THE 2007 COLLAPSE IN SECURITIZATION: A CASE FOR REGULATORY REFORM

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Introduction

Between 2003 and 2007 the U.S. financial markets experienced a period of remarkable growth. The markets had just emerged from the corporate executive and accounting scandals from the turn of the cen-

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tury, interest rates were at an all-time low,[1] and the value of real estate began to skyrocket.[2] Money was cheap and both investors and consumers took advantage.[3] Corporate investment levels rose steadily[4] as companies expanded all facets of their enterprises, and consumer spending levels broke all previous records as Americans took out second mortgages against the rising values in their properties in order to increase their purchasing power.[5] As both corporations and individuals continued to pump money into the economy, the Dow Jones Industrial Average nearly doubled from a close of 7,524.06 on March 11, 2003 to a close of 14,000.41 on July 19, 2007, its first finish above the 14,000 point mark.[6] About two weeks later, the White House released a fact sheet bragging about the economy's performance under the Bush administration.[7] However, everything was not as rosy as it readily appeared.

As real estate values rose over roughly the past two decades, mortgage lenders became increasingly willing to take on more risk. They lowered their lending standards through various methods, including requiring reduced down payments, lowering bank-tacked interest rates, and lending to riskier clients.[8] The rationale was that as

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1. *See Historical Changes of the Target Federal Funds and Discount Rates*, FED. RESERVE BANK OF N.Y., http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited May17, 2010) (table of historical target federal funds and discount rates since 1971). Note that the target federal funds rate broke the 2003 historic low in 2008. *Id.*

2. Robert J. Shiller, IRRATIONAL EXUBERANCE 13 (2d ed. 2006) (index of American housing prices going back to 1890).

3. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 8 fig.7, 10 fig.12 (2010), http://www.federalreserve.gov/monetarypolicy/files/20100224_mprfullreport.pdf (depicting the rise in real personal consumption expenditures from 2003 to 2009 and the rise in household debt as a percent of disposable income from the early 1990s to 2007); CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2010 TO 2020 32 fig.2-6 (2010), http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf (depicting the rise in net business fixed investment as percent of GDP from 2003 to 2007).

4. Mark Boroush, NAT'L SCI. FOUND., NEW NSF ESTIMATES INDICATE THAT U.S. R&D SPENDING CONTINUED TO GROW IN 2008 2 tbl.1 (2010), http://www.nsf.gov/statistics/infbrief/nsf10312/nsf10312.pdf.

5. *See* Stephen S. Roach, MORGAN STANLEY, LEADERSHIP IMPERATIVES FOR A POST-CRISIS WORLD 3 (2009), http://www.realclearmarkets.com/blog/Roach_del_pino.pdf (chart depicting growth of U.S. personal consumption expenditure as percentage of GDP from 1975-2009).

6. *Dow Jones Industrial Average (^DJI), Historical Prices*, YAHOO! FINANCE, http://finance.yahoo.com/q/hp?s=^DJI+Historical+Prices (select dates from "Set Date Range" and click "Get Prices") (last visited Nov. 21, 2010).

7. PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 165 (2009).

8. *See* INST. OF INT'L FIN., PRINCIPLES OF CONDUCT AND BEST PRACTICE RECOMMENDATIONS 88 (2008), *http://www.ieco.clarin.com/2008/07/17/iff.pdf (noting the*

long as the value of real estate continued to rise, lowering lending standards was not too risky; if a client is unable to make a payment he could always refinance or sell the house, in which case the lender recoups his investment through the rise in the underlying value of the property.[9] Lenders had become so persuaded that the continued rise in real estate prices would offset any losses from defaults in the aggregate that they were even willing to originate mortgages that required no down payment and no principal payments.[10] Once the value of real estate began to plummet, the lower lending standards led to larger losses than would have otherwise been realized. Despite the increase in risky lending behavior, bank capital requirements should have prevented losses from reaching crisis proportions, where large, pre-eminent financial institutions were depleted of all of their reserves.

This Note outlines how large and sophisticated investors fell victim to the housing collapse by trading in risky financial instruments, the uncertainties of which they barely understood. It focuses on the regulatory shortcomings in both the private and public asset-backed securities (ABS) markets in the U.S. in the context of the 2007 securitization collapse, and argues for certain regulatory changes designed to ensure for the smoother operation of the markets.

Part I of the Note provides a historical account of the lax lending standards prevalent in the industry, the growth of the ABS markets, and the general shortcomings of ABS that precipitated the crisis. Part II provides background information about what the U.S. Securities and Exchange Commission (SEC) considers a public ABS and it engages in brief discussion about how large the private ABS market had become before the collapse. Part III comprehensively discusses the problems that existed in the private ABS market and why they continued for years, largely unaddressed. Part IV addresses the problems that existed in the public ABS market and how regulatory shortcomings allowed them to survive. Finally, Part V argues that broadening the standards for when securities must be registered with the SEC and adopting more comprehensive regulatory standards for the public ABS markets would minimize the risk of similar upheaval in the future.

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competitive nature of the subprime mortgage market, where borrowers were encouraged to take out low adjustable rate mortgages with high reset rates, with little to no down payment required, all while very little due diligence was conducted to verify the borrower's ability to pay off the mortgage).

9. Krugman, *supra* note 7, at 167.

10. *See Risky Mortgage Business*, N.Y. Times, July 6, 2005, at A18 (noting that the traditional mortgage is being eclipsed by no-down-payment and interest-only mortgages).

In Part V, I contend that Congress should broaden the standards for when a dealer of securities should register such securities with the SEC by narrowing the Rule 144A[11] and Rule 506[12] private offering safe harbors. Second, I argue for certain due diligence and disclosure revisions to Regulation AB.[13] Third, I suggest that Congress amend the Fair Credit Reporting Act[14] to give institutional investors access to credit reports. Finally, I argue for a revision to the regulatory framework for credit rating agencies (CRA).

I.
HISTORICAL BACKGROUND

The housing boom began to deflate in the fall of 2005 when housing prices were becoming too expensive for most Americans.[15] By late spring of 2006, weaknesses in the housing market became apparent as housing prices started to drop rapidly.[16] Even so, when asked about these weaknesses, Treasury Secretary Henry Paulson replied that the problems in the housing market were "largely contained."[17] As the next year and a half illustrated, they were anything but contained. During this time frame, one major U.S. investment bank failed and many banks, mortgage companies, and insurance companies collapsed and were then rescued financially by the U.S. government.[18] The Dow Jones Industrial Average plummeted from an all-time closing high of 14,164.53 on October 9, 2007 to a close of 6,547.05 on March 9, 2009.[19] Had large, sophisticated firms not overexposed themselves by taking on too many mortgages and other loans in the hopes of later offloading them in the form of mortgage-backed securities (MBS) and ABS, they would have survived the downturn.[20]

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11. SEC Rule 144A, 17 C.F.R. § 230.144A (2010).

12. SEC Rule 506, 17 C.F.R. § 230.506 (2010).

13. Asset-Backed Securities, 17 C.F.R. §§ 229.1100–1123 (2010).

14. Fair Credit Reporting Act, 15 U.S.C. § 1681–1681x (2006).

15. KRUGMAN, *supra* note 7, at 166.

16. *Id*.

17. *Id.* at 165.

18. *See History of U.S. Gov't Bailouts*, PROPUBLICA (Apr. 15, 2009, 12:02 PM), http://www.propublica.org/special/government-bailouts.

19. *Dow Jones Industrial Average (^DJI), Historical Prices*, *supra* note 6.

20. *See The Shadow Banking System: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. (2010) (statement of Henry M. Paulson, Jr., Secretary of the Treasury) (explaining that financial institutions failed because they did not understand the risks of the securitized products they were investing in and resultantly overleveraged themselves), *available at* http://fcic.gov/hearings/pdfs/2010-0506-Paulson.pdf.

MBS are a specific kind of ABS. Whereas an ABS is a security whose value and income stream is backed by a specific pool of underlying assets, a MBS is a security whose value and income stream is backed by a specific pool of mortgages. In its simplest form, an ABS transaction involves an investor who pays the issuer an amount equal to the value of the loans underlying the security and in return receives the right to all future principal and interest payments on those loans.[21] MBS were first developed in 1970 by the Government National Mortgage Association (Ginnie Mae) when it issued residential MBS comprised of mortgages insured by the Federal Housing Administration and the Veteran's Administration.[22] By the late-1970s the private sector had entered the mix, offering MBS to interested investors.[23]

In 1985, the securitized market expanded further with the development of the first ABS.[24] Over the next couple of decades, ABS with all sorts of underlying assets, including mortgages, car loans, student loans, and consumer debt, were created.[25] As securitization became more advanced, financial institutions created independent entities called special purpose vehicles (SPV) for the purpose of dumping various loans off of their books into the SPV.[26] The SPV then repackaged the different loans into separate securities and sold different tranches[27] of these ABS to different investors, based on their risk pref-

21. In practice, a number of other variables are factored into determining the price of an ABS (e.g. prepayment risk, credit risk, liquidity risk, and interest rate risk). *See Fixed Income, Factors that Affect Prices of Fixed Income Securities*, RAYMOND JAMES, http://www.raymondjames.com/fixed_income_prices.htm (last visited Nov. 15, 2010).

22. Kurt Eggert, *Held up in Due Course: Predatory Lending, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 537 (2002).

23. *Id.*

24. In 1985, Sperry Computer issued the first ABS. These ABS were backed by computer leases. Arshad A. Ahmed, *Introducing Asset Securitization to Indonesia*, 19 U. PA. J. INT'L. ECON. L. 823, 826 (1998).

25. Gerard Caprio, Jr. et al., *The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats* 11 (World Bank Policy Research Working Paper Series, Working Paper No. 4756, 2008), *available at* http://papers.ssrn.com/abstract=1293169.

26. Dumping the obligations into independent SPV prevents the originator's creditors from reaching them in bankruptcy. This ensures that the holders of the ABS have first priority right to receive payments on the loans. *See* Gary Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 11,190), *available at* http://www.nber.org/papers/w11190.pdf (claiming that the only way to eliminate the risk of either voluntary or involuntary bankruptcy is to legally structure an SPV in a manner that makes it ineligible to be a debtor under the U.S. Bankruptcy Code).

27. A tranche is a set of securities, whose risk characteristics are similar to each other, offered as part of a larger transaction involving related securities with different risk characteristics.

erences.[28] The overall effect was that financial institutions had more capital with which to invest in new loans,[29] and the risk of default was supposedly better spread, since in the case of a default multiple investors would take a percentage of the loss instead of one firm taking the entire loss. Moreover, unlike simple securitization where financial institutions had to keep the original loans on their books and account for them when determining their capital reserve requirements, the incorporation of the independent SPV into the securitization process allowed financial institutions to write the loans off of their books, thus freeing up their internal credit lines and allowing them to reduce their capital reserves.[30] For a while the system seemed to work. However, once the pace in the decline of the value of real estate began to accelerate, the shortcomings of the ABS market became readily apparent.

As the value of real estate began to decline, with property values often dropping below the value of the unpaid portion of the outstanding mortgage, borrowers increasingly defaulted on their mortgages.[31] Since an investor in a MBS holds the rights to all future principal and interest payments on the mortgages underlying the MBS,[32] as more and more of the underlying borrowers defaulted on their mortgages, investors in MBS experienced increasing losses. In an effort to reduce their losses, investors tried to sell their MBS.[33] However, no one was willing to purchase them, because no reliable valuation system existed for ABS.[34] CRA's credit ratings provided a form of evaluation of

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28. Alan N. Rechtschaffen, Capital Markets, Derivatives and the Law 153 (2009).

29. The financial institution originating an ABS receives a lump sum payment of the present value of the cash flow of the loans securitized into the ABS. *See* Ian H. Giddy, *Asset-Backed Securities: Seminars and Resources*, ABSResearch.com, http://absresearch.com/ (last visited Nov. 21, 2010) (diagram depicting the basic structure of an ABS).

30. Parikshit Dasgupta, *Securitization: Crossing Borders and Heading Towards Globalization*, 27 Suffolk Transnat'l L. Rev. 243, 248 (2004).

31. *See, e.g.*, Amy Hoak, *More Homeowners Choose to Default on Loans*, MarketWatch (May 17, 2010, 8:06 AM) http://www.marketwatch.com/story/more-homeowners-choose-to-default-on-loans-2010-05-17; Luke Mullins, *Strategic Defaults and the Foreclosure Crisis*, US News and World Report (Jan. 19, 2010), http://money.usnews.com/money/personal-finance/real-estate/articles/2010/01/19/strategic-defaults-and-the-foreclosure-crisis.html.

32. *See supra* note 21 and accompanying text.

33. *See* Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 Wash. L. Rev. 127, 165 (2009) (noting that many investors attempted to sell their ABS in order to improve their finances).

34. *See* Jill Drew, *Frenzy*, Wash. Post, Dec. 16, 2008 at A1 (explaining how the liquidity glut in structured finance began after the collapse of two Bear Stearns hedge funds, when Merrill Lynch tried to auction off a tranche of their Mantoloking bonds

MBS, but their evaluation methods were not public.[35] Moreover, once investors experienced increasing losses on their MBS, the CRA downgraded the ratings on many MBS, further decreasing the demand for them.[36] The valuation problem quickly spread into ABS, generally, as investors questioned the ratings and quality of all ABS and tried to dump them into the market.[37] The large supply and low demand for ABS meant that many investors were stuck with their holdings, while many SPV were unable to sell their securitized products to investors.[38] As a result, many of the loans underlying the ABS went back onto the balance sheets of the financial institutions.[39] Financial institutions had typically granted loans thinking they would later outsource the risk to investors in ABS.[40] Once they were unable to sell their ABS, they retained more risk than they had planned. Worse yet, much of the risk was realized since borrowers were defaulting in high numbers.[41] Coupled with the fact that one of the main investors in ABS were subsidiaries of large financial institutions, the liquidity shortage and subsequent collapse in value ultimately destroyed the financial institutions.[42]

II.
Public vs. Private ABS

Although all ABS were hit hard during the securitization crisis, private markets were particularly affected.[43] Generally, securities offered to investors are considered public and must be registered with

only to have the auction fail due to little interest caused by investor uncertainty about the value of the bonds).

35. *See* Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. Ill. L. Rev. 1359, 1399 (2009).

36. *Id.*

37. *See* Erik F. Gerding, *The Dangers of Delegating Financial Regulation to Risk Models*, Banking & Fin. Servs. Pol'y Rep., April 2010, at 4 (noting that investors uncertain about the value of ABS began fire sales of them).

38. *See* Gerding, *supra* note 33 at 165 (noting that many investors wishing to sell their ABS were unable to do so due to the liquidity glut that had developed).

39. When an issuer, such as an SPV, is unable to sell the ABS that it has created, it never receives the money from investors that is used to repay the lender for giving it the right to the stream of payments underlying the ABS. As a result, the lender retains the rights to these payment streams. *See* Giddy, *supra* note 29.

40. *See supra* text accompanying notes 26–30.

41. *See supra* text accompanying notes 31–42.

42. Technical Comm. of the Int'l Org. of Sec. Comm'ns, Report on the Subprime Crisis 5–6 (2008), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf [hereinafter Report on the Subprime Crisis]; *see* Gerding, *supra* note 33, at 165–66.

43. *See* Report on the Subprime Crisis, *supra* note 42, at 7.

the SEC unless an exemption exists. Specifically, Section 5 of the Securities Act of 1933 (Securities Act) states that it is unlawful for a person to use instruments of transportation or communication in interstate commerce to sell or deliver securities that have not been registered with the SEC.[44] However, an exemption is provided in Section 4(2) of the Securities Act for transactions by issuers that do not involve a public offering.[45] Rule 144A of the Securities Act provides further protection by creating a resale safe harbor for the private placement of exempt securities to qualified institutional buyers.[46] To qualify under Rule 144A, the class of securities resold cannot be a class of securities trading on a U.S. exchange.[47] In a typical private ABS offering the issuer will sell the ABS to one or more initial purchasers under the Section 4(2) exemption, while the initial purchasers will then resell the securities to qualified institutional buyers under Rule 144A.

Although not used as frequently in private ABS placements, Rule 506 of Regulation D of the Securities Act also provides an important safe harbor for when a securities transaction is not a public offering.[48] According to the rule, a company using the safe harbor exception must make sure that it does not use general solicitation or advertising to market the securities and that it only offers the securities to accredited investors and up to thirty-five sophisticated investors.[49]

Under Rule 501 of Regulation D, an accredited investor is any bank, insurance company, registered investment company, employee benefit plan, charitable organization, corporation, or partnership with total assets in excess of $5 million.[50] In addition, natural persons who

44. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2006).

45. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d (2006).

46. SEC Rule 144A, 17 C.F.R. § 230.144A (2010). A qualified institutional buyer is defined as any entity that owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity, including any insurance company, investment company, or small business investment company. *See* Small Business Investment Act of 1958 § 301(c), 15 U.S.C. § 681(c) (2006). It also includes any plan established and maintained by a state for the benefit of its employees, any employee benefit plan, and any business development company. *See* Investment Advisers Act of 1940 § 202(a)(22), 15 U.S.C. § 80b-2(a)(22) (2006). Finally, any investment advisor, dealer that owns and invests on a discretionary basis at least $10 million in securities of issuers that are not affiliated with the dealer, and bank that owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with it and has a net worth of at least $25 million is also a qualified institutional buyer. SEC Rule 144A(a)(1), 17 C.F.R. § 230.144A(a)(1) (2010).

47. SEC Rule 144A(d)(3), 17 C.F.R. § 230.144A(d)(3) (2010).

48. SEC Rule 506, 17 C.F.R. § 230.506 (2010).

49. *Id.* Note that under Rule 144A there is no ban on general solicitations or advertisements. SEC Rule 144A, 17 C.F.R. § 230.144A (2010).

50. SEC Rule 501(a), 17 C.F.R. § 230.501(a) (2010).

have individual or joint net worth with their spouse that exceeds $1 million at the time of purchase, or individual income exceeding $200,000 in each of the two most recent years (or joint income exceeding $300,000 for those years) and a reasonable expectation of the same income level in the current year, are also deemed accredited investors.[51]

Rule 506(b)(2)(ii) defines a sophisticated investor as someone who has sufficient knowledge and experience in financial and business matters and is therefore able to evaluate the merits and risks of the prospective investment.[52] So long as the securities that an issuer sells fall under the Rule 506 safe harbor, the issuer does not have to register them with the SEC, and the market for them is not regulated by the SEC. When SPV repackage and sell their loans as ABS, they are sometimes specifically structured to qualify under the Rule 506 safe harbor.

Qualified institutional buyers, including hedge funds, pension funds, registered investment companies, and banks were the primary purchasers of ABS in the private markets.[53] In 2006, $754 billion in new ABS (including MBS) were issued in the United States in both the private and public markets.[54] This figure was the equivalent of approximately five percent of U.S. GDP in that year.[55] At the end of 2007, $11.4 trillion in outstanding ABS (including MBS) existed in the United States.[56] Notably, market share was shifting towards private issuances of ABS.[57] A significant shadow market was developing outside of the U.S. regulatory framework.

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51. SEC Rule 501(a)(5)–(6), 17 C.F.R. § 230.501(a)(5)–(6) (2010).

52. SEC Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (2010).

53. This is due to the fact that most ABS offerings on the private market were placed under the Rule 144A safe harbor, which limited sales to qualified institutional buyers. *See supra* note 46 and accompanying text.

54. *U.S. Asset-Backed Securities Issuance*, SEC. INDUS. AND FIN. MKTS. ASS'N (2010), http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-Issuance-SIFMA.xls.

55. *The World Factbook: United States*, CENT. INTELLIGENCE AGENCY (2010), https://www.cia.gov/library/publications/the-world-factbook/geos/us.html.

56. *U.S. Asset-Backed Securities Outstanding*, SEC. INDUS. AND FIN. MKTS. ASS'N (2010), http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-Outstanding-SIFMA.xls; *U.S. Mortgage-Related Securities Outstanding*, SEC. INDUS. AND FIN. MKTS. ASS'N (2010), http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-Mortgage-Related-Outstanding-SIFMA.xls.

57. *See Non-Traditional Mortgages: Hearing Before the Subcomm. on Econ. Pol'y and the Subcomm. on Hous. & Transp. of the S. Comm. on Banking, Hous. & Urban Affairs*, 109th Cong. (2006) (statement of Sandra L. Thompson, Acting Director, Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation), *available at* http://www.fdic.gov/news/news/speeches/archives/2006/chairman/spsep2006.html (stating that the share of U.S. mortgage debt financed through private

III.
Problems in Private ABS Market

Many problems existed in the private ABS market that contributed to the 2007 securitization crisis. But, in a broader sense, all of these issues can be narrowed down to two categories of problems—those related to valuation and those related to due diligence. For various reasons discussed below, the valuation methods for ABS were not clear to investors. Inaccurate and non-market-based valuation methods[58] and inaccurate and non-public credit rating methods played a central role in the 2007 liquidity crisis in the private ABS markets.[59] Moreover, investors' failures to conduct proper due diligence review of the investment instruments, or alternatively, their failure to base their investment decisions on the results of such a due diligence review, allowed the transparency problems in valuation to continue unchecked.[60] As defaults on loans grew and increasing losses on ABS mounted, many investors in ABS found themselves overexposed.[61]

A. *Problems with Valuation*

Since private ABS are not actively traded in a public market, it was difficult for investors to determine how much the securities were actually worth. Valuation was typically based on quantitative models, but these models were often highly secretive and their variables subjective.[62] Once losses on ABS mounted, investors were unsure which

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ABS trusts more than doubled between 2003–2005, from 8.6% to 17.4% of all U.S. mortgage debt financed through ABS trusts) (last visited Nov. 21, 2010).

58. *See* Gerding, *supra* note 33, at 172–75.

59. *See* Gerding, *supra* note 33, at 152; Caprio et al., *supra* note 25, at 17–18; Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions*, 36–37, (May 3, 2007) *available at* http://ssrn.com/abstract=1027475.

60. *See* Caprio et al., *supra* note 25, at 13–14 (explaining that investors deemed it reasonable to allow CRA to assess the risks underlying structured finance products for them without conducting their own due diligence review and that this mentality led to an expansion on the demand side of the structured finance market).

61. *See* Aaron Lucchetti & Serena Ng, *Credit and Blame: How Rating Firms' Calls Fueled Subprime Mess*, Wall St. J., Aug. 15, 2007, at A1 (noting that if certain ABS had received a rating that properly reflected their underlying risk, many pension funds and mutual funds would have been barred from investing in them). Many pension funds and mutual funds are only allowed to invest in investment grade securities, due to either government regulations or their own rules. By investing in ABS that in reality were not investment grade, they were overexposing themselves and their clients to the risks underlying these products.

62. *See* Floyd Norris, *High & Low Finance: Reading Write-Down Tea Leaves*, N.Y. Times, Nov. 9, 2007, at C1 (explaining that the originators of structured finance products are the only ones that really understand them and that certain variables factored into their valuation models are highly uncertain).

ABS were good and which ones were bad.[63] As a result, they stopped investing altogether.[64]

In addition, valuations of ABS based on quantitative models were often flawed before the securities were ever offered to investors. One example of those valuations' defects was the tendency of these models to underestimate correlated risk or neglect it altogether.[65] A high correlation between different assets pooled together into one ABS not only undermines effective securitization, which is dependent on proper diversification of underlying assets, but also means that once losses in an ABS occur, they will be larger than they would be if the underlying asset pool was diversified.[66] MBS were particularly highly correlated, since all of the underlying assets were mortgages.[67] Also, quantitative models underestimated or overlooked the spillover effects that a drop in the value of one class of assets would have on another class.[68] In reality, when one class of assets falls in price, it may drag down the price of similar assets. This is especially true when investors do not understand the differences in risk between the classes of assets.[69] Market risk[70] and credit risk[71] were factored into the models, but liquidity risk,[72] which arises as a result of complex interactions between market and credit risks, was difficult to model and often overlooked.[73] For similar reasons, systematic risk[74] was also inaccurately measured.[75] The fact that firms used virtually identical models exacerbated the valuation problems, because where problems existed,

63. *See id.* (arguing that no one could know whether the structured finance products were over- or under-valued).

64. *See supra* notes 34, 37 and accompanying text.

65. Gerding, *supra* note 33, at 172.

66. *Id.*

67. *See* Mason & Rosner, *supra* note 59, at 35–36 (noting that since the risk/return tradeoff does not improve with the accumulation of more mortgages, there is no diversification in pooling mortgages into MBS).

68. Gerding, *supra* note 33, at 173.

69. *Id.*

70. Market risk is the risk that the value of a portfolio will decrease due to changes in market risk factors, i.e. stock prices, interest rates, foreign exchange rates, and commodity prices.

71. Credit risk is the risk that the value of a portfolio will decrease due to a borrower's failure to make payments on the underlying loans as promised (i.e. default risk).

72. Liquidity risk is the risk that a certain security cannot be traded in the market fast enough to minimize a loss.

73. Gerding, *supra* note 33, at 174–75.

74. Systematic risk is the risk that affects the entire market and cannot be avoided through diversification.

75. Gerding, *supra* note 33, at 174–75.

they tended to be universal.[76] Together, these flaws suggest that not only were valuations of ABS not market-based and secretive, but often they were inaccurate from the beginning.

Unlike other security devices, which larger institutional investors can typically value based on established valuation methods, ABS were often far too complex for even these sophisticated investors to handle.[77] Many money managers lacked the appropriate resources to analyze different pools of assets.[78] The lack of a transparent valuation process throughout the securitization process in the private markets made it even more difficult for sophisticated participants to determine where the risks were accumulating and estimate the amount of potential losses.[79] Unlike ABS in the public markets, ABS in the private markets are not regulated by the SEC. Thus, they are not subject to Regulation AB,[80] which sets out disclosure requirements for publicly traded ABS. As a result, investors in the private ABS market often bought the securities with little to no information about the underlying loans.[81]

In many cases, the only available information on a private ABS would be the credit rating that the security received from one of the three CRA.[82] The rationale was that as long as an ABS received an AAA rating (the highest rating available), the investment was extremely safe.[83] However, once losses on ABS mounted and rating agencies adjusted ratings downwards in droves, it was obvious that the credit ratings were severely flawed. In a general sense, the rating mod-

76. *Id.* at 175.

77. *See* Mason & Rosner, *supra* note 59, at 57 (demonstrating that structured finance products have become more complex over the years).

78. Lucchetti & Ng, *supra* note 61.

79. José Manuel González-Páramo, Member, Exec. Bd. of the European Cent. Bank, Speech at IE Business School Annual Alumni Conference: The Financial Market Crisis, Uncertainty and Policy Responses 2 (Nov. 21, 2008) (transcript available at http://www.bis.org/review/r081128d.pdf).

80. Asset-Backed Securities, 17 C.F.R. §§ 229.1100–.1123 (2010).

81. James Carlson, *To Assign, or Not to Assign: Rethinking Assignee Liability as a Solution to the Subprime Mortgage Crisis*, 2008 COLUM. BUS. L. REV. 1021, 1032 (2008).

82. *See id.* The three CRA that rated most financial products were Moody's Investor Services, Standard & Poor's, and Fitch Ratings. *Id.* at 1040.

83. Carren B. Shulman, *Adapting to the Changing Landscape of Chapter 11, in* THE IMPACT OF THE SUBPRIME MORTGAGE CRISIS: LEADING LAWYERS ON UNDERSTANDING THE FACTORS RESPONSIBLE, MINIMIZING THE FINANCIAL IMPACT FOR CLIENTS, AND RECOGNIZING THE EFFECTS OF THE RECESSION ON BANKRUPTCY LAW 43, 46 (2009); *see also* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 634–35 (1999) (explaining the reputational capital theory which argues that investors' faith in CRA's ratings is directly based on the historical accuracy of their ratings).

els were not proper models for rating ABS.[84] CRA used the same models to rate ABS as they used for rating corporate bonds, even though corporate entities can dynamically manage their investment strategies, while the ABS pool trustee has no authority to change the pool's investment strategy in response to underperformance.[85] Furthermore, ratings are lagging indicators that move too slowly. They are created based on the state of affairs at a certain time and are not always promptly adjusted when the situation changes. Frequently, they are created either too early or too late to help investors with their investment decisions.[86] Instruments receiving a certain rating by a CRA also often barely met the requirements for that rating.[87] Since the process of rating an ABS is often a bilateral negotiation, with the issuer specifying the rating that it is looking for and the CRA trying to satisfy that request, ABS frequently barely met the minimum threshold for the specific rating that they received, and often dipped below the threshold.[88] Moreover, the CRA's ratings were frequently dependent on the information that an issuer decided to disclose to the CRA.[89] Issuers often cherry-picked the information they disclosed in order to boost their ratings.[90] Finally, many of the instruments were so novel that real-world data on risk of loss had to be drawn from an entirely unrepresentative period.[91] Once the economy began to turn and investors suffered increasing losses on their ABS, all of these flaws were exposed as CRA downgraded ABS en masse.

B. Problems with Due Diligence

It is noteworthy that the flaws in the CRA's rating methodology would have had much less of an impact, as far as aggregate losses are concerned, if investors had conducted the necessary due diligence before investing in ABS. However, investors often purchased these securities having done little to no due diligence.[92] Many investors bought into the hype that these were diversified products with little downside exposure that offered greater returns than other investments

84. Caprio et al., *supra* note 25, at 17l; Mason & Rosner, *supra* note 59, at 37.
85. *See* Mason & Rosner, *supra* note 59, at 37 (stating that the dynamic nature of corporate investment decisions creates benefits and risk for corporate debt that are not relevant to MBS).
86. *Id.* at 17.
87. Caprio et al., *supra* note 25, at 17–18.
88. *Id.*; *see also infra* text accompanying notes 103–10 (detailing the specific incentives of the issuer and CRA in a typical, bilateral ratings negotiation).
89. Gerding, *supra* note 33, at 152.
90. *Id.*
91. Caprio et al., *supra* note 25, at 19.
92. *Id.* at 13.

of similar risk.[93] For these investors the credit rating was sufficient because they had grown accustomed to following CRA ratings in the corporate bond market and most felt secure relying on ratings handed out by these established and reputable organizations.[94] They invested in spite of the fact that the models that the CRA used and the data underlying the models were typically not public.[95] Others may have known that this was a flawed system from the start, but they invested nonetheless, thinking they would ride the bubble and get out before the market turned. A tragedy-of-the-commons-based argument has also been suggested.[96] According to this argument, some investors may have known that systematic risk was building with each securitization, but they were unwilling to step down their securitization business and make less money, in order to lower the systematic risk exposure of others.[97] Regardless of the reasons why investors decided to depend on credit ratings, nobody anticipated the severity of the liquidity crisis that would follow.

It is troubling that sophisticated investors would invest in these ABS based on an underwriter's valuation of the instrument or a CRA's credit rating without having conducted any due diligence of their own. Not only does this behavior go against one of the main rationales for the Rule 144A and Rule 506 safe harbors,[98] but it is also

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93. *See* Winston Sale, *Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing*, 18 J. AFFORDABLE HOUS. & CMTY. DEV. L. 287, 295 (2009) (noting that in the late-1990s to early-2000s investors were hungry for MBS that could provide a handsome profit but appeared to carry little risk); *id.* at 17 (explaining that investors flocked to higher rated tranches of structured security products, because they promised "extraordinarily high yields").

94. *See Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs* 111th Cong. (2010) (statement of Sen. Carl Levin, Chairman, S. Subcomm. on Investigations) (stating that for one-hundred years main street investors trusted CRA's credit ratings and that even sophisticated investors such as pension funds, municipalities, insurance companies, and university endowments have relied on them). Before the development of the first MBS in 1970 and subsequently of ABS, *see supra* notes 22, 24 and accompanying text, credit ratings were applied primarily to bonds.

95. *See* Carlson, *supra* note 81, at 1032 (explaining that investors often invested in structured finance products with "little to no information," other than the security's credit rating); Caprio et al., *supra* note 25, at 13 (noting that until 2008, many investors thought it was reasonable to allow CRA to assess the risks underlying their investments for them and forgo the lender's or their own due diligence analysis).

96. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 400 (2008).

97. *Id.*

98. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 580–81, 676 (2d ed. 2008) (explaining that Regulation D, which includes Rule 506, addresses the SEC's concern of selling unregistered securities to unsophisti-

completely obvious that neither originators, underwriters, nor CRA had the same interests as investors.[99] The SEC seeks to protect investors from fraud and ensure the stable operation of U.S. securities markets by requiring broker-dealers to register securities that they offer to the public.[100] However, in crafting the Rule 144A and Rule 506 safe harbors, the SEC recognized that certain sophisticated investors do not need as much protection[101] and that the benefits of protecting those investors do not offset the negative implications that such a policy would have on capital formation.[102] The fact that these same sophisticated investors were unable to protect themselves from errors in valuation of these instruments and errors in credit ratings for them, suggests that the safe harbors are ineffective.

Before taking valuations and credit ratings at face value, investors also should have realized that neither originators of the loans underlying the ABS, underwriters of the ABS, nor CRA shared their interests. Originators make their money from the fees they receive for originating the loans.[103] Sometimes, they take a stake in the ABS, in order to instill investor confidence, but rarely is it enough to have a significant impact on their operations.[104] Underwriters, too, are motivated primarily by the fees they receive for underwriting ABS.[105] As long as the originators and underwriters are able to sell the securities

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cated investors, and that the $100 million threshold in the definition of qualified institutional buyers under Rule 144A represents a presumption by the SEC that institutions with such a large portfolio are sophisticated and experienced enough to be able to invest in unregistered securities).

99. *See* Caprio et al., *supra* note 25, at 14–15 (explaining how compensation systems in both commercial and investment banks and CRA created incentives for employees in these industries that were perverse to those of the investors they were servicing).

100. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. AND EXCH. COMM'N, http://sec.gov/about/whatwedo.shtml (last visited Nov. 21, 2010).

101. *See supra* note 98 and accompanying text.

102. *See* CHOI & PRITCHARD, *supra* note 98, at 568 (explaining that the securities laws recognize the high costs of public offerings and that the benefits of such offerings may vary depending on the issuer's and investor's characteristics).

103. *See* Frederic S. Mishkin, Member, Bd. of Governors of the Fed. Reserve System, Speech at the U.S. Monetary Policy Forum: Leveraged Losses: Lessons from the Mortgage Meltdown (Feb. 29, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm).

104. *See* Jan Pieter Krahnen & Günter Franke, *The Future of Securitization* 15–16 (Ctr. for Fin. Studies, Working Paper No. 2008/31, 2008), *available at* http://ssrn.com/abstract=1284989 (explaining that originators never commit in public to retaining a particular percentage of the equity tranche of an ABS, and that in the days leading up to the subprime crisis, anecdotal evidence showed an increasing number of issuances with no risk retention).

105. *See* Mishkin, *supra* note 103.

and earn their fees, they do not have much of an incentive to ensure the loans are high quality.[106] CRA's primary revenues come from the fees they charge issuers for analyzing the credit quality of the securities they issue.[107] They have no exposure to the underlying security they are rating. As a result, it is in the CRA's best interest to work with the issuer and not upset it, for fear that otherwise it will ask another CRA to rate future security offerings.[108] CRA also have a long-term incentive to be somewhat lenient with their ratings, since if they establish a reputation of being a strict rater, issuers will avoid them in the future.[109] Issuers have an incentive to hold out for higher than appropriate ratings, since a higher rating implies that their securities are more valuable.[110] These incentives were not hidden from investors; they could easily have been inferred by anybody willing to do the research.

Investors are not solely to blame for failing to conduct adequate due diligence before investing in ABS in the private markets, especially if they lacked the resources to engage in such analysis. For over a decade, the structured finance market was very profitable to large institutional investors, allowing them to earn bigger returns than comparable financial products would.[111] It is not too big of a stretch to believe that investors will flock to something that has proven to be profitable, regardless of whether they understand the risks involved. Congress and regulators, namely the SEC, the Federal Reserve (Fed), and the Federal Depository Insurance Corporation (FDIC), share the blame by failing to limit investors' abilities to invest in securities that they did not properly review.[112]

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106. *See id.* (explaining how defaults had little effect on the originators of loans repackaged into ABS).

107. Caprio et al., *supra* note 25, at 14–15.

108. *See* Jeffrey Manns, *Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1046 (2009) (asserting that rating agencies may have been grossly negligent or willfully complicit in allowing the bubble market to grow more by giving securities higher than appropriate ratings).

109. CRA cannot be too lenient with their ratings, because that could also hurt their reputation as a credible rater in the marketplace. *But see* Paul Lasell Bonewitz, *Implications of Reputation Economics on Regulatory Reform of the Credit Rating Industry*, 1 WM. & MARY BUS. L. REV. 391, 399–400 (2010) (arguing that the credit rating industry framework has the potential to undermine reputational incentives).

110. Such ratings are more valuable because the primary investors in ABS are larger institutions such as pension funds and hedge funds who have either internal or regulatory requirements to invest only in investment grade securities. *See supra* note 61.

111. *See supra* note 93 and accompanying text.

112. *See* Caprio et al., *supra* note 25, at 13 (noting that the SEC and bank regulators set rules that fed an outsized demand for highly rated securities); *see also* Partnoy, *supra* note 83, at 692 n.349 (noting that the SEC, the Fed, the FDIC, the Federal

Notably, the SEC was too lenient in drafting the Rule 144A and Rule 506 safe harbors. Rule 144A was first codified in 1990[113] and last amended in 1992.[114] Rule 506 was first codified in 1982[115] and last amended in 1989.[116] Since 1992, the market for securities has become much more complex.[117] Participants have devised a plethora of new and complex products in their eternal quest to arbitrage profits and better contain risk.[118] Whereas in 1992 an individual or entity meeting the requirements of the safe harbor may very well have been financially sophisticated enough to be able to value the merits and risks of a particular investment, this is no longer the case with the complexity of some of the financial products that exist today.

C. Credit Rating Agency Reform Act of 2006—Too Little, Too Late

Inadequate regulation of CRA also played a large part in the securitization crisis, since so much emphasis was placed on credit ratings, particularly by investors in the private ABS markets, who had little other information on which to base their decisions. Until Congress drafted the Credit Rating Agency Reform Act of 2006 (CRARA)[119] and the SEC implemented it in 2007,[120] the process of

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Housing Finance Board, the Housing and Urban Development Housing Finance Agency, and the Student Loan Marketing Association have all incorporated credit ratings into their regulations in one way or another); *id.* at 690 (mentioning that since 1973, credit ratings have been incorporated into hundreds of rules, releases, and regulations, spanning a wide array of substantive areas, including securities, pension, banking, real estate, and insurance regulation).

113. Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, 55 Fed. Reg. 17,933 (April 30, 1990).

114. Private Resale of Securities to Institutions, Fed. Reg. 48,721 (Oct. 28, 1992).

115. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982).

116. Regulation D; Accredited Investors and Filing Requirements, 54 Fed. Reg. 11,369 (Mar. 20, 1989).

117. *See supra* notes 24–30 and accompanying text.

118. *Cf.* Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 356 (2008) (explaining that the fragmented nature of the U.S. securities regulatory environment provides ample opportunity for arbitrage); Alan Greenspan, Chairman, Bd. of Governors of the Federal Reserve System, Speech at the National Association for Business Economics Annual Meeting: Economic Flexibility (Sept. 27, 2005), (transcript available at http://www.federalreserve.gov/BoardDocs/Speeches/2005/20050927/default.htm) ("These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago.").

119. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006) (codified at 15 U.S.C. § 78o-7 (2006)).

identifying Nationally Recognized Statistical Rating Organizations (NRSRO) was governed by a collection of SEC no-action letters.[121] This approach to regulating CRA was often criticized for lacking transparency.[122] The CRARA streamlined the process by making it more concrete and giving any credit rating agency the opportunity to be recognized as a NRSRO.[123]

Today, the CRARA is the authority for the federal regulation of CRA. Specifically, it defines the term NRSRO and gives the SEC authority to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered CRA. Prescribed requirements for credit ratings in federal and state statutes and regulations typically require that the credit ratings be issued by a CRA recognized as a NRSRO.[124] Furthermore, federal and state statutes and regulations confer certain benefits on CRA recognized as NRSRO.[125]

The CRARA "implements the program for NRSRO registration and regulation by adding definitions to Section 3 of the Securities and Exchange Act of 1934 (Exchange Act), creating a new Section 15E of the Exchange Act, and amending Section 17 of the Exchange Act."[126] In Section 3, an NRSRO is defined as a credit rating agency that has been in the credit rating business for three years prior to registration, issues credit ratings certified by at least ten qualified institutional buyers, and is registered under Section 15E of the Exchange Act.[127] Upon registration, amongst other things, Section 15E requires that the CRA furnish statistics measuring its credit ratings' historical performance, the procedures and methodologies that the CRA used in determining credit ratings, policies and procedures implemented to prevent the

120. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564 (June 18, 2007).

121. *Id*. at 33,564.

122. *Id*. *See also* Nationally Recognized Statistical Rating Organizations, 59 Fed. Reg. 46,314 (Sept. 7, 1994) (suggesting that the SEC was aware of the huge role that CRA played in shaping investors' decisions as early as 1994, yet continued to use the non-transparent, no-action letter process in regulating CRA); Larry P. Ellsworth & Keith V. Porapaiboon. *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 Bus. L. Today, Mar./Apr. 2009, at 38 (noting a number of lawsuits after the corporate scandals at the turn of the century, alleging that CRA may have increased the magnitude of losses on corporate bonds through faulty ratings).

123. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564. Before the CRARA, in order to be recognized as a NRSRO, amongst other things, a credit rating agency had to be nationally recognized by the predominant users of credit ratings as issuing credible and reliable ratings. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. Exchange Act of 1934 § 3(a)(62), 15 U.S.C. § 78c(a)(62) (2006).

misuse of nonpublic information, the organizational structure of the CRA, and any conflicts of interest relating to the issuance of credit ratings by the CRA.[128] Section 17 requires that NRSRO make and disseminate such records and reports as the SEC requires.[129]

The first problem with the CRARA is its timing: adopted in 2006 and implemented in 2007, the CRARA became effective far too late to have any chance of stopping the issues that existed with CRA and credit ratings. The housing boom began to deflate in 2005 and by 2006 investors were already seeing rising default rates on the mortgages underlying their MBS.[130] By 2007 a liquidity crisis was developing in the ABS markets and thus, even if investors tried to alter their investments based on any information that came to light as a result of the CRARA, they would be hard-pressed to sell their securities.[131] However, even if the timing had been proper, the act would still not have prevented the crisis, as the act fails to address several issues essential to the effective regulation of CRA.

One critical issue that the CRARA fails to address is the conflict of interest problem that exists between CRA and issuers, arising from the compensatory scheme through which CRA make most of their revenues. While the CRARA added a requirement under Section 15E of the Exchange Act that NRSRO list all conflicts of interest relating to the issuance of credit ratings by the CRA, beyond disclosure of the conflicts of interest, the act does nothing to address those conflicts. In fact, the CRARA actually exacerbates the conflict of interest problem between CRA and issuers through its NRSRO pre-registration requirements in Section 3 of the Exchange Act.[132] In order to be able to register as a NRSRO with the SEC, a CRA has to have been in the credit rating business for three years and it must receive certifications from at least ten qualified institutional buyers who have been satisfied with their ratings.[133] However, a qualified institutional buyer will not be satisfied with the CRA's rating unless it has historically gotten the ratings that it wanted.[134] As a result, the NRSRO pre-registration scheme essentially encourages CRA aspiring to be recognized as NRSRO to cater to the desires of their clients rather than investors even more so than the pre-CRARA period.

128. Exchange Act of 1934 § 15E(a)(1)(B), 15 U.S.C. § 78o-7(a)(1)(B) (2006).
129. Exchange Act of 1934 § 17(a), 15 U.S.C. § 78q(a) (2006).
130. *See supra* notes 15–16 and accompanying text.
131. *See supra* note 33 and accompanying text.
132. Exchange Act of 1934 § 3(a)(62).
133. *Id.*
134. *See* Mendales, *supra* note 35, at 1386.

The CRARA also fails to address the problems arising from the fact that the statistical rating models used by CRA are not public. Section 15E of the Exchange Act requires that NRSRO disclose the general procedures and methodologies they used in determining credit ratings,[135] but nothing else. As a result, CRA are required to disclose neither the model they used in rating a specific ABS nor certain key elements about the asset pool underlying a specific ABS that they rated. For example, information such as the data underlying an asset pool which was relied on in making the rating, the date that the statistical models used were developed on, the data on which the statistical models used are based, and the record of the historical accuracy of the models used is not required.[136] In spite of the fact that a CRA's credit rating is arguably the most important element of an ABS to investors, the CRARA actually specifically prohibits the SEC or any other political body from regulating "the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."[137]

The fact that the models used by a CRA to rate ABS and the data underlying them were typically not clear contributed heavily to the securitization crisis.[138] Had these models and this data been more transparent, it is more likely that flaws would have been exposed before the collapse and the ratings adjusted appropriately. Moreover, more transparency would have prevented the severity of the liquidity crisis that ensued, since investors would have had a better idea of the actual underlying risk.

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135. Exchange Act of 1934 § 15E(a)(1)(B)(ii), 15 U.S.C. § 78o-7(a)(1)(B)(ii) (2006).

136. Mendales, *supra* note 35, at 1384. The date of the development of specific models used is important, because models developed years earlier often do not take into consideration the different characteristics of the loans securitized today. *See id.* (noting that a model developed in 1996 for a well documented pool of loans that required 10% owner equity will not be an accurate predictor of the riskiness of a 2005 asset pool that includes undocumented loans and loans with no mortgagor equity). Moreover, earlier models are unlikely to take into account the different macroeconomic conditions that exist today that have differing effects on the overall riskiness of the underlying loans. *See id.* (explaining that a model developed in 1996 would understate risk in 2005 because it would not take into consideration macroeconomic trends such as the rising rate of consumer indebtedness).

137. Exchange Act of 1934 § 15E(c)(2), 15 U.S.C. § 78o-7(c)(2) (2006).

138. *See supra* note 59 and accompanying text.

IV.
Problems in Public ABS Market

Many of the problems that existed in the private ABS markets were also present in the public ABS markets, due to the regulatory shortcomings prevalent in the public markets. Key information, and especially data on specific underlying assets of ABS, is widely non-transparent, due diligence standards are inadequate, and the issues relating to CRA in the private ABS markets[139] exist in the public ABS markets as well. Although comprehensive and transparent regulations for both ABS and CRA do exist, thanks to the promulgation of Regulation AB[140] and the implementation of the CRARA regulatory standards, many of the major issues prevalent before the regulations were enacted still plague the ABS markets.

Although the public markets have comprehensive disclosure requirements for ABS, both at time of issuance and on an ongoing basis, key information is still not required and often omitted. For example, the disclosure requirements are modeled on disclosure requirements for public companies, rather than focusing on the specific problems posed by ABS.[141] Furthermore, due diligence requirements in the public ABS markets are also less than ideal, typically treating ABS as if they were any other security and failing to address certain unique issues that ABS present.[142]

A. *Regulation AB—Key Disclosure Omissions*

Regulation AB clarifies the Securities Act registration requirements for ABS offerings and codifies existing interpretive positions that allow modified reporting under the Exchange Act. Most importantly, the regulation lays out detailed disclosure requirements for Securities Act and Exchange Act filings involving ABS. Prior to the drafting of Regulation AB, no disclosure items specifically tailored to ABS had existed.[143] While some disclosure items in Regulation S-K[144] were relevant to ABS, most were not.[145] Since Regulation S-K

139. *See generally* Part III., *supra*.

140. Asset-Backed Securities, 17 C.F.R. §§ 229.1100–.1123 (2010). Regulation AB comprehensively addresses the registration, disclosure and reporting requirements for ABS. Prior to Regulation AB, the SEC regulated the market through its numerous no-action and interpretive positions. Asset-Backed Securities, 70 Fed. Reg. 1506, 1512 (Jan. 7, 2005).

141. *See* notes 153–55 and accompanying text.

142. *See infra* Part IV.2.

143. Asset-Backed Securities, 70 Fed. Reg. at 1531.

144. Regulation S-K is part of the SEC's streamlined integrated disclosure system. It lists the disclosure requirements for non-financial statements. Regulation S-K, 17

was designed primarily with equity securities in mind, its disclosure requirements focus on business and management.[146] However, for ABS, there is no business or management to describe. In most instances, the issuer is an SPV, created for the sole purpose of acting as a holding company for the ABS.[147]

Instead, at time of issuance, Regulation AB requires that issuers disclose the classes of securities being issued as well as the material risks involved in investing in the ABS.[148] Further, disclosure about the asset pool, the sponsors, the depositors, the issuing entity, the servicers, the trustees, the originators, any significant obligors, and each of their respective duties, is also required.[149] Finally, offering documents must include information on the structure of the transaction, any credit enhancements used, any derivative instruments used, relevant tax matters, and any material legal proceedings.[150]

On a continuing basis Regulation AB is primarily concerned with static pool disclosure. This information focuses on how the performance of a group of assets (static pools), originated at different times, has fared. The information is important, because it discloses to investors trends otherwise unavailable from portfolio data.[151] Specifically, static pool data is required for delinquency, loss, and prepayment history of a sponsor's portfolio for the preceding five years that is material to the type of asset being securitized.[152] Although overall Regulation AB better addresses the regulation of ABS than the haphazard collection of interpretive positions that existed before, it is far from a seamless set of rules.

Rather than focus on the specific problems that ABS present, Regulation AB treats ABS as if they were any other corporate debt offering.[153] The regulation focuses on disclosure of the repayment record of the obligations placed in a certain asset pool.[154] Although repayment history may be useful to investors investing in corporate bonds, since it gives them an idea of the likelihood that the corpora-

C.F.R. §§ 229.1100–1123 (2010). Regulation S-X, which lists the financial statement requirements, is the other part of the integrated disclosure system. Regulation S-X, 17 C.F.R. §§ 210.1-01 to .12-27 (2010).

145. Asset-Backed Securities, 70 Fed. Reg. at 1531.
146. *See id.*
147. *See supra* note 26 and accompanying text.
148. 17 C.F.R. §§ 229.1102–03 (2010).
149. *Id.* at §§ 229.1104, 229.1106–12.
150. *Id.* at §§ 229.1113–17.
151. *See* Asset-Backed Securities, 70 Fed. Reg. at 1540.
152. 17 C.F.R. § 229.1105.
153. Mendales, *supra* note 35, at 1383.
154. *See id.*

tion will satisfy its obligation, it is not as relevant in the context of ABS. Looking at the repayment record of specific obligations is hardly a complete picture of the creditworthiness of the underlying borrower—it forces investors to estimate the borrower's creditworthiness based on a specific loan, rather than his or her general repayment history. Second, the repayment record of the obligations placed in a certain asset pool is completely irrelevant in the context of ABS composed of newly issued loans.[155] In such a situation, investors have no specific information on the creditworthiness of the borrowers and the riskiness of the underlying assets.

Notably, Regulation AB also fails to require the disclosure of automatic reset-of-interest-rate provisions in loans. Often the loans grouped into an ABS had built-in automatic interest-rate-reset provisions, where at some specified future time the interest rate on the loan would reset to a much higher rate.[156] It is obvious that such a provision can only have a detrimental effect on the likelihood that a borrower will repay.[157] In fact, many borrowers did default on these sorts of loans.[158]

Also, Regulation AB fails to require specific disclosure of a sponsor's contingent liabilities or use of SPV. Although Regulation AB addresses disclosure requirements concerning sponsors of ABS, those requirements focus more on the general character of the sponsor's business and a general discussion of the sponsor's experience in originating or acquiring and securitizing assets of the type included in the specific transaction.[159] Although SPV are required to be independent if a sponsor is to write the obligations off of its books, sometimes this has not been the case. There have been instances where a sponsor provides recourse to a SPV that was supposed to be independent.[160]

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155. *See id.*

156. *See supra* note 8 and accompanying text.

157. *See, e.g.*, Mendales, *supra* note 35, at 1394 (explaining that adjustable rate mortgages were offered to mortgagors who could afford the initial low teaser rates, but who could not afford later resets to much higher rates).

158. *See, e.g.*, *Subprime Mortgage Market: Testimony Before the S. Comm. on Banking, Hous. & Urban Affairs* 110th Cong. (2007) (statement of Roger T. Cole, Division of Banking Supervision and Regulation Director, Federal Reserve System), *available at* http://www.federalreserve.gov/newsevents/testimony/cole20070322a.htm (last visited Nov. 21, 2010).

159. 17 C.F.R. § 229.1104 (2010).

160. *See* Joseph R. Mason & Eric J. Higgins, *Advanta and the Fiction of True-Sale*, THE BIG PICTURE (May 23, 2009, 10:43 PM), http://www.ritholtz.com/blog/2009/05/securitization-advanta-and-the-fiction-of-true-sale (noting a study that found 17 instances of recourse provided by credit-card issuers from 1991–2001 that were specifically announced by the parent company, even though the providee was said to have been an independent entity). It is also noteworthy to mention that it is debatable

B. Regulation AB—Due Diligence Inadequacies

In addition to disclosure requirements, Regulation AB also lays out certain due diligence requirements that the underwriters, issuers, and servicers (due-diligence parties) of the ABS are obliged to follow.[161] However, just as in its approach to disclosure requirements, Regulation AB's approach to due diligence is misguided. By subjecting the due-diligence parties to liability under Section 11 of the Securities Act,[162] Regulation AB is treating the registration of ABS as if they were any other equity offering and fails to address certain distinct issues that ABS present.

For example, one distinct characteristic of an ABS is that the income earned on the security comes from a bundle of underlying assets in the hands of third parties—the borrowers. As a result, certain features of the loans pertaining to these assets are of particular importance to investors.[163] However, Regulation AB does not set forth a requirement that the due-diligence parties ensure that these loans are adequately documented.[164] Instead, issuers are only required to present general statistical data on the characteristics of an entire asset pool.[165] Since an audit of the underlying loans is not required, investors cannot be sure of the quality of specific loans.[166]

Another distinct characteristic of ABS is that a servicer is required to collect the stream of payments from the underlying assets. However, the servicer is sometimes affiliated with the sponsor of the securities or one of its affiliates.[167] This relationship has created problems in the past. For example, in the Student Finance Corporation (SFC) fraud, SFC made payments on tuition-payment loans to the re-

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whether the popular practice of having a sponsor retain a portion of the risk of default on an ABS through a credit enhancement is consistent with the SPV being independent. *See* Mendales, *supra* note 35, at 1370–71 (explaining why it is difficult to classify SPV in situations where such credit enhancements exist as bankruptcy remote and noting that there is little case law on the topic, and that the little case law that does exist tends to go against classifying such SPV as bankruptcy remote).

161. Section 11 gives any purchaser of a security an explicit private right of action against every person who signed the registration statement, if the purchaser relies on a material fact in the statement that turns out to be untrue or misleading. In addition to signatories, any person whose profession gives authority to a statement made by him and who has willingly prepared any part of the registration statement and all underwriters can be sued. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006).

162. Asset-Backed Securities, 70 Fed. Reg. 1506, 1558 (Jan. 7, 2005).

163. Two such features are the principal and interest payments on the loans underlying the ABS, including any reset rates on adjustable loans.

164. Mendales, *supra* note 35, at 1383–84.

165. *See* 17 C.F.R. §§ 229.1101(a)(5), 229.1111 (2010).

166. *See* Mendales, *supra* note 35, at 1384.

167. Asset-Backed Securities, 70 Fed. Reg. at 1535.

lated servicer in order to hide high default rates on financial assets consisting of these loans.[168] It took years to discover the fraud.[169] In another case, the sponsor is alleged to have misled the due-diligence parties and investors by depositing money into the collection account on the day that collections were analyzed and then withdrawing it the next day.[170] If better due diligence requirements existed, each of the frauds could have been prevented at the onset.

V.
Solutions

Since the collapse of the ABS market in 2007, the popularity of ABS has decreased significantly.[171] Investors continue to have their doubts about the riskiness of the securities. Market participants have reduced the number of ABS that they offer, largely due to restrictive consumer lending banking policies, resulting from concerns over the borrowers' ability to repay.[172] Some have called for the complete abolition of the securities, arguing that their underlying risk is too great and too much of a potential burden on the markets to justify the advantages that they create.[173] However, with the Fed's adoption of the Term Asset-Backed Securities Loan Facility (TALF), it has become unlikely that the federal government will respond to the securitization crisis by completely abolishing ABS.[174] In fact, the government

168. MBIA Ins. Corp. v. Royal Indem. Co., 286 F. Supp. 2d 347, 348–51 (D. Del. 2003).

169. *Id.* at 350–51.

170. Steven L. Schwarcz, Complexity as a Catalyst of Market Failure 21 (Feb. 16, 2009) (unpublished manuscript), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1011&context=steven_schwarcz.

171. *See U.S. Asset-Backed Securities Issuance*, Sec. Indus. and Fin. Mkts. Ass'n (2010), http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/SF-US-ABS-Issuance-SIFMA.xls (showing that the value of new issuances of ABS in the United States has fallen from a high of $753.88 billion in 2006 to $150.91 billion in 2009).

172. *See* Monetary Policy Report to the Congress, *supra* note 3, at 5. Although ABS issuances have rebounded somewhat since their low point, they remain well below historical levels. *See id.* at 6.

173. *See, e.g.*, Nouriel Roubini and Stephen Mihm, *Excerpt: Crisis Economics*, N.Y. Times, May 6, 2010, http://www.nytimes.com/2010/05/07/books/excerpt-crisis-economics.html.

174. Announced on November 25, 2008, TALF encourages the issuance of ABS collateralized by student loans, credit card loans, and loans guaranteed by the Small Business Administration by allowing the New York Fed to lend up to $200 billion on a non-recourse basis to investors holding certain AAA-rated ABS backed by such loans that have been recently originated. *Other Lending Facilities: Term Asset-Backed Securities Loan Facility (TALF)*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/monetarypolicy/otherlending_TALF200906.htm (last visited Nov. 15, 2010).

should not abolish ABS, because they have proven to provide substantial advantages to any economy that allows them,[175] and many of the problems that they cause can be mended by an overhaul of the regulatory approach.

A. Narrow the Rule 144A and Rule 506 Safe Harbors

One of the main reasons for the degree of the collapse of the ABS market in 2007 was investors' inability or failure to conduct the proper due diligence necessary before investing in ABS.[176] Had investors adequately evaluated the risks underlying their investments in these securities, they would not have overexposed themselves to the extent they did, and it is unlikely the liquidity crisis in the market would have been as severe as it was. Although this failure in due diligence occurred in both the private and public ABS markets, the impact to investors was larger in the private markets since the securities there were not priced by the market.[177] Rules 144A and 506 of the Securities Act spell out when a security offering shall not be considered a public offering and thus is not subject to SEC regulation.[178] The Rules presume that SEC regulation is not as necessary when securities are offered to investors capable of evaluating the underlying risks.[179] However, in light of the securitization crisis the SEC should re-determine who is able to make such evaluations. Specifically it should alter the definitions of an "accredited investor" and a "sophisticated investor" under Regulation D and add a sophisticated investor requirement to the definition of a qualified institutional buyer under Rule 144A.

Both accredited investors and sophisticated investors that fall under the language of the Rule 506 safe harbor should be required to demonstrate their financial prowess and specifically their ability to assess the risks underlying a specific security that they are purchasing. Currently, most banks, savings and loans institutions, brokers, dealers, insurance companies, and investment companies qualify as accredited investors under Rule 501 of Regulation D of the Securities Act.[180]

175. *See, e.g.*, Gerding, *supra* note 37, at 2 (listing several benefits of ABS, including their ability to spread risk more efficiently, lower interest rates and allow for hedging of bets, all factors that promote economic growth).
176. *See supra* Part III.2.
177. *See supra* Part III.1.
178. *Supra* Part II.
179. *See supra* notes 98, 101, and accompanying text.
180. Virtually all of these entities will have the required $5 million in assets to qualify as accredited. *See supra* note 51 and accompanying text. In fact, almost all participants in ABS offerings are accredited investors due to the broad definition of an "accredited investor."

Once any of these entities qualifies as an accredited investor, Rule 506 gives issuers permission to offer securities to them without having to register the securities with the SEC.[181] Notably, there is no requirement that the accredited investor demonstrate his ability to assess the risks underlying these securities.

To qualify as a sophisticated investor, Rule 506 requires "such knowledge and experience in financial and business matters" that enable the purchaser to "evaluate the merits and risks of the prospective investment," or that the issuer reasonably believes prior to making the sale that the purchaser falls within this description.[182] The major problem with this requirement is that it does not provide for an objective standard. It is unclear how one determines whether an investor is financially sophisticated and experienced enough to "evaluate the merits and risks of [their] prospective investment."[183] It is also unclear what constitutes a "reasonable belief" that a purchaser falls within this description.[184]

The SEC should revise the two definitions so that investors are required to objectively demonstrate that they are able to assess the risks of the specific type of investment they are making. For example, if an investor is investing in ABS, he should be required to demonstrate that he is able to assess the specific risks of ABS. The SEC could require that he disclose to the issuer the procedures and methodologies that he has used in evaluating the underlying risk of his ABS investments in the past and the procedures and methodologies that he intends to use in evaluating the specific investment at hand. This information should include specific models as well as specific data used. The information should then be compared by the issuer to the investor's targeted risk preference on those specific investments. Based on this information, a decision can then be made by the issuer as to whether the investor qualifies as a sophisticated investor for a specific securities offering. Liability could be placed on the issuer to ensure that investors investing in its securities are indeed sophisticated investors.[185]

Similarly, the SEC should introduce an objective financial sophistication requirement into Rule 144A. Notably, Rule 144A requires

181. SEC Rule 506(a), 17 C.F.R. § 230.506(a) (2010).
182. SEC Rule 506, 17 C.F.R. § 230.506 (2010).
183. *Id.*
184. *Id.*
185. Note that under Rule 506, liability is already placed upon the issuer to ensure the investor is sophisticated enough to qualify under the exemption, before the issuer sells any unregistered securities to the investor. *See* SEC Rule 506, 17 C.F.R. § 230.506 (2010).

that securities be sold to a qualified institutional buyer and be different than any class of securities trading on a U.S. exchange, if they are to qualify for the resale exemption. However, the safe harbor fails to include a financial sophistication requirement. One of the requirements of being classified as a qualified institutional buyer under Rule 144A should include a demonstrated ability to adequately assess the risk underlying the specific type of security that is being purchased. This requirement should take a form similar to the one suggested for Rule 506.[186] Had such a standard been in place before the securitization crisis, most of the problems in the private ABS markets that were made possible as a result of failures in due diligence by investors would not have occurred, because it would have been clear that investors were failing to conduct any due diligence in the first place.

Critics may argue that this requires too much of such investors. They may argue that required disclosure of such information might eliminate any competitive advantage that a firm has over another firm in assessing the risk underlying the privately offered securities. Although this may be a valid general concern, the point hardly applies in the financial industry. As can be seen in a historical analysis of the marketplace, whenever new types of securities appear in the marketplace and a major investor's peer firms profit from such investments, eventually virtually all other major investors will invest in the new security.[187] Even during the securitization crisis, despite most firms using inaccurate methods to evaluate the risks underlying ABS, they were using virtually the same methods to evaluate those risks.[188] No firm had a competitive advantage. In an industry where taking top talent from other firms is the norm, rather than the exception,[189] it is always only a matter of time before a firm that has been successful in investing in a certain security sees its methods spread into the larger marketplace.

186. *See supra* pp. 271.

187. One needs to look no further than to the dramatic increase in trading volume and widespread popularity of stocks, options, futures, MBS, ABS, collateralized debt obligations, credit default swaps, etc. to realize how mainstream profitable financial instruments typically become.

188. *See supra* note 76 and accompanying text.

189. *See* Jessica Papini, *JMP Capitalizes on Rebound in Stock Market*, WALL ST. J., Oct. 14, 2009 (noting that many small- and mid-cap banks were able to take advantage of the recent financial downturn and hire plenty of top talent from larger firms); *see also* Aaron Lucchetti, *Big Bonuses are Back for Many on Street*, WALL ST. J., Nov. 5, 2009, at C1 (mentioning that some security firms and commercial banks have insisted on paying whatever it takes to hold on to top talent that is vulnerable to poaching by rivals).

Even if this were not the case, a more detailed disclosure of due-diligence practice should be required to qualify under the Rule 144A or Rule 506 safe harbors. As was seen during the recent securitization crisis, investors' inability to adequately evaluate the risks underlying the ABS that they invested in had drastic effects on the financial markets.[190] In order to dampen the chances of a similar crisis developing in the future, the SEC must do a better job of ensuring that investors investing in certain types of securities understand their underlying risks. Adding a financial sophistication requirement into Rule 144A and bolstering the requirements for when one qualifies as a sophisticated investor and an accredited investor under Rule 506 is a great way to bring a number of offerings that should not be private in the first place within the scope of SEC regulation. If it comes at the cost of eliminating certain competitive advantages firms may have, that is a tradeoff the SEC must be willing to take. The benefits of greater market stability for society as a whole greatly outweigh the benefits of allowing certain firms these competitive advantages.

Another argument against adding a financial sophistication requirement into Rule 144A and boosting the requirements for qualification as a sophisticated investor and accredited investor under Rule 506 is that such revisions would restrain the free flow of capital in the U.S. securities markets. The rationale is that at some point investors are sophisticated enough to make their own investment decisions and SEC regulation only restrains them from making investments that they consider profitable and would otherwise make.[191] However, under my proposed changes, investors that are actually sophisticated will still be allowed to invest in these securities without any obstruction from the SEC. The only aspect of the equation that changes is that in order to qualify, investors will now be subject to an increased burden of proving their exempt status. These changes would actually be more in line with the purposes of Rules 144A and 506, because as the securitization crisis has shown, the previous definitions were often ineffective in drawing the line between who was and who was not sophisticated enough to be able to invest in unregistered securities.

It is noteworthy to mention that some have argued for a minimum standard for the quality of the collateral underlying an ABS.[192] The basis for this argument is that in the years leading up to the securitization crisis, one of the key problems was the erosion of down payment

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190. *See supra* text accompanying notes 31–42.
191. *See supra* notes 98, 101, and accompanying text.
192. *See* Mendales, *supra* note 35, at 1411.

requirements.[193] With the implementation of this minimum standard, a pool underlying an ABS would have to have a certain percentage of assets that meet certain minimum credit risk standards, intended to address the down-payment-erosion problem.[194] Although such a requirement would undoubtedly lower the risk of many ABS and better contain any potential losses, this is not necessarily the best option for the markets. It is better to regulate investors' sophistication than to close the markets entirely to these investments. If entities want to invest in such risky securities for the better returns that they provide and they have proven they are financially sophisticated enough to do so, then they should be able to. Perhaps regulators could regulate how much entities can invest in such risky securities based on their sophistication and capital reserves. However, imposing minimum credit risk standards on pools underlying ABS is not appropriate.

B. Revise Due Diligence Requirements for ABS

Adding a financial sophistication requirement and bolstering the requirements for who qualifies as a sophisticated investor and an accredited investor brings within the purview of SEC regulation more security offerings, but it does not necessarily mean that many of the issues that existed in the lead up to the recent securitization crisis will cease to exist. In order to address these issues, not only does the SEC have to do a better job of regulating those ABS offerings that can potentially cause problems in the marketplace, but the SEC also has to change its approach to regulating ABS. New rules need to be adopted in order to address some of the issues that the securitization crisis exposed in the public ABS markets, which were regulated by the SEC.

The SEC needs to strengthen the due diligence requirements that certain parties involved in an ABS issuance are obliged to follow. Most importantly, the SEC should require that issuing parties ensure that loans underlying an ABS are adequately documented.[195] Issuers should be required to conduct an audit of the underlying securities[196]

193. *See id.* One of the main reasons for the erosion of down payment requirements was lenders' desire to cater to a larger market. Many borrowers could not afford a down payment, thus doing away with the requirement allowed these borrowers to take out loans. However, since these were less affluent borrowers, this also meant that there was a higher credit risk (i.e. default risk) on these loans. *See id.* at 1411–12.

194. *See id.* at 1411–12.

195. *See id.* at 1383–84 (arguing that one of the main problems with Regulation AB is that it requires no due diligence by issuers or underwriters to confirm that assets underlying a securitized pool are adequately documented).

196. *See id.* at 1384 (arguing that one problem with Regulation AB is that it does not require an audit of the loans underlying an ABS).

and present specific data on specific loans, rather than only general statistical data on the underlying pool of loans. Data on specific underlying loans, such as their date of origination, historical income streams, and any late and missed payments, should all be disclosed in the initial prospectus. Disclosure of updated data should be required in an annual report and should be gathered and provided by the servicer of the ABS. The availability of such data to investors would allow them to better evaluate the risks underlying their ABS investment.

It is also imperative that the servicer is not affiliated, either directly or indirectly, with the sponsor of the securities. As was mentioned earlier, this created problems in the past when an affiliated servicer collected the stream of payments from the underlying assets.[197] The servicer's independence becomes even more critical when the servicer has the added responsibility of conducting an annual audit of the underlying securities.[198] In order to ensure such data is both fair and accurate, it is important to eliminate any conflict of interest that may exist between the servicer and other parties to the transaction.

C. *Revise Disclosure Requirements for ABS*

The SEC must also address certain key disclosure omissions that exist in Regulation AB. For example, any automatic reset-of-interest-rate provisions on loans should be disclosed to investors. Such disclosure would allow investors to better assess the risk underlying an ABS, since they would be able to account for the possibility that a future reset in the interest rate causes a default. Disclosure of the models that a CRA uses in issuing a credit rating, including the data underling an asset pool which is relied on in making the rating, the date that the statistical models used were developed on, the data on which the statistical models used are based on, and the record of the historical accuracy of the models used, should also be required. As was seen during the securitization crisis, investors in ABS are highly dependent on CRA's credit ratings.[199] As such, it is imperative that investors analyze the ratings and ensure that they are not flawed. Finally, disclosure of sponsors' contingent liabilities and use of SPV must also be required. In the lead up to the securitization crisis, many liabilities that were considered off-balance sheet were in reality still liabilities of the sponsor.[200] Investors in the sponsor must be aware of such liabilities.

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197. *See supra* note 168 and accompanying text.
198. *See supra* note 170 and accompanying text.
199. *See supra* notes 82, 83, 94, and accompanying text.
200. *See supra* note 160 and accompanying text.

D. *Amend Fair Credit Reporting Act to Give Institutional Investors Access to Credit Reports*

In addition to addressing the aforementioned disclosure omissions, the lack of transparency regarding the credit worthiness of the borrower must also be addressed. Some have argued that a good start to addressing the disclosure and due diligence short comings would be to require securitizers to divulge certain periodical information on the asset pools underlying an ABS.[201] Although such information would undoubtedly help, it is imperative that the SEC require in-depth disclosure of the credit worthiness of the borrower as well. This does not necessarily mean that the SEC has to require the divulgence of the credit history of the borrowers underlying each loan in an ABS to all investors of such ABS, as such disclosure would clearly run against federal financial privacy laws.[202] However, Congress should amend the Fair Credit Reporting Act (FCRA)[203] so that institutional investors, at the very least, have access to individual credit reports of the borrowers to whom the underlying loans in their ABS were made. One of the main purposes of the FCRA is to provide the banking system with fair and accurate credit histories, since the efficiency of the banking system is dependent on such credit reports.[204] This rationale should hold true for the structured finance industry as well. Since investors in structured finance are essentially investing in the same loans that the banking industry originally invested in, the efficiency of the structured finance industry would also be improved with the availability of fair and accurate credit reports. The structured finance industry may not be as dependent on these reports as the banking industry,[205] but their availability would still cause investors in ABS to better evaluate the risk underling their investments. Making credit reports available only to larger institutional investors would ensure that individuals' credit histories remain protected, but that the primary investors in ABS have access to them.

201. *See* Caprio et al., *supra* note 25, at 41 (arguing that a good start to allowing investors to do more of their own due diligence would be to require securitizers to "report monthly balance sheets and income statements for each underlying asset pool and to explain to holders of structured claims on these pools what each turn in the data implies about the value of the subordination structure supporting various tranches").

202. Right to Financial Privacy Act, 12 U.S.C. §§ 3401–22 (2006).

203. Fair Credit Reporting Act, 15 U.S.C. §§ 1681–1681x (2006).

204. Fair Credit Reporting Act § 602(a)(1), 15 U.S.C. § 1681(a)(1) (2006).

205. The banking industry should be more dependent on these reports, because they are the ones that decide whether to make a loan in the first place. The structured finance industry has the benefit of knowing that the loans were already made by the banking industry, after it had presumably analyzed the credit history of the borrower.

E. Revise Regulatory Framework for CRA

The SEC must also address the regulation of CRA. Some have argued that the NRSRO designation should be eliminated altogether, because it provides an explicit government blessing and introduces barriers to entry.[206] However, this view fails to properly value the benefit that such a designation provides. Such a barrier to entry is absolutely necessary so entities that are not qualified to hand out credit ratings are not allowed to do so on a large scale and cause even more market turmoil. It is possible that the current NRSRO requirements are flawed, but that does not mean that a few tweaks to the CRARA cannot fix them.[207]

Just as the NRSRO designation should not be eliminated, references to ratings should not be removed from all SEC and bank regulations as some have proposed.[208] References to such ratings, although imperfect, create an objective standard. Even though they may reduce investors' incentives to conduct sufficient due diligence before making such investments,[209] it is still important to have some sort of objective standard when regulating investments made by large institutions, such as pension funds and commercial banks, whose failure may have a ripple effect in the markets and on the economy. Rather than eliminate such references, markets would be better served if the SEC adopted the due diligence proposals that I set forth earlier,[210] as well as the revisions to the CRA regulatory framework that I suggest below.

In revising the regulatory framework for CRA, it is important that the SEC require that CRA disclose the specific models they used to rate specific ABS and certain underlying data of the asset pools used in the models.[211] It is also important that the SEC add to and alter certain regulatory provisions in the CRARA in order to minimize conflicts of interest that typically exist between CRA and issuers. Requiring NRSRO to list all conflicts of interest relating to the issuance of

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206. *See* Caprio et al., *supra* note 25, at 41.

207. For example, instead of requiring that CRA go through a three-year trial period, where their ratings must be certified by at least ten qualified institutional buyers, *see supra* note 127 and accompanying text, regulations could instead focus on a CRA's accuracy in issuing ratings during a three-year trial period. *See also supra* note 128 and accompanying text (stating that Section 15E of the Exchange Act requires that a CRA disclose the historical performance of its credit ratings upon registration as a NRSRO).

208. Caprio et al., *supra* note 25, at 41.

209. *Id.*

210. *See supra* Part IV.2.

211. *See supra* text accompanying notes 131–37.

credit ratings is not adequate.[212] The SEC must change the compensatory scheme through which CRA make their profits. It should enact regulations that either limit the conflict of interest that exists between issuers and CRA or prohibit the CRA from making most of their profits through the fees that they charge issuers for rating their ABS. Further, instead of requiring NRSRO to list all conflicts of interest relating to the issuance of credit ratings, NRSRO should be held to independence standards, similar to the standards for outside auditors under the Sarbanes-Oxley Act (SOX).

The main problem with the current scheme—where the issuer pays the CRA for its credit rating—is that the issuer wants the highest rating possible, and the CRA is dependent on the issuer for both current and future business, therefore providing the CRA with motivation to inflate the credit ratings. A potential remedy for this shortcoming is to require that originators of ABS lock-in with the same CRA for all their credit rating needs through a five-year service contract, with a prohibition against consecutive five-year terms with the same CRA. This would eliminate CRA's incentives to cater to the issuer's needs in order to retain their business in the future. Moreover, the limitation on consecutive terms with the same CRA would further eliminate a CRA's incentive to cater to issuer demands further down the road when the existing five-year service contract is about to expire. It is imperative that originators are bound to CRA, not SPV to CRA, because in the latter scenario such an arrangement has little deterrent effect. Originators constantly create different SPV for different ABS marketed to investors.

Were these five-year originator-CRA service contracts established, exceptions would have to exist where originators would be allowed to break their contract in certain situations. These exceptions may include insolvency of the CRA, fraud by the CRA, or gross negligence by the CRA. In the case of insolvency of its present CRA, an originator should be allowed to contract with another CRA for a new five-year term if its current CRA is incapable of continuing its credit rating operations. Otherwise an originator would be unable to market any new ABS for the period remaining on its existing contract with the insolvent CRA, and there is no purpose to punishing the originator in this scenario.

An exception should also exist if credit ratings issued by the CRA are deemed fraudulent or based on fraudulent practices in a court of law. A requirement that such a CRA continue on as an originator's

212. Exchange Act of 1934 § 15E(h)(2), 15 U.S.C. § 78o-7(h)(2) (2006).

CRA for the duration of the contract would unnecessarily punish the originator by decreasing the value of his current and future ABS in the marketplace. Moreover, such an exception should also provide additional incentive for CRA to not engage in fraudulent practices, since it could virtually destroy their revenue stream.

Finally, an originator should also be allowed to break his service contract with a CRA if it is proven in a court of law that the CRA was grossly negligent in rating any of the originator's securities. The standard should be higher than simple negligence, because it is unfair to charge someone with negligence for flawed ratings models, *ex post*, when these models are often very complex and subjective to begin with. Also, the standard should be narrow and apply only to gross negligence involving the originator's securities, because a culpability of gross negligence does not justify virtually destroying a CRA's entire revenue stream as it does when the culpability level is that of fraud. However, just as with the fraud exception, a gross negligence exception should still exist, so that at the very least, originators are not unjustifiably punished in the marketplace for a CRA's mistake involving their securities.

In an effort to provide additional incentives for CRA to accurately rate securities, a scheme could also be developed to expose CRA to liability, should a court find that a CRA was grossly negligent or engaged in fraud while rating a specific security.[213] It is obvious that in many cases a CRA would not have the financial capacity to pay actual damages to investors, as measured by the change in fair market value of their securities between the time of purchase and the time that the defect in rating was recognized. Moreover, CRA's liability is often more subtle, and they bear much less of the financial upside than their clients through their wrongdoing.[214] As a result, CRA could be forced to pay a certain percentage of damages, for example, one, five, or ten percent, that is small enough for them to financially withstand, but large enough to incentivize proper due diligence during the rating process. Such a damage provision would also be more in line with their culpability than a requirement that they pay all damages.

In addition to the mandatory five-year service contracts and limited damage provision, the SEC should apply certain strict independence standards to CRA that are currently applied to public company auditors by SOX. For example, just as a public company's outside auditor is limited in its ability to engage in a consulting relationship

213. *See* Manns, *supra* note 108, at 1034.
214. *Id.*

with the public company,[215] CRA should be limited in their ability to engage in consulting relationships with originators whose security products they rate. Such a requirement would further sever the link between an originator's and a CRA's interests. In addition, just as a public company is required to disclose all audit- and non-audit-related fees paid to its auditor,[216] an issuer should be required to disclose all credit-rating-related and non-credit-rating-related fees paid to CRA.

It is important to mention that action is required from Congress in order to implement any of the aforementioned plans. The SEC currently has the authority to require NRSRO to register with them and disclose certain information through the CRARA.[217] However, in order to bind originators to CRA through mandatory five-year service contracts or to create new regulations outlining a NRSRO's limited liability and independence requirements, Congress must delegate additional authority to the SEC.

Conclusion

The 2007 collapse in structured securitization led to much turmoil and distress in U.S. financial markets. Security prices spiraled downward, lending facilities froze, and millions of jobs were lost. The collapse created the landscape for the onset of the largest recession in the United States since the Great Depression. However, amidst all the doom and gloom, the 2007 collapse in structured securitization also had a positive effect. It brought to light certain regulatory weaknesses prevalent in the U.S. structured securities markets. Now as the U.S. financial markets begin to turn the corner, it is absolutely crucial that Congress and federal regulators do not remain complacent but instead address the weaknesses. Otherwise, it is only a matter of time before they spring up again and wreck additional havoc on the markets and the American economy.

215. Exchange Act of 1934 § 10A(m)(3), 15 U.S.C. § 78j-1(m)(3) (2006).

216. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76.008, 76,056–57 (Dec. 5, 2000) (codified at 17 C.F.R. § 240.14a-101 Item 9(e)).

217. *See supra* text accompanying notes 119–129.