009, Goldman Sachs, Morgan Stanley and UBS responded to these concerns by providing mutual access to their dark pool trading networks in Europe.<sup>58</sup> NASDAQ OMX Europe is also launching “Neuro Dark” in 2009, which will allow entries of any size (not just large block trading), to satisfy increasing demand for dark pool liquidity across a broader spectrum of investors.<sup>59</sup> Neuro Dark will feature “SELF,” a complicated ordering system where traders can “prioritize their own orders” while still retaining access to the general liquidity pool.<sup>60</sup> Increased demand for dark pools in Europe has also increased the need for algorithmic security features such as Neonet’s

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<sup>54</sup> FIN. INDUS. REG. AUTH., REGULATORY NOTICE, INDICATIONS OF INTEREST (May 2009), <http://www.finra.org/Industry/Regulation/Notices/2009/P118780>.

<sup>55</sup> Stavros Gadinis, Comment, *Market Structure for Institutional Investors: Comparing the U.S. and E.U. Regimes*, 3 V.A. L. BUS. REV. 311, 321 (2008).

<sup>56</sup> Merrin, *supra* note 6.

<sup>57</sup> Ivy Schmerken, *Fragmented Liquidity in Pan-European Securities Hinders Transparency, Best Execution*, ADVANCED TRADING, Apr. 16, 2009, <http://www.advancedtrading.com/exchanges/showArticle.jhtml?articleID=216600031>.

<sup>58</sup> Grant, *supra* note 1.

<sup>59</sup> NASDAQ OMX Europe Announces Launch of NEURO Dark, ACTUSNEWS ENGLISH, May 7, 2009.

<sup>60</sup> *Id.*

“Neonet Dark,” which sweeps European exchanges for liquidity pools.<sup>61</sup>

Dark pools face a tougher challenge in Asian markets. Regulators in Asia keep as much trading on the public exchange as possible, because Asian markets already have “lower levels of liquidity;” if dark pools are introduced, liquidity will be even scarcer.<sup>62</sup> In other ways, however, Asia is a prime market for dark pool liquidity, because unlike the time-consuming technological developments that American and European models had to develop for high-speed trading, Asian markets will be able to simply adopt those strategies immediately.<sup>63</sup> Asia’s economic culture may also prove amenable to dark pools over time. Schapiro fears a “two-tiered market,” but Ian Smith, head of AES Product for Asia Pacific for Credit Suisse, says competition between public and private exchanges “provide real benefits to end investors.”<sup>64</sup> Despite its potential, the economic downturn that decreased liquidity worldwide has prevented dark pool development in Asia, where dark pool activity totals below 1% of daily electronic trading.<sup>65</sup>

Some countries have articulated official state policies responding to dark pool liquidity, some favorable and some not. The London Stock Exchange recently said that there is a place for dark pools, having launched its own pool, Baikal (named after Europe’s deepest lake).<sup>66</sup> In contrast, Thomas Callahan, a high-level U.S. NYSE Euronext executive, is pushing the SEC to increase regulation of ATS’s, arguing that dark pools create “private markets for securities transactions,” harming price discovery and exacerbate short-term volatility.<sup>67</sup> Similarly, the President of the Indian National

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<sup>61</sup> *Neonet Launches Dark Algorithm*, BUSINESS WIRE, Sept. 23, 2009, [http://www.businesswire.com/Portal/site/google/?ndmViewId=news\\_view&newsId=20090923005428&newsLang=en](http://www.businesswire.com/Portal/site/google/?ndmViewId=news_view&newsId=20090923005428&newsLang=en).

<sup>62</sup> Bayani S. Cruz, *Longing to become unfettered*, THE ASSET, July 2009, <http://www.theasset.com/article/17139.html>.

<sup>63</sup> Lauren Hilgers, *Leapfrogging Dark Pools*, INCISIVE MEDIA LTD., June 2, 2008, <http://www.incisivemedia.com/public/showPage.html?page=796008>.

<sup>64</sup> Bayani, *supra* note 62.

<sup>65</sup> Carlos Tejada, *Asia’s ‘Dark Pools’ Lack Depth Due to Downturn*, WALL ST. J., Apr. 22, 2009, <http://online.wsj.com/article/SB124034401750240151.html>.

<sup>66</sup> Moulds, *supra* note 12.

<sup>67</sup> Peter Chapman, *New Scrutiny: SEC Worried About Dark Pools*, TRADERS MAGAZINE, July 1, 2009, at 24.

Stock Exchange, Ravi Narain, expressed fairness concerns about dark pools, saying that “increased liquidity cannot come at the expense of transparency.”<sup>68</sup>

### E. Conclusion

The tension between fairness and liquidity is never so pointed as it is in evaluating arguments for and against dark pool liquidity. As dark pools increase in number, commentators argue that this trend furthers global market disaggregation.<sup>69</sup> Increased demand for dark pools, particularly from smaller traders, sheds positive light on their future. However, their fate ultimately depends on how stringent new government regulations will be (if any are passed at all). Where traditionally dark pooling has been utilized by HFTs, who benefit from dark pools’ highly efficient transaction rates, small traders in a volatile economy may now take refuge in dark pools of liquidity.<sup>70</sup> Regulators fear that too much dark pool liquidity will draw business away from Wall Street and NASDAQ. As scholar Jeff Brown noted, “We may be witnessing the early stages of a sustainable and fundamental shift in the trading landscape, as dark pools move from the periphery and take center stage.”<sup>71</sup>

Aubrey Gallo<sup>72</sup>

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<sup>68</sup> *Shining light on dark pools*, MINT, Sept. 3, 2009, <http://www.livemint.com/2009/09/03010214/Quick-Edit-Shining-Light-On.html>.

<sup>69</sup> Leibowitz, *supra* note 17.

<sup>70</sup> *NASDAQ OMX*, *supra* note 59.

<sup>71</sup> Brown, *supra* note 16.

<sup>72</sup> Student, Boston University School of Law (J.D. 2011).



## ***XII. Flash Trading***

### **A. Introduction**

Flash trading is a controversial practice utilized by some equity and option exchanges. Flash trading centers around unfilled orders.<sup>1</sup> When an exchange that participates in flash trading receives a bid (or offer) for a certain amount of shares, it will first check its own books to see how many it can fill.<sup>2</sup> If the exchange itself cannot complete the order, it will “flash” the order to a select group of customers, to which the exchange charges a fee. These customers are allowed to see the order before it goes to the consolidated quotation feed.<sup>3</sup> The length of the flash varies by exchange and market, but most last for approximately 30 milliseconds; the maximum allowable time is 500 milliseconds, or half a second.<sup>4</sup> During this flash time, high-speed computers are used to fill the bid.<sup>5</sup> If, after the flash time, the orders are still not filled by that special group of customers, the order is either cancelled or routed to the public.<sup>6</sup>

Flash orders can also be used by traders to get an early peek at how others are trading.<sup>7</sup> Traders do this by sending out a small order to an exchange or Alternative Trading System (“ATS”) that utilizes flash orders and waiting for a contra-side order response from the exchange.<sup>8</sup> If the exchange receives a big contra-side response that is not filled because only a small order went out, they then flash the order to its participants, one of which will be the trader that sent out the original small order.<sup>9</sup> The trader can then match the large number of stocks or options orders that were not filled with its own

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<sup>1</sup> James Bone, *So What is Flash Trading Anyway and Why Does the SEC Care*, CORPORATE COMPLIANCE INSIGHTS, Aug. 12, 2009, <http://www.corporatecomplianceinsights.com/2009/flash-trading-algorithmic-trading-sec-investigating>.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> Nina Mehta, *Flash Point: Equities industry clashes over flash and step-up Orders*, TRADERS MAG., July 1, 2009, at 34.

<sup>5</sup> Bone *supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> Jenny Anderson, *SEC Moves to Ban Edge Held by Fast Traders*, N.Y. TIMES, Sept. 18, 2009, at A1.

<sup>8</sup> John Durie, “*Dark Pools*” lack transparency, AUSTRALIAN, Oct. 2, 2009 at 32, available at 2009 WLNR 19338030.

<sup>9</sup> *See id.*

orders it originally did not send out.<sup>10</sup> Flash orders are also known as “step up” or “pre-routing display” orders.<sup>11</sup> Due to recent activities and developments, the Securities and Exchange Commission (SEC) proposed rules to ban the practice of flash trading in the United States.<sup>12</sup>

### B. A History of Flash Trading

Flash Trading is often compared to another practice called high frequency trading.<sup>13</sup> This practice originally had to do with market makers (brokers and dealers) on the floor of exchanges that would get to see the prices and bids minutes before the ticker displayed the price to the public.<sup>14</sup> During this time, the floor traders would receive a better price for their securities since the information was not yet public.<sup>15</sup> In response to this practice, the SEC successfully moved to ban floor trading on exchanges with volatile price fluctuations by 1965.<sup>16</sup> In proposing this change, the SEC cited many of the same problems that flash trading is causing today, such as two-tiered markets and private investors.<sup>17</sup>

In 1978 Congress adopted Rule 602 of the Regulation NMS pursuant to 17 CFR 242. Rule 602 states that each exchange must “make available to vendors the best bid [and] best offer.”<sup>18</sup> The best offer is the lowest price a dealer will accept when selling a security and the best bid is the highest price a dealer will pay when buying a security.<sup>19</sup> The SEC enacted this Rule to protect the public and make sure they have access to the best prices at which the specialists and

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<sup>10</sup> *See id.*

<sup>11</sup> Mehta, *Flash Point*, supra note 4.

<sup>12</sup> Mary L. Schapiro, Chairman Sec. & Exch. Comm’n., Speech by SEC Chairman: Statement before the SEC Open Meeting–Flash Orders (Sept. 17, 2009), available at <http://sec.gov/news/speech/2009/spch091709mls-flash.htm>.

<sup>13</sup> Anderson, supra note 7.

<sup>14</sup> David Silver, Op-Ed, *a Short History of Fast Times on Wall Street*, N.Y. TIMES, Sept. 18, 2009, at A31.

<sup>15</sup> *See id.*

<sup>16</sup> *Second Segment of SEC Market Study Report Filed*, SEC. & EXCHANGE COMMISSION NEWS DIG. (U.S. Sec. & Exch. Comm’n), July 17, 1963, at 11.

<sup>17</sup> *Id.*

<sup>18</sup> 17 CFR 242.602.

<sup>19</sup> *Trade Execution: Rules your Brokerage Firm must Follow*, <http://www.sec.gov/answers/trdexbd.htm> (last visited Oct. 13, 2009).

market makers are willing to trade.<sup>20</sup> However, Rule 602(a)(1)(i)(A) builds in an exception for “any bid or offer executed immediately after communication.”<sup>21</sup>

When the SEC adopted Rule 602, most trading was done on the floor of the exchanges. However due to developments in technology, people were slowly replaced by computers using highly complex algorithms.<sup>22</sup> This process, called algorithmic trading or high-frequency trading, allows computers to take bids and offers and fill trades in less than a second while scanning dozens of market places simultaneously.<sup>23</sup> Algorithmic trading accounts for about 70% of the trading in the market today.<sup>24</sup>

### C. Flash Trading Today

Due to high speed computers and the use of algorithmic trading, trades can be completed in less than one second.<sup>25</sup> Because flash orders are executed “immediately”, they fall under the Rule 602(a)(1)(i)(A) exception.<sup>26</sup> Flash orders find their roots back in 2004 when the SEC approved a rule that allowed orders for options to be flashed electronically to market participants for a three second period instead of on the floor of the exchange.<sup>27</sup> In 2006, the SEC approved the use of flash trading for an equities trading platform on the Chicago Board Options Exchange.<sup>28</sup> The SEC determined that less than half a second was “immediate” and that is where the 500 millisecond maximum for flash orders came from.<sup>29</sup> After the SEC

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<sup>20</sup> *Id.*

<sup>21</sup> 17 CFR 242.602.

<sup>22</sup> Nina Mehta, *SEC Adopts Proposal to Ban Flash Orders*, TRADERS MAG. ONLINE NEWS, Sept. 18, 2009, <http://www.tradersmagazine.com/news/sec-proposal-ban-flash-orders-104384-1.html>.

<sup>23</sup> Anderson, *supra* note 7.

<sup>24</sup> Ivy Schmerken, *Seth Merrin Examines the Pros and Cons of High Frequency Trading*, ADVANCED TRADING, Aug. 19, 2009, <http://advancedtrading.com/regulations/showArticle.jhtml?articleID=219400777>.

<sup>25</sup> Silver, *supra* note 14.

<sup>26</sup> Elimination of Flash Order Exception from Rule 602 of Regulation NMS, 74 FR 48632-01 (proposed Sept. 23, 2009) (to be codified at 17 C.F.R. pt. 242) at 5 [hereinafter *Flash Order Ban Proposal*].

<sup>27</sup> *Id.* at 12.

<sup>28</sup> *Id.*

<sup>29</sup> *Flash Trading*, PRACTISING LAW INSTITUTE, IN BRIEF, Aug. 29, 2009, <http://inbrief.pli.edu/2009/08/flash-trading.html>.

approved these rules for one exchange, other exchanges adopted similar rules and practices.<sup>30</sup> Many opposed the rule adoptions regarding flash orders and the SEC approval of them, but there is not much case law on the matter.<sup>31</sup> NYSE Euronext, the holding company of the New York Stock Exchange (“NYSE”) and protestor of flash trading, stated that “[in today’s trading environment] where trading and reaction time are discussed in micro seconds, an order that is held for even 500 milliseconds cannot be deemed an ‘immediate’ execution.”<sup>32</sup>

In July 2009, flash orders represented about 2.8% of the 9 billion shares of stocks traded in the United States.<sup>33</sup> In the options market, flash orders represented about 1.9% of total trading volume.<sup>34</sup>

Despite the arguments in favor of flash trading (discussed below), the SEC decided that the costs of flash trading outweigh its benefits. The SEC stated in its proposal for changing Rule 602 that by implementing this change, it will prioritize the benefits to the long term investors over the benefits to short term investors.<sup>35</sup>

#### **D. Benefits of Flash Trading**

The most common argument in favor of flash trading is that it increases liquidity.<sup>36</sup> The use of flash orders allows for another outlet for stocks to be traded if, when orders arrive at the exchange, there is no contra-side order.<sup>37</sup> Practices, such as exchanges offering rebates to liquidity providers, incentivize people to create these high speed practices that increase liquidity, but reduce transparency.<sup>38</sup>

Proponents also argue that flash trading makes individual markets more efficient.<sup>39</sup> Flash orders allow for better matchups

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<sup>30</sup> *Flash Order Ban Proposal*, *supra* note 26 at 12

<sup>31</sup> *Id.* at 13.

<sup>32</sup> *Id.* at 13-14.

<sup>33</sup> Anderson, *supra* note 7.

<sup>34</sup> *Flash Order Ban Proposal*, *supra* note 26, at 15.

<sup>35</sup> *Id.* at 16.

<sup>36</sup> Silver, *supra* note 14.

<sup>37</sup> *Flash Order Ban Proposal*, *supra* note 26, at 20.

<sup>38</sup> *Rise of the Machines*, THE ECONOMIST, July 30, 2009 at 64.

<sup>39</sup> Anderson, *supra* note 7.

between bid and asked prices.<sup>40</sup> Since the bid/offer is shown to the members that receive flash orders before it is routed to the market, it can be matched up against more offers/bids at that exchange than it normally would before being routed to other exchanges.<sup>41</sup> Though this is a benefit, the spread between the bid price and ask price could eventually be compressed down to zero.<sup>42</sup> If a spread reaches zero, this could create a locked market (explained in more detail below), which the SEC prohibits in public markets.<sup>43</sup>

An advantage of flash trading to the one submitting the bid or offer is that as long as the order is executed internally, the submitter does not have to pay an additional charge to reroute your order out to another exchange.<sup>44</sup> Public customers benefit from this both due to the better price they get, since many times flash orders generally display prices that are better than the best displayed price in the consolidated quotation data, and by the reduction of transaction costs.<sup>45</sup> Another benefit that stems from the lower transaction costs is that traders get more size out of their orders and are able to move more securities for the same amount of money.<sup>46</sup>

Lowered transaction costs, improved liquidity, and efficient markets allow for sophisticated, fast moving traders to gain while slower market participants lose out.<sup>47</sup>

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<sup>40</sup> Joe Ratterman, *Flash Order Myths*, FORBES.COM, July 30, 2009, <http://www.tradersmagazine.com/news/sec-proposal-ban-flash-orders-104384-1.html>.

<sup>41</sup> See, *Flash Order Ban Proposal*, *supra* note 26, at 8.

<sup>42</sup> Ratterman, *Flash Order Myths*, *supra* note 40.

<sup>43</sup> Joe Ratterman, *July 2009 Newsletter*, BATS GLOBAL MARKETS NEWSLETTER (BATS Exch., Inc., Kansas City, Kan.) July 7, 2009 at 4 [hereinafter Ratterman, *BATS Newsletter*].

<sup>44</sup> Kid Dynamite, *Why You Really Shouldn't Care About Flash Trading*, SEEKING ALPHA, Sept. 21, 2009, <http://seekingalpha.com/article/162387-why-you-really-shouldn-t-care-about-flash-trading>.

<sup>45</sup> Nina Mehta, *ISE Suggests Displaying Flash Orders to All*, TRADERS MAG. ONLINE NEWS, Aug. 19, 2009 <http://www.tradersmagazine.com/news/flash-orders-locked-markets-104260-1.html?pg=1>.

<sup>46</sup> *Id.*

<sup>47</sup> Anderson, *supra* note 7.

### E. Disadvantages of Flash Trading

The most common argument against flash trading is that it creates a two-tiered market by allowing only certain market participants to be able to access information about the best available prices for listed securities.<sup>48</sup> The SEC implemented the consolidated quotation data streams so that there would be a single source of information on the best prices for a listed security across all markets.<sup>49</sup> This way the public does not have to search all the different exchanges and markets in order to learn the best prices for securities.<sup>50</sup> Flash orders generally display prices that are better than the best displayed price in the consolidated quotation data.<sup>51</sup>

This disadvantage leads to the concern that flash trading will discourage the public display of trading interest and harm quote competition among markets.<sup>52</sup> Flash orders are normally executed at prices that match the best prices at other exchanges and as a result are diverting flow away from those exchanges.<sup>53</sup> If flash orders could be offered by all other major markets, greatly expand their trading volume, this would put pressure on the competitors of these markets to offer flash trading in order to stay competitive.<sup>54</sup> National Association of Securities Dealers Automated Quotations (“NASDAQ”) and Better Alternative Trading System Exchange, Inc. (“BATS”) started their flash trading practices due to this pressure.<sup>55</sup> Due to the lack of information that is publically disseminated about flash orders, this could “significantly undermine the incentives to display limit orders and quote competitively.”<sup>56</sup> This detracts from the efficiency of the public national market system.<sup>57</sup>

Another concern is the idea that flash trading offers a “last-mover” advantage.<sup>58</sup> Markets can get a sneak peek at how things are

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<sup>48</sup> *Flash Order Ban Proposal*, *supra* note 26, at 28.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 17

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 17.

<sup>53</sup> *Id.* at 19.

<sup>54</sup> Ratterman, *Flash Order Myths*, *supra* note 40.

<sup>55</sup> Liz Moyer, *Schumer Calls for Crackdown On ‘Flash’ Trading*, FORBES.COM, July 24, 2009 <http://www.forbes.com/2009/07/24/flash-trading-schumer-business-wall-street-flash.html>.

<sup>56</sup> *Flash Order Ban Proposal*, *supra* note 26, at 18.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

trading by sending out a small bid, waiting to see the response and filling it with a flash order.<sup>59</sup> In utilizing this tactic, a trader gets an advanced look at how others are trading by relying on public information, but does not have its trading information used in publishing a quote for the public to see how they are trading.<sup>60</sup> Traders are supposed to display their orders in advance of incoming market flow, but by using flash orders, they are able to program their systems to pick and choose when to execute trades.<sup>61</sup> By allowing a trader to receive information without providing any, it reduces incentives to display liquidity as described in the preceding paragraph.<sup>62</sup>

Additionally, there is the concern that flash trading can lead to locked markets.<sup>63</sup> “A locked market occurs when one market publishes a bid (offer) at the same price as another market’s offer (bid).”<sup>64</sup> Locked markets are currently prohibited by Rule 610(d), pursuant to statute 17 CFR 242.610,<sup>65</sup> which requires exchanges to avoid practices that display quotes that would lock any quotation.<sup>66</sup> According to one opponent to flash trading, the problem with the rule as it stands is that flash orders only create private locked markets instead of a public locked market.<sup>67</sup> “[F]irms are [thus] locking the market by design, but not by the SEC definition.”<sup>68</sup> While locked markets have both pluses and minuses, they are prohibited.<sup>69</sup> By allowing flash orders to lock markets, exchanges that allow flash trading are undermining the regulatory rules.<sup>70</sup>

Other arguments include the fact that, while anyone can gain access to flash orders for a fee, only those with high-speed computers and complicated algorithms can actually act on the information.<sup>71</sup> Finally, participants could act in ways that would cause an unfilled flash order to be less likely to receive quality execution elsewhere in

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<sup>59</sup> Durie, “*Dark Pools*” *Lack Transparency*, *supra* note 8.

<sup>60</sup> Schapiro *supra* note 12

<sup>61</sup> *Flash Order Ban Proposal*, *supra* note 26, at 18.

<sup>62</sup> *Id.*

<sup>63</sup> Mehta, *ISE Suggests Displaying Flash Orders to All*, *supra* note 45.

<sup>64</sup> *Id.*

<sup>65</sup> *Flash Order Ban Proposal*, *supra* note 26, at 20.

<sup>66</sup> 17 CFR 242.610(d).

<sup>67</sup> Mehta, *Flash point*, *supra* note 4.

<sup>68</sup> *Id.*

<sup>69</sup> Ratterman, *BATS Newsletter*, *supra* note 43 at 4.

<sup>70</sup> *Flash Order Ban Proposal*, *supra* note 26, at 19.

<sup>71</sup> Anderson, *supra* note 7.

the market.<sup>72</sup> For example, a recipient would be capable of rapidly transmitting orders that would take out trading interests at other exchanges before an unfilled flash order could be routed to those exchanges.<sup>73</sup>

#### F. The SEC's Proposal

The SEC submitted a proposal on September 18, 2009 to do away with paragraph (a)(1)(i)(A) of Rule 602 entirely.<sup>74</sup> It would also apply the amendment in a consistent way to Rule 301(b) of Regulation ATS, pursuant to statute 17 CFR 242.301, which currently allows flash orders on ATSS.<sup>75</sup> The SEC realizes that eliminating paragraph (a)(1)(i)(A) of Rule 602 might affect other legal trading services that they do not mean to interrupt.<sup>76</sup> The SEC preliminarily believes that this will not affect other trading practices, but opened the proposal up to comment from the public on this issue.<sup>77</sup> Other issues are also open for comment included whether the SEC should adopt a more narrow approach to the elimination,<sup>78</sup> whether it should adopt a different approach for equities and listed orders,<sup>79</sup> and the potential impact of the proposed rule amendment on the economy on an annual basis.<sup>80</sup>

The reaction from exchanges in the United States is mostly supportive of the SEC's proposal. The NYSE never adopted rules regarding flash trading and were stark supporters of the ban from the start.<sup>81</sup> NASDAQ did have a flash trading practice, but canceled this practice as of September 1, 2009.<sup>82</sup> BATS, currently the fourth largest exchange in terms of market share, also previously had a flash trading practice, but it too canceled its practice on September 1,

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<sup>72</sup> *Flash Order Ban Proposal*, *supra* note 26, at 22

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 26.

<sup>75</sup> *Id.* at 29.

<sup>76</sup> *Id.* at 26.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 28.

<sup>79</sup> *Id.* at 32.

<sup>80</sup> *Id.* at 49.

<sup>81</sup> Whitney Kisling & Jesse Westbrook, *Flash Trade Halt Backed for NASDAQ, BATS as SEC Votes*, BLOOMBERG.COM, Sept. 18, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aCHizjnQq73E>

<sup>82</sup> *Id.*



2009.<sup>83</sup> Direct Edge, the third largest equity market in the US and pioneer of flash trading,<sup>84</sup> is the only exchange that is still offering flash trading at this time.<sup>85</sup>

In other markets, flash trading is not common. In Europe, though they have high frequency traders and utilize algorithmic trading, there are no flash procedures that are hidden from the public quotation feed.<sup>86</sup> The interest in flash trading in Europe is mainly academic.<sup>87</sup> United Arab Emirates markets also say that adoption of the practice is unlikely due to the large amount of manual labor required (licensed brokers enter all orders directly).<sup>88</sup> There is not much news about flash orders in other markets around the world.

### G. Conclusion

After lying in the shadows, flash trading has finally been brought to the foreground of the American conscious, due to the SEC proposal to ban the technique. It is clear that many support this ban, but there are still those that are fighting to keep the practice going. An alternate solution previously suggested is to show these flash orders to everyone and to change regulation on locked markets,<sup>89</sup> but this proposal has not garnered much attention.

Keith Spence<sup>90</sup>

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<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Flash trading continues at direct edge*, ZACHSTOCKS.COM, Sept. 18, 2009 <http://zachstocks.com/2009/09/flash-trading-direct-edge/>.

<sup>86</sup> Jeremy Grant, *Europe calm on flash orders*, FT.COM, Aug. 2, 2009, [http://www.ft.com/cms/s/0/495092a0-7f8d-11de-85dc-00144feabdc0,dwp\\_uuid=a8d4603a-76a5-11de-9877-00144feabdc0.html](http://www.ft.com/cms/s/0/495092a0-7f8d-11de-85dc-00144feabdc0,dwp_uuid=a8d4603a-76a5-11de-9877-00144feabdc0.html)

<sup>87</sup> *Id.*

<sup>88</sup> Arno Maierbrugger, *Flash trading not an option for UAE markets*, GULFNEWS, Sept. 26, 2009, available at 2009 WLNR 18976848.

<sup>89</sup> Mehta, *ISE Suggests Displaying Flash Orders to All*, supra note 45.

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