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Fraud is Already Illegal: Section 621 of the Dodd-Frank Act in the Context of the Securities Laws

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FRAUD IS ALREADY ILLEGAL: SECTION 621 OF THE DODD-FRANK ACT IN THE CONTEXT OF THE SECURITIES LAWS

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In the aftermath of the financial crisis, lawmakers and the public focused on abuses in the securitization industry. Abacus, a Synthetic CDO created by Goldman Sachs & Co., became a symbol of what many felt was a corrupt system when it became known that Goldman and Fabrice Tourre, a Vice President at its Correlation Trading Desk, had assisted a hedge fund in designing the security to fail. Perceived failings of the securities laws to prevent transactions like Abacus spurred Congress to enact Section 621 of the Dodd-Frank Act, which prohibits conflicts of interest in asset-backed securitizations. But the law is unnecessary and counterproductive. Antifraud laws already address the abuses and certain conflicted transactions, if properly disclosed, can be beneficial. The section should be repealed.

Introduction

In the aftermath of the most severe financial crisis since the Great Depression, lawmakers and the public searched for causes. In the hearings that followed the crisis, lawmakers honed in on the sector of the economy in which the crisis originated—the housing market. In particular, they looked at securitization, or the process of pooling many home loans into a security and selling that security to investors, because this practice contributed to the loosening of loan standards. This loosening eventually resulted in too many borrowers defaulting at one time, which set off the contagion in the rest of the markets.[1] Lawmakers held hearings focusing on behavior in the securitization market that aggravated the problems securitization caused. One key behavior was the presence of undisclosed conflicts of interest in the securitization process that allowed unwitting investors to be convinced to buy securities that were "designed to fail."[2] Though it was not the only firm guilty of this conduct, Goldman Sachs & Co. ("Goldman") was frequently singled out at the hearings as a particularly bad actor in the securitization market.

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1. *See generally* Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 Ind. L. J. 213 (2013).

2. Staff of S. Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Government Affairs, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, 476 (2011).

Lawmakers responded to behavior like Goldman's by amending the Dodd-Frank Act, which was then winding toward its eventual passage, to include Section 621,[3] prohibiting conflicts of interest in asset-backed securitizations. This section, however, was both unnecessary and counterproductive. The verdicts against individual wrongdoers and large settlements entered into by their employers show that existing laws already prohibited Goldman's conduct. Further, Section 621 is so broad that it proscribes conduct that would be beneficial, and the section may negatively affect the price-discovery process that is essential to well-functioning markets.

Throughout this Note, it is important to remember that securitization is not a problem in itself. Securitization is "a valuable financial innovation that enables financial institutions to deploy capital more effectively" than would otherwise be possible.[4] Although securitization was the target of a great deal of criticism in the wake of the financial crisis, it "does not crash economies; rather, it is unethical and irresponsible people who do."[5] Section 621 targets securitization in general, but the real problem is unethical participants in the securitization process. This Note argues that Section 621 is a major shift from existing law, creates more problems than it solves, and is not necessary because the problem it purports to address can be solved more efficiently.

Part I of this Note will discuss the securitization process and introduce the specific security, ABACUS-2007-AC1, that Congress singled out as an example of Goldman's conflicted practices. Part II will examine existing law and Section 621. Part III will present reasons the law is unnecessary and harmful, and Part IV will propose a simpler solution that addresses the bad practices without negatively affecting the market.

I. Background

Before examining the legal framework of Section 621, it is first necessary to understand the structure of and market for securitized products. This Part begins with background on the securities covered by Section 621. It then explains the way the market was

3. Dodd-Frank Wall Street Reform and Consumer Protection Act § 621, 15 U.S.C. § 77z-2a (2012). *See* Senator Jeff Merkley & Senator Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 Harv. J. on Legis. 515, 532 (2011).

4. Charles Austin Stone & Anne Zissu, The Securitization Markets Handbook xv (2d ed. 2012).

5. *Id.*

supposed to work and ends with a discussion of a synthetic CDO known as ABACUS-2007-AC1 ("Abacus"), which was cited repeatedly by members of Congress as the impetus behind Section 621.

A. Securitization, CDOs, and Synthetic CDOs

A major driver of the loose loan standards in the run up to the financial crisis was the process of securitization, which allowed banks to "increase significantly the volume of their consumer and commercial lending facilities."[6] Before securitization, banks were only able to lend money that had been deposited by their customers, but, by securitizing and selling their mortgage portfolios, they were able to make new loans with the proceeds from their securities sales. Simple economics dictated that the increased volume available to lend naturally lowered the interest rates charged to consumers, with one study finding that a ten percent increase in securitization of loans led to a decrease in subprime loans' interest rates of between 0.24 and 0.38 percentage points. This allowed many people who would not otherwise have been able to access credit to receive loans.[7]

It is easiest to think of a Synthetic CDO—a CDO related to a home mortgage, but several layers of abstraction away—as a tower. Each layer of the tower was formed by securitization, "the process of pooling relatively illiquid obligations into securities that can be traded in the capital markets,"[8] of the layer below. The tower's bottom layer consists of home mortgages, which are aggregated together to form the second layer, a Residential Mortgage-Backed Security ("RMBS"). Several RMBSs make up the third layer when they are aggregated by other parties and re-securitized into Collateralized Debt Obligations ("CDOs"). The fourth layer, a Synthetic CDO, is created by writing what are essentially insurance contracts for certain parts of the other securities. These insurance contracts

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6. Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 984 (2009).

7. Faten Sabry & Chudozie Okongwu, NERA Econ. Consulting & Am. Securitization Forum, Study of the Impact of Securitization on Consumers, Investors, Financial Institutions and the Capital Markets 95 (June 17, 2009), http://www.americansecuritization.com/uploadedfiles/ASF_NERA_Report.pdf [hereinafter Study of the Impact of Securitization]. This intuitive result has been challenged. *See, e.g.*, Andrea Heuson, Wayne Passmore, and Roger Sparks, Fed. Reserve Bd., Credit Scoring and Mortgage Securitization: Implications for Mortgage Rates and Credit Availability 40 (Dec. 21, 2000), http://www.federalreserve.gov/pubs/feds/2000/200044/200044pap.pdf (arguing that "the liquidity premium from securitizing mortgages may have little or no effect on mortgage rates.").

8. *See* Sabry & Okongwu, *supra* note 7, at 16.

make the Synthetic CDO perform similarly to a CDO containing the securities referenced by the insurance contracts, allowing sophisticated investors to expose themselves to specific yields and risk levels based on their needs. Each layer of a Synthetic CDO will be discussed in turn.[9]

The bottom layer of a Synthetic CDO is a simple home loan, which, along with other loans, is securitized into the second layer, an RMBS. An RMBS is formed when the sponsor of the securitization,[10] transfers a pool of loans to a Special Purpose Entity ("SPE"), which then issues a set of notes backed by the income stream generated by the loan pool.[11] There is a risk that certain loans in the pool may go into default, which would cause the SPE to be unable to pay all its obligations to the noteholders. To account for this risk, the SPE does not pay all the notes it issued at the same time. The notes are divided into tranches[12] based on their seniority in the payment order.[13] When borrowers make payments on their loans, the SPE makes payments on the senior tranche of notes first, then makes payments on the next most senior tranche if money is available, and continues to pay more junior tranches until either all the money owed to the noteholders is paid out or the SPE has no more money.[14] The ability to pay more senior holders in full before paying junior holders allows otherwise risky loans to be pooled to spread the risk. This means that even when the underlying loans are risky, "under normal circumstances," the most senior tranches will still be "very secure against credit risk" because in order for them to not be paid, many people must default on their loans at the same time.[15] Junior tranches, in turn, receive higher yields to compensate for the higher likelihood that they will not be paid in full.[16]

A CDO takes the process one step further, adding a third layer to the tower. CDOs were created when junior RMBS tranches proved difficult for issuers to sell because of the higher risk they presented to investors. Bankers responded by pooling junior RMBS tranches

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9. *See* Frank J. Fabozzi & Vinod Kothari, Introduction to Securitization 211 (2008).

10. Often but not always the issuer of the underlying mortgages.

11. Fabozzi & Kothari, *supra* note 9, at 8–10.

12. Tranche literally means "slice." A tranche of an issuance is one slice in which all notes have the same risk.

13. Int'l Monetary Fund, Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness 56 (2008), available at http://www.imf.org/External/Pubs/FT/GFSR/2008/01/pdf/text.pdf.

14. *Id.* at 59.

15. *See id.*

16. *See id.* at 56.

into a new security, called a CDO.[17] This new security had its own payment order, meaning, that more senior tranches of the CDO were thought to be relatively likely to be paid off while more junior tranches bore the risk of loss and had correspondingly higher yields.[18] As long as losses remained small, only the junior tranches would take any loss and the senior tranches would continue to be paid.[19]

The fourth layer, Synthetic CDOs "developed as an outgrowth of" regular CDOs and are yet another level of abstraction further away from actual mortgages.[20] Like RMBSs and CDOs, Synthetic CDOs are sold in tranches that pay based on the performance of other securities. But, unlike RMBSs and CDOs, Synthetic CDOs are not composed of actual securities, hence the term "synthetic."[21] Instead, Synthetic CDOs are a bundled set of contracts—Credit Default Swaps ("CDSs")—that function like insurance.[22] Each CDS in a Synthetic CDO is a bet on the performance of a specific tranche of an RMBS or, sometimes, of a CDO, and, thus, each Synthetic CDO is a bet on a collection of RMBSs or CDOs.

Unlike regular CDOs, a Synthetic CDO requires two parties to actively bet against each other. In a regular CDO, all investors are "long," meaning they benefit when the homeowners at the bottom of the structure keep paying, which keeps the value of the security high. By contrast, a Synthetic CDO requires one party to take the long position and another to take the short position, meaning they make money if the homeowners are not able to pay their mortgages and the value of the security declines.

Synthetic CDOs require both a long and a short party because they require two separate, offsetting transactions. Rather than buying bonds, the creator of a Synthetic CDO selects certain securities that will be "referenced" in the contracts creating the Synthetic CDO—meaning those securities whose performance will determine the performance of the entire Synthetic CDO. They then set up an SPE, which finds long investors who agree to enter into a CDS stating they will be paid a certain amount every quarter based on the

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17. FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 127 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

18. *Id.* at 127–28.

19. *Id.* at 128.

20. MICHAEL S. GIBSON, FED. RESERVE BD., UNDERSTANDING THE RISK OF SYNTHETIC CDOS 1 (2004), *available at* http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf.

21. FIN. CRISIS INQUIRY COMM'N, *supra* note 17 at 142.

22. *Id.*

performance of the referenced securities. In exchange for this payment, the long investors agree that if any of the referenced securities default or experience certain other "credit events,"[23] they will pay the SPE however much those securities are worth.

As the SPE only references securities and does not actually own them, it needs cash to pay the long investors, which it gets from short investors. At the same time it sells notes to the long investors, the SPE enters into a CDS in which it agrees to pay the short party if a credit event occurs. In exchange for this protection, the short parties agree to pay the SPE every quarter and these payments are passed on to the long parties.

The payouts of the Synthetic CDO are backed by the payouts on the CDS written with the long and short parties, not the assets secured by the underlying loans themselves.[24] The CDS making up a Synthetic CDO are essentially insurance contracts, where in return for regular payments from the protection buyers, protection sellers guarantee against default of the underlying instruments.[25] The long party is thus betting that the bonds will not decrease in value, and they will continue to get insurance premiums without having to pay while the short party is betting that the bonds will decrease in value, meaning they will get a payout based on that value. When all the CDSs are taken together, they can be structured so that the cash flows are very similar to what a CDO made of the same securities would have paid, allowing parties to treat them very similarly, and giving parties exposure to a certain type of credit risk that would not otherwise be available.

B. The Market

With an understanding of the structure of Synthetic CDOs, it is time to turn to how investors use them to make money. Tranches of CDOs,[26] like many securities, are given a credit rating by a rating agency like Moody's or Standard & Poor's. The credit rating of a

23. In addition to actual default, a security's downgrade by a rating agency is often a credit event.

24. Frank Partnoy and David A. Skeel, Jr., *Debt as a Lever of Control: The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1022 (2007).

25. Gibson, *supra* note 20, at 6–8.

26. The distinction between CDO and Synthetic CDO is unimportant here. I will use "CDO" to mean both.

tranche of a CDO is an assessment of its creditworthiness. According to Standard & Poor's, "The likelihood of default is the single most important factor in [that] assessment."[27]

Prior to the financial crisis, many market participants bought RMBSs and CDOs based solely on their price and credit rating without investigating the underlying loans making up the securities. This provided a profitable opportunity for firms that had the time and resources to investigate the quality of the underlying assets. Though rating agencies are careful not to represent that their ratings are an absolute measure of default probability,[28] over the five years following being rated, the highest-rated debt has only defaulted 0.23% of the time.[29] But ratings are really a range of probabilities, with each security of a certain rating having a slightly different actual probability. This means that investors could make a profit by determining whether the securities were on the lower or higher end of that range. Consequently, investors who tailored their investment strategy based on underlying assets' *actual* risk were in a position to profit off of investors who only based their strategy on the risk of default implied by a tranche's credit rating.

This conduct is not illegal; it is capitalism. In all areas of the market, a party that has done its research is in a position to profit from a counterparty operating with limited information. For example, if someone buying a car with 90,000 miles has not done their research and does not know that the car's brakes will likely fail before reaching 100,000 miles, the seller has no duty to disclose this fact.[30] Similarly, a party selling a security is generally under no obligation to inform a counterparty that the assets are riskier than their credit ratings imply. In both transactions, the seller's only obligation is to not mislead their counterparty.

Like a seller with no duty to disclose that a car is prone to developing brake problems within the next 10,000 miles, organizers of a CDO or Synthetic CDO have no general obligation to inform potential buyers that they will probably lose money because the

27. *Credit Ratings Definitions & FAQs*, Standard & Poor's (Sept. 7, 2014, 5:51 PM), http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us.

28. *See, e.g., id.* ("Standard & Poor's ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.").

29. *See* Greg M. Gupton et al., The RiskMetrics Group, CreditMetrics—Technical Document 58 (2007), *available at* http://www.msci.com/resources/technical_documentation/CMTD1.pdf.

30. This analogy is adapted from an article by Senators Merkley and Levin about their amendments to the Dodd-Frank Act, including Section 621. *See* Senator Jeff Merkley & Senator Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 523 (2011).

borrowers at the bottom of the transaction will likely default. When the long party in a Synthetic CDO makes its decision to buy based on credit rating and yield without much research into the underlying assets, the short party who did this research is in a position to make a perfectly legal profit off their counterparty's failure to do the same. However, if the car seller tampered with the brakes prior to selling the car, that seller cannot rely on his counterparty's failure to do research when the brakes fail.

C. ABACUS-2007-AC1

ABACUS-2007-AC1 is a now-notorious Synthetic CDO in which one party added a wrinkle similar to the tampering salesman. The "brakes" that did not work in the Abacus transaction were tampered with when the short counterparty, who would benefit if the CDO declined in value, helped select the securities that went into the transaction. Because the short party only got paid if the securities declined in value, they had an incentive to select the securities that seemed likely to fail, creating a conflict of interest hidden from the other side.

Abacus was a Synthetic CDO referencing ninety tranches of other CDOs with an aggregate notional value of two billion dollars.[31] Each underlying tranche was rated Baa2 by Moody's,[32] which is on the lower end of what is typically considered investment grade, but nonetheless associated with only a 1.7 percent risk of default during the five years following being rated.[33] Despite the ratings of the underlying securities, the CDSs were packaged and repackaged such that all of the notes actually sold to investors had a credit rating of Aaa, the highest rating available.[34] Additionally, Abacus did not make use of overcollateralization, a commonly used method to make the CDO more likely to pay out all investors, making it even riskier than the average Synthetic CDO.[35]

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31. Goldman Sachs, Pitchbook, ABACUS-2007-AC1 11 (Mar. 23, 2007), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-03-00_Abacus%202007AC1_CDO%20Pitchbook.pdf.

32. *Id.*

33. Greg M. Gupton et al., *supra* note 29, at 58.

34. *See* Goldman Sachs, Final Termsheet, ABACUS-2007-AC1, Ltd. 1 (July 2, 2007), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-03-00_Abacus%202007-AC1_CDO%20Term%20Sheet.pdf. Although other classes and ratings are mentioned, only the Aaa-rated classes A-1 and A-2, were ever issued.

35. Goldman Sachs, *supra* note 31, at 15. Overcollateralization involves putting extra securities into a CDO than would be necessary to generate the promised cashflows if none of the underlying assets defaulted. It is a common way to reduce the risk for the most junior "equity" tranche of a CDO. See Stone and Zissu, *supra* note 4, at 36.

In a normal Synthetic CDO, the portfolio is selected by a third party with no interest in the transaction. The documents Goldman used to market Abacus intimated that this was the case and stated that the third party selecting the portfolio was ACA Capital Management ("ACA").[36] The documents said that ACA was incentivized to "avoid losses relative to a standard [CDO structure]," implying that Abacus was less risky than a normal Synthetic CDO for long investors.[37] However, Goldman never disclosed to investors that ACA's role was "essentially ministerial" and the real party that selected the underlying assets was the short counterparty, the one who made money if the assets declined in value, a Chicago hedge fund called Paulson & Co.[38] By 2006, the fund had a profit strategy aimed "specifically at profiting on subprime defaults,"[39] and the selection of assets in Abacus was a means to that end. Paulson & Co. focused on filling Abacus with "bonds that weren't going to perform," knowing that the company would profit when the bonds defaulted.[40] If Abacus was a used car, Paulson & Co. was a company who tampered with the brakes and then took out an insurance policy on the car, knowing it had a high likelihood of getting into a wreck.

Although the short counterparty's intention to profit off of Abacus's decline in value would not be news to any of the long parties—remember that is how a Synthetic CDO works—the fact that the short counterparty had exercised control over selection of its assets would have been a red flag to the long counterparties had they known. In the term sheet it used to market Abacus, Goldman disclosed the identities of the underlying securities, which ordinarily would have been all the information the long counterparties should have needed to decide how much to pay for the Abacus notes. Despite this, knowing that Paulson had played such a large role in selecting the bonds would, at the very least, have caused the long parties to take a second look before they decided to purchase. If the long parties decided to go through with the transaction, they likely would have demanded higher insurance premiums in exchange for assuming the risk that the securities in Abacus would decline in value.[41] The managing director of a credit rating agency

36. *See, e.g.*, GOLDMAN SACHS, *supra* note 31, at 19; GOLDMAN SACHS, *supra* note 34, at 1.

37. GOLDMAN SACHS, *supra* note 31, at 13.

38. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 2, at 565.

39. Mark Whitehouse, *As Home Owners Face Strains, Market Bets on Loan Defaults*, WALL ST. J., Oct. 30, 2006, http://online.wsj.com/news/articles/SB116217677563707491.

40. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 2, at 567.

41. Something as simple as calling a counterparty an "opponent" rather than "partner" without changing the underlying economics of a transaction can result in market participants demanding higher prices. This leads to the inference that knowing Goldman was acting as an agent of their "opponent" would cause long investors to demand higher prices. *See* Terence

stated that the decision to purchase a product like Abacus is "more of a qualitative not a quantitative assessment,"[42] and knowledge of Paulson's identity would have "change[d] the whole dynamic of the structure."[43] But the long investors were never informed.

As explained below, by deceiving its counterparties about the true selection agent, Fabrice Tourre, the architect of the Abacus deal at Goldman, as well as Goldman itself,[44] violated federal law. Eventually, Tourre was found liable for breaking securities laws and for his role in the deal. But it does not follow that transactions with conflicts of interest like Abacus should be per se illegal, which is what Section 621 requires.[45] If all conflicts are disclosed, transactions like Abacus can increase market efficiency by allowing buyers and sellers with different views on the quality of a security to take one side of the transaction, which pushes prices toward the "true" measure.[46] Section 621 should be repealed because the default position of disclosure available under the laws prior to Section 621 is preferable.

II. The Legal Framework for Conflicted Transactions

In general, issuers of securities have wide latitude in how they conduct their businesses and how much they tell their investors, but this is limited by the principle that anything they do communicate in connection with the purchase or sale of their securities must be truthful. For the purposes of the securities laws, "truthful" means issuers have both a duty not to make affirmative misstatements and a duty not to disclose "half-truths—literally true statements that create a materially misleading impression."[47]

A maze of regulations, most of which will not be addressed here, governs the securities markets. This Part begins by discussing the underlying themes in securities law, knowledge of which is necessary to understand why Section 621 is such a radical shift. It then

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Burnham, Kevin McCabe, & Vernon L. Smith, *Friend-or-foe Intentionality Priming in an Extensive Form Trust Game*, 43 J. of Econ. Behavior & Org. 57 (2000).

42. Anatomy of a Financial Collapse, *supra* note 2, at 568.

43. *Id.* at 569.

44. The SEC filed suit against Goldman, but the parties reached settlement before trial. By finding Fabrice Tourre liable for violating Section 20(e) of the Exchange Act, the jury implicitly found Goldman liable since 20(e) is an aiding and abetting claim and Tourre was accused of aiding and abetting Goldman's violations. Verdict at 2, Sec. Exch. Comm'n v. Fabrice Tourre, No. 10-cv-03229-KBF (S.D.N.Y. 2013).

45. See Part II, *infra*.

46. See Part III, *infra*.

47. Final Jury Charges at 19, Sec. Exch. Comm'n v. Fabrice Tourre, No. 10-cv-03229-KBF (S.D.N.Y. 2013).

examines the federal antifraud laws governing transactions like Abacus and contrasts those laws with Section 621.

A. Background of the Federal Securities Laws

The federal securities laws are incredibly broad in scope and in many cases quite detailed. Like the Dodd-Frank Act, of which Section 621 is a part, the major federal securities laws were enacted shortly after a terrible financial crisis, the Crash of 1929, in a climate where many people's trust in the markets had been severely shaken. Like the Senators who viewed conflicts of interest like the one in Abacus as a cause of the recent crisis,[48] many people believed that the Great Depression was due in part to people who stood to benefit from a collapse in prices.[49]

Though many federal laws govern the securities industries, by far the two most important prior to the Dodd-Frank Act were the Securities Act of 1933 ("The '33 Act")[50] and the Securities Exchange Act of 1934 ("The '34 Act").[51] The discussion here will be limited to the laws' antifraud provisions, which govern conduct like what happened in Abacus. The antifraud provisions are quite general, and, though they are clarified somewhat by rules promulgated by the SEC, they are still left open to interpretation by judges. This has led to the development of common law and has allowed interpretations of the laws to evolve to take account of situations that the original writers would not have imagined.[52]

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48. *See* Letter from Sens. Jeff Merkley & Carl Levin to Office of the Comptroller of the Currency et al. (Feb. 13, 2012), *available at* http://www.federalreserve.gov/SECRS/2012/February/20120216/R-1432/R-1432_021412_104998_542080912901_1.pdf [hereinafter Merkley-Levin Rulemaking Comment] (Comment on rulemaking by OCC, Federal Reserve, FDIC, SEC and CFTC repeatedly citing Abacus transaction as reason for rules against conflicts of interest); Letter from Sens. Jeff Merkley & Carl Levin to Ben Bernanke, Chairman, Federal Reserve Board, et al. (Aug. 3, 2010), *available at* http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-2.pdf [hereinafter Merkley-Levin Letter to Bernanke] (Letter to rulemakers shortly after passage of Dodd-Frank Act urging immediate action on Merkley-Levin provisions).

49. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 395 (1990).

50. Act of May 27, 1933, c. 38, Title I, § 1, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a et seq.).

51. Act of June 6, 1934, c. 404, Title I, § 1, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a et seq.).

52. The generality of the antifraud provisions is one of their biggest strengths. A set of specific laws could give rise to the assumption that if something is not specifically covered, this was a purposeful choice by Congress not to prohibit it. Lack of specificity as to exactly what conduct is fraudulent leaves judges and juries free to apply the old laws to new situations. *See* Sec. & Exch. Comm'n v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (discussing the reach of the laws beyond the "obvious and commonplace" and stating that

In contrast to "merit" regulation of securities, which seeks to allow only high quality (as determined by a regulator) securities to be sold, the '33 and '34 Acts do not attempt to determine which securities are of sufficient quality to be sold. President Roosevelt, whose campaign platform included securities reform, stated shortly after his election that the government "cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit."[53] Instead, the purpose of the securities laws he proposed was to ensure that "no essentially important element attending the issue shall be concealed from the buying public" and to put "the burden of telling the whole truth on the seller," giving "impetus to honest dealing in securities and thereby bring back public confidence."[54]

True to President Roosevelt's vision, the Acts' mandate that securities issuers truthfully disclose a great deal of information about the security, but do not attempt to distinguish the good buys from the bad. Rather than simply preventing certain securities from being sold, the goal of the '33[55] and '34[56] Acts and their subsequent amendments is to ensure full disclosure of material facts and allow investors to make their own informed decisions. The laws were designed to protect potential investors from shady issuers, not from their own bad decision-making.[57]

Rather than a blanket ban on certain transactions, the securities laws promote a full-disclosure policy, allowing the investor to work out for himself whether the securities are worth the money. The laws respect investors' autonomy, protecting them from fraudulent disclosure, but allowing them to decide in light of that disclosure whether to purchase the securities. For example, in marketing Abacus, Goldman distributed a pitchbook and termsheet outlining the

their purpose was to regulate "[n]ovel, uncommon, or irregular devices, whatever they appear to be.").

53. Charles J. Johnson, Jr. & Joseph McLaughlin, Corporate Finance and the Securities Laws § 1:02 (4th ed., 2013).

54. *Id.*

55. "It cannot be emphasized too often that the 1933 Act is a disclosure statute. Its principal purpose, as set forth in its preamble, is to provide 'full and fair disclosure of the character of securities.' " *Id.* at § 1:05.

56. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 230 (1988) (the "fundamental purpose" of the '34 Act is "implementing a philosophy of full disclosure.").

57. The '33 Act was "designed merely to secure essential facts for the investor, not to substitute the government's judgment for his own." F. Frankfurter, *The Federal Securities Act: II*, Fortune 53, 108 (August 1933), cited in Corporate Finance and the Securities Laws, *supra* note 53 at §1:05.

structure of its proposed Synthetic CDO.[58] True to the purposes of the '33 and '34 Acts, the representations in those documents were required to be truthful, meaning that what they said had to be literally true and could not create misleading impressions by leaving out details that a potential investor would consider material to their decision whether to buy or sell the security.

B. Liability for Conflicted Transactions Under the Antifraud Provisions

1. Section 17(a) and Section 10(b)

The primary antifraud provisions relevant to transactions like Abacus are Section 17(a)[59] of the '33 Act and Section 10(b)[60] of the '34 Act. Though they have differences, both Sections 17(a) and 10(b) prohibit the same basic conduct: lying to or misleading a counterparty about a material fact involving a security. Section 17(a) concerns offers to sell the security as well as actual sales, while Section 10(b) only concerns actual sales. As will be shown, the conduct of Fabrice Tourre, the Goldman employee who implemented the Abacus transaction, as well as the conduct of Goldman itself,[61] was already illegal under Sections 17(a) and 10(b), obviating the need for any new prohibitions.

In marketing a security like Abacus, liability can stem from any of the three subsections of Section 17(a), which states that it shall be illegal

> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
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> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[62]

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58. GOLDMAN SACHS, *supra* note 31; GOLDMAN SACHS, *supra* note 34.
59. Securities Exchange Act of 1933 § 17(a), 15 U.S.C. § 77q(a).
60. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b).
61. *See supra* text accompanying note 44.
62. Securities Exchange Act of 1933 § 17(a), 15 U.S.C. § 77q(a).

The section prohibits not only affirmative lies, but also certain lies of omission. It is broader than just conduct, prohibiting other "course[s] of business" or "scheme[s]" that would defraud a counterparty. Only Section 17(a)(1) requires a showing of intent or recklessness; Sections 17(a)(2) and (3) both require only a showing of negligence.[63]

Liabilities can also stem from violations of Section 10(b) and Rule 10b-5 thereunder,[64] which like Section 17(a) prohibit lies of omission and commission, misleading conduct, and other devices, schemes, or artifices to defraud. A finding of liability under Section 10(b) or Rule 10b-5 requires a showing of either intent or recklessness.[65] Unlike Section 17(a), a finding of liability under Section 10(b) requires an actual purchase or sale, not just an offer to sell.[66]

2. Applied to Abacus

Although the antifraud provisions of the securities laws do not apply to a homeowner applying for a mortgage, they do come into play when that mortgage is securitized and sold to others. In order to understand why Abacus was a problem, it is important to understand how liability in the transaction was created. In the discussion that follows, it is important to remember that it is not illegal to be smarter than one's counterparty or to have done more research, it is illegal to *lie* to them. This distinction is key.

The securities referenced by a Synthetic CDO like Abacus are collections of home loans. Certain homeowners will pay their loans and certain homeowners will not, but whether a hedge fund *thinks* a homeowner will pay their mortgage does not influence whether the homeowner actually does. Only whether a homeowner actually pays their mortgage influences the performance of a Synthetic CDO including that mortgage. Because the parties who selected securities referenced by a Synthetic CDO cannot influence the performance of the product itself—they cannot choose who defaults on their loan—the identity of who selected the underlying securities should be irrelevant to determining their value.

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63. *Compare* Final Jury Charges, *supra* note 47, at 22 (state of mind for 17(a)(1) claims is intent or recklessness), *with id.* at 25, *and id.* at 32 (state of mind for 17(a)(2) and (3) claims includes negligence).

64. Commodity and Securities Exchanges, 17 C.F.R. 240.10b-5.

65. Final Jury Charges, *supra* note 47, at 42–43.

66. *Id.* at 37; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754 (1975).

The value of Abacus could have been determined solely from the list provided at the end of the term sheet, which named each security that would be referenced by the Abacus Synthetic CDO.[67] From the list, an investor could identify which RMBSs were contained in the CDO tranches, and, armed with that knowledge, she could investigate the underlying securities and determine their value and attendant level of risk. Indeed, that is exactly what Paulson & Co. did in selecting securities to place into Abacus. Neither the Securities and Exchange Commission ("SEC") nor any parties to the transaction ever alleged that this list itself was misleading.

Despite this, Goldman and its salespeople knew that appearances matter. Recognizing the likelihood that a potential long party would be especially likely to take a second look at the transaction if they knew that Paulson & Co. had both selected the underlying securities and positioned itself as the short party, Goldman's pitchbook for the Abacus transaction failed to mention Paulson & Co.'s role in the process. Goldman's pitchbook for the proposed Abacus deal stated the reference portfolio was "selected by ACA Management," which was incentivized to select assets that would not decline in value, meaning potential long investors would infer that they would not lose money since the company that selected the assets was making the same bet.[68] As a regular participant in the securitization market, Goldman knew that the fact that less than half the assets were actually selected by ACA ran "counter to what the usual assumption" was about the structure of a normal CDO.[69]

Under the law prior to Section 621, neither Paulson & Co. nor Goldman broke any laws when they selected RMBSs that seemed likely to decline in value as the reference securities for Abacus. So long as they dealt honestly with their counterparties, Paulson & Co. and Goldman could sell whatever securities they wanted. Section 621 has not changed this duty not to defraud investors. The illegality occurred when Paulson & Co. and Goldman made it appear that the CDOs Abacus referenced were selected by a party who wanted them to go *up* in value, rather than *down*.[70] The affirmative lies

67. *See* Final Termsheet, *supra* note 34, at 8–9.

68. GOLDMAN SACHS, *supra* note 31, at i.

69. The "usual assumption," of course, is that when a pitchbook says the assets are "selected by" a party, they actually are selected by that party. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 2, at 569; *see also* Letter from Jeffrey W. Rubin, Chair, Committeee on Federal Regulation of Securities, American Bar Association, to Securities and Exchange Commission, at 4–5 (Oct. 29, 2010), *available at* http://apps.americanbar.org/buslaw/committees/CL410000pub/comments/20101029000000.pdf ("Potential conflicts of the type [covered by Section 621 (the same existing in Abacus)] that either exist, or are contemplated, at the time of an ABS transaction are customarily disclosed in the offering materials.").

70. *See* Verdict, *supra* note 44.

about the involvement of Paulson & Co.,[71] as well as the deceptive wording in other parts of the pitchbook, made it look like long investors had nothing to fear because the selecting party in the transaction was on the same side, when in fact the selecting party was in an adversarial position.[72]

Although Goldman and Tourre had no affirmative duty to disclose who structured the CDO, the antifraud provisions required any statement or other representation they *did* make regarding who picked the assets to be truthful and not misleading.[73] Hiding Paulson & Co.'s role in the transaction from the long counterparties was illegal, and a jury found that Tourre's misleading statements and conduct violated Sections 17(a) and 10(b).[74]

C. The Dodd-Frank Act

In the wake of the financial crisis, many argued that existing laws had failed and a new regulatory regime was necessary to prevent another meltdown.[75] The Dodd-Frank Act is a regulatory response to the excesses, some real and some perceived, of Wall Street in the 2000s.[76] It has more than 1,500 sections, covering everything from the conflicts of interest in asset-backed securitizations discussed here, to provisions providing for orderly liquidation of failing banks,[77] and even special reporting requirements relating to mine safety.[78] A full analysis of the ways it impacts the financial industry could fill an entire treatise[79] and most of the effects are not relevant here. The three sections that will be analyzed are Section 621, which proscribes conflicts of interest in securitizations and is the focus of this Note, and two sections that may provide a preview of

71. Anatomy of a Financial Collapse, *supra* note 2, at 569.

72. The deceptive wording included describing what looked like the equity tranche as "pre-committed" and implying that Paulson & Co. was buying it when in fact the Abacus structure did not have an equity tranche. *Id.* at 569–70.

73. *See, e.g.*, Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321–22 (2011).

74. *See* Verdict, *supra* note 44, at 1–2.

75. *E.g.* Stephen Labaton, *Leading Senator Pushes New Plan to Oversee Banks*, N.Y. Times, Sept. 20, 2009, at A1, *available at* http://www.nytimes.com/2009/09/20/business/economy/20regulate.html.

76. Binyamin Appelbaum & David M. Herszenhorn, *Congress Passes Major Overhaul of Finance Rules*, N.Y. Times, July 16, 2010, at A1.

77. Dodd-Frank Wall Street Reform and Consumer Protection Act § 201–217, 12 U.S.C. § 5390–97.

78. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1503, 12 U.S.C. § 78m-2.

79. *See, e.g.*, Commerce Clearing House, Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis (2010).

how Section 621 would likely operate in practice: Section 619, the Volcker Rule, and Section 941, which governs risk retention.

1. Section 621

In 2011, the Senate released a report on the financial crisis. This report contained four recommendations for reforming the investment banking industry in the wake of the financial crisis. One recommendation contained a number of provisions aimed at restricting conflicts of interest, including Section 621.[80]

Section 621 states, in pertinent part, that:

> An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (. . . [including] a synthetic asset-backed security), *shall not*, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, *engage in any transaction that would involve or result in any material conflict of interest* with respect to any investor in a transaction arising out of such activity.[81]

Recognizing that certain traditional investment banking activities are unlikely to harm investors, this provision makes exceptions for the following: (1) hedging transactions, which are designed not to make money for the bank but instead to reduce the risk caused by a separate trade;[82] (2) underwriting, or committing to sell a certain number of securities to customers and purchase them for their own account if unable to sell;[83] and (3) market-making, meaning buying from customers who want to sell and selling to customers who want to buy without any expectation of profit or loss from the transaction.[84]

Despite regulating a large area of the economy, the provision is quite open-ended and directs the SEC to adopt specific rules implementing the provision to clarify which activities it covers.[85] The SEC proposed rules to implement the provision in 2011, but since then

80. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 2, at 639.
81. Securities Exchange Act of 1933 § 27(b), 15 U.S.C. § 77z-2a(a) (emphasis added).
82. *Id.* at (c)(1).
83. *Id.* at (c)(2)(A).
84. *Id.* at (c)(2)(B).
85. *Id.* at (b).

has not advanced the proposal.[86] Because the rules have not been finalized, Section 621 has not yet taken effect.[87]

Though the proposed rules are over fifty pages long, they fail to precisely define a "material conflict of interest."[88] The SEC takes the position that any definition could be "both over- and under-inclusive," because of the "complex and evolving nature of the securitization markets."[89] Instead, the SEC proposes a two-part test to determine whether a conflict of interest exists. Under the proposed test, a party has a material and, therefore, prohibited conflict of interest if:

> (1) (a) the party would benefit from the adverse performance of the security, *or*
>
> (b) the party controlling the selection of assets in the security will receive benefits from a third party with an interest in the adverse performance of the security and allowed that third party to help select the assets; *and*
>
> (2) it is substantially likely that a reasonable investor would take that into account in making an investment decision.[90]

Basically, the proposed rule prohibits *per se* what was formerly illegal only if undisclosed.[91] Rather than relying on full disclosure to allow investors to make informed decisions, the provision and the proposed rule completely prevent investors from deciding. This paternalism is a departure from previous practice, which focused on disclosure as the best remedy for potential problems.[92] Furthermore, it has the potential to distort the market[93] without offering

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86. Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60,320 (proposed Sept. 28, 2011) (to be codified at 17 C.F.R. 230) [hereinafter "Proposed Conflicts Rule"].

87. Pub. L. 111–203, title VI, § 621(b), 124 Stat. 1632 (2010) ("[Section 621], shall take effect on the effective date of final rules issued by the Commission under subsection (b) of such section.").

88. Proposed Conflicts Rule, *supra* note 86, at 60,329.

89. *Id.*

90. *Id.*

91. *See* discussion, *infra* Part III.

92. *See, e.g.*, Mary Jo White, *The Importance of Independence*, Sec. & Exch. Comm'n (Oct. 3, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539864016#.VAyJmWSwLdI ("'The foundational cornerstone of the [SEC's] regulatory regime has remained fixed. It is disclosure. For over 75 years, the SEC's signature mandate has been to use disclosure to promote transparency.'") (internal citations omitted); Daniel M. Gallagher, *Remarks to the Forum for Corporate Directors*, Sec. & Exch. Comm'n (Jan. 24, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370540680363#.VAyIymSwLdI ("The SEC is, first and foremost, a *disclosure* agency. . . . That is the foundation of our securities law regime and the core principle by which we administer those laws.").

93. *See* discussion, *infra* Part III.C.

any material improvements because the conduct was already illegal if undisclosed.[94]

2. Sections 619 and 941

The Dodd-Frank Act was a comprehensive attempt to reform the financial system and prevent a financial crisis like the one that started in 2008. Many people thought securitization was at least partly to blame for the financial crisis, so many sections of the Act deal with it in some respect. Of the sections that deal with securitization, two warrant special mention: Section 619 and Section 941.

The final text of the rule implementing Section 619, referred to as the "Volcker Rule," runs to roughly 1,000 pages. Most of its effects are not relevant here, as many of the entities that issue securitizations are not covered banking entities. This Note will only examine the provision prohibiting conflicts of interest and the exceptions from the proprietary trading rule. Because regulators have already begun interpreting the exceptions in Section 619 and Sections 619 and 621 are worded similarly, understanding the way the exceptions have been applied under that rule may provide insight into Section 621, where rulemaking has yet to be completed.

The Volcker Rule proscribes proprietary trading by banking entities[95] subject to certain exceptions. These exceptions, like the exceptions to Section 621, allow an otherwise prohibited trade if it is for the purpose of underwriting,[96] market-making,[97] or risk-mitigating hedging,[98] along with other minor exceptions.[99] This means that, under the Volcker Rule, proprietary trading, while generally prohibited, is allowed if the trade falls under a recognized exception. However, there is a "backstop" prohibition against conflicts of interest, meaning if activity that would otherwise fall into an exception results in a conflict of interest, it remains prohibited.[100] The conflict of interest backstop in the Volcker Rule, unlike Section 621, allows issuers to "cure"[101] their conflict of interest by either

94. *See* discussion, *infra* Part III.B.
95. 79 Fed. Reg. 5536, 5781.
96. *Id.* at 5783.
97. *Id.*
98. *Id.* at 5784.
99. Namely, an exception to trade U.S. government securities. *Id.* at 5785.
100. *Id.* at 5786–5787; *see also* Final Volcker Rule Proprietary Trading Flowcharts, DAVIS POLK & WARDWELL LLP (Dec. 23, 2013), http://www.davispolk.com/download.php?file=sites/default/files/DavisPolk_Final_Volcker_Rule_Flowcharts_Prop_Trading_0.pdf.
101. 79 Fed. Reg 5536, 5787.

disclosing the conflict prior to engaging in the transaction[102] or using information barriers within the firm to prevent it from benefitting from this conflict.[103]

The conflicts prohibition in the Volcker Rule can be seen as, in a way, the inverse of Section 621. The Volcker Rule allows hedging or market making unless those activities result in a conflict of interest not cured through disclosure or information barriers. In contrast, Section 621 prohibits conflicts of interest unless they fall into a listed exception like hedging or market-making and does not allow issuers to remedy their conflict through disclosure or information barriers.

Section 941,[104] commonly referred to as the risk retention provision, adds a new section to the '34 Act requiring creators of asset-backed securities like CDOs (but not Synthetic CDOs[105]) to put "skin in the game"[106] by retaining at least five percent of the credit risk for any security they create.[107] Although the exact structure of the rules implementing Section 941 is not yet finalized,[108] market participants expect that the rules will achieve their goal of giving issuers a disincentive from selling securities that will lose money for their customers because the issuer will lose money as well.[109] Section 621 makes clear that the holdings required by the risk retention provision will not be considered a conflict of interest.[110]

Even without the clarity of a final rule, and despite the exceptions for certain activity, the scope of Section 621 is no doubt wider than prior law and prohibits a great deal more conduct than was illegal before. In addition, other sections of the Dodd-Frank Act are better suited to remedy the illegal activity at issue in Abacus. As noted above, the abuses in Abacus were already illegal under federal law. The broad scope of Section 621 sweeps in market activity

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102. *Id.*.

103. *Id.*.

104. Credit Risk Retention, 78 Fed. Reg. 57,928. (proposed Sept. 20, 2013) (to be codified at scattered sections of the C.F.R.).

105. *Id.* at 57,936 n.36.

106. Kevin L. Petrasic & Amanda J. Kowalski, *Regulators Re-Propose Dodd-Frank QRM Rule*, Paul Hastings 1 (Sept. 2013), http://www.paulhastings.com/Resources/Upload/Publications/Re-Proposed%20QRM%20Rule.pdf.

107. 15 U.S.C. § 78o-11(c)(1)(B)(i).

108. *See* Credit Risk Retention, 78 Fed. Reg. at 57,931.

109. *See, e.g.*, Christopher B. Killiam, *Credit Risk Retention; Re-Proposed Rule*, SIFMA (Oct. 30, 2013), *available at* http://www.sifma.org/comment-letters/2013/sifma-and-other-associations-submit-comments-to-multiple-federal-agencies-on-credit-risk-retention/ (stating 5 percent risk retention requirement aligns interest of sponsors and investors) [hereinafter SIFMA Letter].

110. 15 U.S.C. § 77z-2a(d) (2012).

that is good, which could distort the market, while the detrimental activity it prohibits was already illegal.

III. THE CASE FOR REPEAL

The stated purpose of Section 621 is to "put an end to [the] conflict-ridden practices"[111] that produced Abacus and to the economic harm that the undisclosed conflicts of interest caused.[112] Section 621, however, is a solution in search of a problem. It is unnecessary, potentially harmful, and should be repealed. This Part lays out the reasons why Section 621 is not the right response to transactions like Abacus. It begins by explaining that existing law already prohibits the conduct that Section 621's sponsors wanted to address. Then, it discusses why other justifications for Section 621, like those coming from behavioral economics, are unpersuasive. Lastly, it shows that Section 621 is over-inclusive and prohibits market conduct that has never been viewed as problematic and that, in fact, aids efficient price discovery.

A. Adequacy of Existing Law

Perhaps the most obvious reason that Section 621 should be repealed became apparent in July, 2013 when the man who had been referred to as the "architect" of the Abacus transaction, Fabrice Tourre,[113] was convicted of violating Section 17(a) of the '33 Act and Section 10(b) of the '34 Act.[114] The specific wrongdoing for which Tourre was found liable was concealing Paulson & Co.'s involvement in the transaction, which the jury determined was a piece of information an average investor would want to know and, thus, a material omission. As discussed above, this was exactly the way the laws were supposed to work.[115] Section 621 does not make a major difference because proving a violation still requires proving that the

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111. Merkley-Levin Letter to Bernanke, *supra* note 48, at 5.

112. *See, e.g.*, *id.*

113. *Trial of Ex-Goldman Sachs Trader Begins in New York*, ASSOCIATED PRESS, July 15, 2013, http://bigstory.ap.org/article/trial-goldman-sachs-trader-opens-new-york.

114. Verdict, *supra* note 44.

115. *See* discussion, *supra* Part II.B.2.

conflict is material;[116] the only major change is that plaintiffs no longer must prove that the conflict was not disclosed.[117]

If there were questions about whether the general prohibitions in Sections 17(a) and 10(b) applied to the specific situation where an issuer misrepresents the party responsible for choosing the component securities in a CDO in its marketing materials, Section 621 may have been an appropriate response. However, at Fabrice Tourre's trial, the court firmly ruled that the securities laws do cover undisclosed conflicts of interest in marketing materials, like in the Abacus transaction, and many other cases have held similarly.[118] As there is no uncertainty about whether the laws apply, Section 621 does not increase investor protection because there is no evidence that an issuer willing to break one law will be deterred by another law prohibiting substantially similar conduct.

If additional investor protections are needed to prevent fraud, such protections are more appropriately achieved through contractual guarantees than outright prohibitions. Contractual guarantees allow a party in a transaction to force their counterparty to disclose conflicts. If a potential buyer of a stake in a Synthetic CDO transaction finds the counterparty's involvement in the reference portfolio selection to be important, then the buyer could simply ask the issuer whether or not the counterparty was involved or whether the issuer itself had a conflict of interest. If the issuer answered in the

116. Proposed Conflict Rule, *supra* note 86, at 60,329. The language in part (b) of the rule is identical to the materiality test used in securities actions. *See, e.g.*, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

117. Because Section 621 makes conflicts themselves illegal, not just undisclosed conflicts, it would not be necessary for plaintiffs to prove whether or not a conflict was disclosed, just that it existed. Private plaintiffs, but not the government, also need to prove reliance on the fraudulent statements, though this is often presumed in omission cases. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 152–54 (1972). *But see* Jennifer O'Hare, *Synthetic CDOs, Conflicts of Interest, and Securities Fraud*, 48 U. Rich. L. Rev. 667, 692–696 (2014) (discussing issuers' use of "big boy letters" to defeat presumption of reliance). Part IV, *infra*, discusses whether sophisticated parties should be able to say they are "big boys" and contract around this issue. Part III.A, *supra*, discusses securities laws' objective to protect investors from nondisclosure, not from themselves.

118. The finding of liability in the *Tourre* case is not the only such finding. As there have been no shortage of successful enforcement actions in other cases involving conflicts of interest in CDO transactions, any uncertainty would be unwarranted. *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Charges Merrill Lynch With Misleading Investors in CDOs: Firm Agrees to $131 Million Settlement (Dec. 12, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540492377; Press Release, Sec. & Exch. Comm'n, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), https://www.sec.gov/news/press/2011/2011-214.htm; Press Release, Sec. & Exch. Comm'n, J.P. Morgan to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market (June 21, 2011), https://www.sec.gov/news/press/2011/2011-131.htm; Aladdin Capital Mgmt. LLC & Aladdin Capital LLC, Securities Act Release No. 9374, Investment Advisers Act Release No. 3514 (Dec. 17, 2012).

affirmative, the buyer could refuse to buy or lower their bid to compensate for the increased risk. If the issuer answered in the negative, the buyer could rest assured that they were protected because that affirmative response is clearly covered by existing antifraud provisions.

Even if the issuer refused to answer, the buyer would be protected because he or she would know that any rational issuer who was not conflicted would state as such and be willing to be bound by the antifraud provisions. Therefore, any issuer who did not answer a direct question about conflicts could be safely assumed to have a conflict of interest and the potential buyer could either lower their bid accordingly or decline to participate in the presumptively conflicted transaction.[119]

B. Market Distortion

If Section 621 were merely duplicative, no harm would result from simply allowing the rules to take effect. However, Section 621 is not so benign. The flat prohibition on conflicts of interest has the potential to alter market structures in a detrimental way. For example, the ban removes part of the Synthetic CDO market, which has the potential to create price distortions that could lead to asset bubbles. In addition, Section 621 prevents parties from hedging some balance sheet risk, meaning they can potentially become overleveraged. If a systemically important institution becomes overleveraged and is unable to use synthetic securitizations to hedge some of that risk, it could become insolvent which could have painful effects on the rest of the financial system. These two risks are discussed below, in turn.

Section 621 distorts the normal operation of market forces. By preventing conflicted parties from taking part in a transaction, it keeps prices from being as accurate as they would otherwise be. This can lead to the underlying assets becoming overpriced because it prevents certain parties from betting on the market and exerting downward price pressure.[120] This mispricing of securities may, in

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119. Joshua R. Rosenthal, *Burning Down the House or Simply Rolling the Dice: A Comment on Section 621 of the Dodd-Frank Act and Recommendation for Its Implementation*, 17 FORDHAM J. CORP. & FIN. L. 1263, 1297–99 (2012). Contractual "warranties" of the quality of securities issued by reputable issuers followed by purchaser discounting of securities that do not come with such a guarantee is a classic solution to the "lemon problem," which is widely discussed in law and economics literature. *See, e.g.*, George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

120. This risk is compounded by the fact that, like many bonds, CDOs are not liquid enough to short. As noted above, short sellers exert downward pressure on prices, but in an

turn, lead to overextension of credit to homebuyers since the cost to an issuer of protecting against their default is lower than it would otherwise be if the market were allowed to work unimpeded. This overextension of credit to homebuyers could, in turn, cause an asset bubble akin to the bubble in the housing market that resulted in the financial crisis. Said another way, Section 621 could actually cause the reoccurrence of the negative effects it was designed to prevent.

When one party believes that the borrowers of a certain pool of mortgages will continue to pay their loans while another party believes that some of the borrowers will default, a Synthetic CDO referencing the securities containing those underlying mortgages allows both parties to express their views on the probabilities of default or continued payment. The buyer of a short position in a Synthetic CDO is making a bet that the price of the referenced securities will go down and they will be able to get "insurance" payouts in excess of the premium they paid to insure the assets. The price a short party pays for a position in a Synthetic CDO is reflected by the percentage of the insured value it pays to the long party each quarter. A short party willing to pay a high percentage is more confident that securities will go down in value than a party willing to pay a smaller amount.

When the parties enter into the transaction, their views have an effect on prices; if many people in the market believe that mortgage holders will default en masse, they will all bid on protection offered by Synthetic CDOs. This increased demand will result in long parties charging a higher price for the protection. Even though synthetic CDOs do not actually contain any securities, the pricing of the insurance offered by a Synthetic CDO exerts an influence on the price of the underlying asset because parties can choose to buy either a real CDO or its synthetic clone depending on which is cheaper.[121] If, due to Section 621, certain short parties are not able

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illiquid market where shorting is impossible, the only way to exert any downward pressure is through a synthetic CDO. *See* Antulio N. Bomfim, Understanding Credit Derivatives and Related Instruments 37– 38 (2005).

121. *See* Bomfim, *supra* note 120, at 39–40 (noting that some market observers suggest that CDS prices incorporate new information aster than the underlying assets); William Arrata, Alejandro Bernales and Virginie Coudert, *The Effects of Derivatives on Underlying Financial Markets: Equity Options, Commodity Futures and Credit Default Swaps*, *in* 50 Years Of Money and Finance: Lessons and Challenges 445, 459–66 (2013). The carrying costs, poor liquidity, and counterparty risk involved in a synthetic CDO mean the movements of prices in the synthetic CDO market will not have a one-to-one relationship with the prices of their underlying securities. *See* Arrata et al. *supra*. For a more detailed examination of the relationship between cash CDOs and synthetics, see Brian McManus, Anik Ray & David Freston, *Index Mania and the Growth of CDS Markets*, 12 J. of Structured Finance 13 (2006) (discussing role of CDS indices as check on price appreciation in CDOs).

to bid because of their conflicts of interest, the short exposure on a Synthetic CDO would decrease, allowing a party to buy the protection on the security (the Synthetic CDO) for a price less than it would pay for the actual security (the CDO). The difference in prices between the synthetic and actual assets would result because not all parties would be able to participate in the market for buying protection. Because protection is so cheap, the investors will be able to afford bidding up the price of the actual asset.

Beyond possibly contributing to asset bubbles, Section 621 prevents firms from managing risk as effectively as they otherwise could. Prior to the crisis, a common way for firms to reduce their exposure to a certain type of asset on their balance sheet was to structure a Synthetic CDO and take the short position on that security. A firm with a CDO investment could thus transfer the risk of default to a different party while retaining ownership of the underlying asset. Even though this is often more cost-effective for both parties than an outright sale, Section 621 prohibits it.[122] The SEC recognizes this "could have a negative effect on efficiency and capital formation,"[123] which is its mission to promote.[124]

C. Behavioral Justifications are Unpersuasive

There is a second, potentially stronger argument in favor of Section 621 that can be paraphrased as follows:[125] Investors are not always rational. Even when they know their advisors have conflicts of interest, investors fail to adequately account for those conflicts by discounting the price they are willing to pay for an investment or by

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122. Balance sheet Synthetic CDOs "would generally be prohibited under the proposed rule . . . . Though securitization participants might be able to effect similar types of transactions in the form of non-synthetic ABS (which generally would not be prohibited by the above interpretation of material conflict of interest), there may be reasons why a synthetic form of a balance sheet CDO is a more efficient form of the transaction from the standpoint of the issuer or investors. In addition, this aspect of the proposed rule would limit the hedging options available to a lender who originated assets without the intent to securitize them." Proposed Conflict Rule, *supra* note 86, at 60, 347.

123. *Id.*

124. "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last visited October 10, 2014).

125. This argument is laid out well by Daylian M. Cain, George Loewenstein, and Don A. Moore in *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005).

choosing not to participate in the transaction at all. In fact, disclosure of conflicts of interest might perversely incentivize conflicted parties to give even worse advice because they feel "morally licensed and strategically encouraged to exaggerate" when recipients have information that might cause them to discount the advice.[126]

Although this Note does not dispute the general premise of this argument for most transactions, especially those involving unsophisticated investors, its application to transactions like Abacus is not persuasive for two reasons. First, the Synthetic CDOs necessarily involve opposing interests between the two parties that are impossible to remedy without prohibiting them altogether. Additionally, both parties are sophisticated, professional investors paid to undertake these transactions precisely because they are supposed to be adept at valuing risky assets.

In a Synthetic CDO, long parties know they are betting against short parties; the only way a long party can succeed is for the short party to fail.[127] The reverse is true as well: a short party can only make money at the expense of the long party—if the reference securities generate less cash than the long party expected. The long and short investors assess the future cash flows from the reference securities directly opposite from each other. Each thinks it is getting the best of its respective counterparty and only one can be right. Unlike a scenario with a conflicted advisor, the parties in a Synthetic CDO are only relying on the issuer to facilitate their bets against each other, not for advice. If the issuer has a conflict of interest, the conflict does not affect any of the parties to the transaction because they know they are betting against *someone*, the identity of whom is unimportant so long as that person did not help select the underlying securities.

The misconduct at issue in Abacus was a failure of disclosure. In situations where a party with a conflict of interest is giving advice, evidence shows investors fail to adequately take the conflict of interest into account.[128] But here, there were no claims that anyone gave bad advice to the long parties or that the long parties even *wanted* that advice. The claims were that Goldman's failure to disclose that the short party had selected the underlying securities caused the long investors to value them incorrectly. Because Goldman's conflict did not affect any advice given to the long party and because

126. *Id.* at 1.

127. The SPE pays one party with cash received from the other when he or she is wrong about which direction the security will move. *See* discussion, *supra* pp. 105–06.

128. *Id.* at 108–10.

the conflict could not have influenced the performance of the underlying securities, which depended on the ability of individual borrowers to pay their mortgages, the conflict is not of the type meant to be addressed by the behavioral argument.

In addition, the application of a behavioral argument to situations like Abacus is weakened by the fact that the parties were all extraordinarily sophisticated. Abacus was only offered to Qualified Institutional Buyers—investors with more than $100 million in liquid assets.[129] Even skeptics of the disclosure paradigm note that it is more effective when parties to the disclosure "have extensive professional experience" allowing them to gain a "reasonably accurate idea" of how one party's conflicts affect the information they provide.[130] The long parties in Abacus "had an army of Ph.D. types,"[131] exactly the sorts of people who know how to discount a conflicted party's advice, supporting the idea that it was nondisclosure of a conflict of interest, not the conflict itself, that caused the problems. It is therefore the nondisclosure, and not the conflict itself, that should be the target of any solution.

Examining the behavioral arguments around securities regulation, experts have noted the "one-way ratchet effect" of new laws.[132] New regulations are "easy to promulgate but difficult to remove," and even when research shows the regulations are "imposing costs in excess of benefits," the research tends to be ignored.[133] Because of this, they argue for a "strong presumption against regulation" when it takes the form, as Section 621 does, of "directly supplanting market decisionmakers," because these regulations have a high risk of error.[134] Rather than merely trying to help investors make the right choice, Section 621 removes a choice altogether. Merely positing that some investors might behave irrationally in purchasing securities where the issuer has a conflict of interest is not sufficient evidence to remove the securities from the market. This is especially true in light of the successful application of securities laws, prior to The Dodd-Frank Act, to discourage violations, as in *SEC v. Tourre*. Section 621 is not the right answer.

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129. Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 611 (2013).

130. Cain, Lowenstein, & Moore, *supra* note 125, at 20.

131. Davidoff & Hill, *supra* note 129, at 599 (punctuation and capitalization changed slightly from original).

132. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 45 (2003).

133. *Id.*

134. *Id.* at 56–58.

IV. A Way Forward: Amending the ISDA Contract

Even without Section 621, much of the wrongdoing in transactions like Abacus will not reoccur for the simple reason that it is no longer profitable. Most CDOs are subject to the risk retention provision, which requires the originator of an asset-backed security like a CDO to retain five percent of the risk in the transaction.[135] Industry commentators have noted this removes the incentive to create a product that is likely to decline in value because if it does decline in value, the originator will bear some of the loss.[136] Thus, even if the antifraud provisions did not adequately protect investors prior to the adoption of the risk-retention provision in the Dodd-Frank Act, they do now. However, the risk-retention provision does not apply to Synthetic CDOs. Therefore, if Section 621 is repealed, an additional fix could more fully protect investors in Synthetic CDOs without the negative effects of the proposed mandatory law.[137]

This Note proposes such a fix, and an easy one at that. Synthetic CDOs are created using a series of CDSs, almost all of which use a standard set of contracts written by the International Swaps and Derivatives Association ("ISDA").[138] Before parties enter into any CDS with each other, they sign a Master Agreement which "governs those aspects of the legal relationship between the two counterparties that are not specific to the CDS transaction at hand."[139] Then, whenever they enter into a CDS, they exchange a Confirmation Letter, a "fill in the blank" document from ISDA that is governed by the Master Agreement but adds terms specific to the transaction.[140]

The same investor protection offered by Section 621 could be achieved by simply adding a provision to the Master Agreement in which the parties agree not to have material conflicts of interest in transactions governed by the documents and to subrogate any claims under the agreement to buyers of notes linked to any CDSs governed by it. Then, should the parties in a certain transaction decide that they are willing to tolerate a conflict of interest, they would be able to waive the conflict of interest clause in their Confirmation Letter. But, if they do not waive the conflicts clause, they can rely on the protection of the antifraud provisions of the securities laws.

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135. *See* discussion, *supra* Part II.C.2.
136. *See* SIFMA Letter, *supra* note 109.
137. *See* discussion *infra* Part III.A.
138. *See* Bomfim,, *supra* note 120, at 286–97.
139. *Id.* at 286.
140. *Id.* at 287.

Amending the ISDA Master Agreement to make the default position a ban on conflicts of interest allows parties to ensure they are protected by the antifraud provisions in situations where a conflict is not disclosed. Because most transactions are not subject to conflicts of interest and the confirmation letter is only five pages long,[141] there is little risk that parties to a CDS will be so buried under disclosure that they will not notice when a firm wants to waive the proposed conflicts clause of the Master Agreement. This, in turn, will draw attention to the potential conflict of interest, and ensure that the parties will have ample opportunity to adjust their risk calculations to account for the conflict. This is preferable because it protects investors from unscrupulous issuers, but allows sophisticated parties to contract around the no-conflicts clause when a business need arises.

CONCLUSION

Market participants make money on Synthetic CDOs by researching the referenced securities in order to determine how much they should pay. They "are typically large, sophisticated financial institutions, such as banks, pension funds, mutual funds, and hedge funds," with vast resources on hand to investigate what they are buying.[142] The short party in the Abacus transaction, Paulson & Co., made nearly a billion dollars on the trade because it did exactly the sort of research necessary to determine which securities were about to fail. The conflict of interest was incidental to the transaction, evidenced by Paulson & Co.'s ability to profit off of many other short positions where it played no role in the selection of the underlying assets.

Abacus was problematic not because of the conflict of interest itself, but because the conflict was undisclosed. Had the long parties known that the short party was involved in selection of the reference securities, they may have lowered the price they were willing to pay in order to compensate for the increased risk. Alternatively, they could have declined to participate. Section 621 mandates the second option, but it does not force investors to make smart decisions. The violations of the law committed by Goldman and its salesman Fabrice Tourre had the effect of denying investors

141. Form of Confirmation, INT'L SWAPS & DERIVATIVES ASS'N, http://www.isda.org/cgi-bin/_isdadocsdownload/download.asp?DownloadID=276 (click on "ISDA Documents available for transactional use") (last visited Sept. 7, 2014).

142. Steven L. Schwarcz, *The Roberta Mitchell Lecture: Structuring Responsibility in Securitization Transactions*, 40 CAP. U. L. REV. 803, 811 (2012).

the choice whether to engage in a transaction with a conflicted party. However, investors who made such a poor bet on the basis of information that *was* available—the same information which the short party used to predict that most of the securities underlying Abacus would soon be worthless—would have likely lost their money another way if they had not been able to take the long position in Abacus.

Although prohibiting conflicts of interest allows lawmakers to return to their constituents trumpeting a new law, it is unclear whether this will actually make the market safer since it does not address the underlying basic failure by one party to research a transaction. What the section *does* do is add potential systemic risk and yet another layer of complexity to the financial system, increasing costs and distorting the market without making a meaningful addition to investor protection.

Goldman's conflicts of interest could not have caused Abacus to perform poorly; they could not make people default on their mortgages. Those borrowers would have defaulted regardless of the illegal conduct in the Abacus securitization. "Markets can price and expose risk, if we give them . . . the tools to do so," like mandating disclosure.[143] Rather than preventing sophisticated participants in the financial markets from taking on risks in securitizations they create, the financial system should use full disclosure of material information to help shift the risk to parties who are willing to bear it. Repealing Section 621 and replacing it with an update of the ISDA Master Agreement is a better solution than simply banning certain firms from profiting off securitizations they create.

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143. Adam J. Levitin, Andrey D. Pavlov & Susan M. Wachter, *Securitization: Cause or Remedy of the Financial Crisis?* 16 (Georgetown Univ. L. Ctr., Bus., Econ. & Regulatory Policy Paper Series, Research Paper No. 1462895, Univ. of Penn., Inst. For L. & Econ., Research Paper No. 09-31, 2009), *available at* http://ssrn.com/abstract=1462895.