

# Fitting An Old Tiger with New Teeth: Protecting Public Employee Funds Investing in Complex Financial Instruments

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# **FITTING AN OLD TIGER WITH NEW TEETH: PROTECTING PUBLIC EMPLOYEE FUNDS INVESTING IN COMPLEX FINANCIAL INSTRUMENTS**

RICHARD E. MENDALES\*

*State employee benefit funds invested heavily in complex financial instruments before the crash of 2008. These investments were tempting to the funds because the instruments carried higher yields than those offered by traditional securities in the low interest climate created largely by Federal Reserve policies after the turn of the century. The risks of the unconventional securities were concealed by investment-grade ratings issued by credit rating agencies and by deceptive marketing practices. With the crash, funds incurred major losses, which, unlike losses by private funds, are not insured by the federal Pension Benefit Guaranty Corporation.*

*This Article deals both with enforcing claims based on deceptive practices, and protecting funds against future investments of this kind. Enforcement is an issue because the SEC has limited resources, though it faces fewer procedural burdens than the states, and is the only party with standing to bring actions under statutes such as the Investment Advisers Act of 1940. Enforcement by states acting alone is problematic because most states have limited experience in securities litigation, and because they may proceed under state law, risking divergent outcomes that could undermine the consistency in dealing with securities fraud intended by the federal securities laws.*

*This Article proposes that the SEC create within itself an Office of State Coordination to help train state legal personnel in securities fraud actions, and to enable the SEC to coordinate enforcement with state*

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agencies in order to maximize the effectiveness of limited enforcement resources. Next, it discusses protecting benefit funds in future investments and analyzes the provisions of the new Dodd-Frank Act intended to improve the securities rating process, finding them to be largely ineffective. It therefore recommends largely bypassing Dodd-Frank, and giving earlier securities laws new teeth through regulatory changes restricting the sale of unregistered securities to larger, more sophisticated funds. It also recommends extending the SEC's "Plain English" disclosure rules—now applicable only to registered securities—to all securities offerings. These rules require issuers to disclose the risks of the instruments they offer in plain English and in order of the magnitude of the risks they pose. Thus, these rules would provide better guides to risk than the rating system, even as modified by Dodd-Frank, and will aid states both in regulating investments by their funds and in enforcement actions against deceptive practices.

I.	INTRODUCTION .....	244
II.	EXOTIC SECURITIES IN THE NEW GILDED AGE .....	254
	A. <i>The Onset of Complexity: Asset-Backed Securities</i> .....	256
	B. <i>Ratcheting Up Complexity: Derivatives Based on Asset-Backed Securities</i> .....	263
	C. <i>The Downward Spiral of Quality in Collateral: The Great Debt Bubble of 1998–2006</i> .....	269
III.	THINGS FALL APART: THE FINANCIAL CRISIS .....	274
	A. <i>The Crumbling Firewall: Deregulation and the Financial Crisis</i> .....	275
	B. <i>Prelude: The Credit Bubble Reaches Its Limits</i> .....	279
	C. <i>The Financial Crisis: The Crash of 2008</i> .....	280
IV.	THE SECURITIES LAWS AND INVESTMENTS BY BENEFIT FUNDS .....	282
	A. <i>Ad Hoc Responses: Trying to Contain the Crisis</i> .....	282
	B. <i>Incomplete Answers: The Dodd-Frank Act and Preliminary Attempts at Regulation</i> .....	284
V.	WHERE DO WE GO FROM HERE? .....	296
	A. <i>Enforcement: Regulations in Aid of Benefit Funds for Pre-Crisis Investments</i> .....	297
	B. <i>Enforcement: Giving Statutes Regulatory Teeth</i> .....	298
	C. <i>Rethinking Exemption from Registration for Asset-Backed Securities</i> .....	300
	D. <i>Amplifying Disclosure: Borrowing from the FDA</i> .....	304



## I. INTRODUCTION

The financial panic that began almost invisibly late in 2006 spread, like an epidemic, from largely unregulated organizations such as hedge funds to supposedly regulated institutions such as securities dealers and banks.<sup>1</sup> It has now reached beyond that circle to strike at sovereign nations and, within the United States, at institutions deeply embedded in the fabric of society such as public employee benefit funds.<sup>2</sup> Benefit funds face a continuing threat similar in nature to that already experienced by other financial institutions on Wall Street. During the years preceding the crisis, the entities administering the benefit funds invested heavily in complex financial instruments that they did not understand, and which, when the crisis hit, proved to be worth far less than their cost, or proved to be impossible to value and therefore impossible to sell.<sup>3</sup>

Public benefit funds are also threatened because the states and municipal entities that sponsor them have not made adequate contributions to support their future obligations.<sup>4</sup> This is chiefly a

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1. See RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION *passim* (2009); James R. Barth et al., *The Financial Crisis: How Did We Get Here and Where Do We Go Next?*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 95, 97–98, 100 (Robert W. Kolb ed., 2010) (noting that the wave of foreclosures that ended the subprime housing boom began in 2006). Judge Richard A. Posner, writing in 2009, described the worldwide financial crisis that climaxed in 2008 with the crash of global financial markets following the failure of the noted investment banking firms of Bear Stearns and Lehman Brothers as having sufficient magnitude to be described as a “depression” without parallel since the Crash of 1929 and the Great Depression that followed. See POSNER *supra*.

2. The term “benefit fund” will be used generically for purposes of this Article to cover trust funds established by states and their instrumentalities, including municipalities, school boards, and similar entities, for the welfare of their employees. These include old age and disability pensions, medical benefit plans, and other similar funds.

3. See Gretchen Morgenson, *Wall Street's Tax on Main Street*, N.Y. TIMES, Aug. 7, 2011, at BU1 (municipalities and benefit funds face financial ruin not only because of benefit obligations and weak revenues, but because of investment in financial instruments they do not understand and whose downside is not adequately disclosed to them); Louise Story, *A Question of Value: What's an Asset Worth? It's Not Always Easy to Tell*, N.Y. TIMES, June 20, 2008, at C1 (outlining that “one of most vexing problems” facing Wall Street, even before the crash of 2008, was how to value securities backed by subprime mortgages).

4. See Meredith Whitney, Opinion, *The Hidden State Financial Crisis*, WALL ST. J., May 18, 2011, at A17; David Evans, *Banks Sell 'Toxic Waste' CDOs to Calpers, Texas Teachers Fund*, BLOOMBERG (June 1, 2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW5vEJn3LpVw>; see also Morgenson, *supra* note 3 (discussing the recent bankruptcy filing by Central Falls, Rhode Island).

political problem, although it is linked to the securities law issues that are the primary subject of this Article, because the fund administrators are under intense pressure from beneficiaries and political officials to make up for insufficient contributions. As a result, the administrators have made improvident investments to obtain unrealistically high yields on their assets.<sup>5</sup> Most public pension funds, for example, still base required employee contributions and promised benefits on assumed returns of 7% to 8%, while actual yields have been 5% to 7% since the turn of the century, and less since the crash of 2008.<sup>6</sup> During the period preceding the crash, fiduciaries for plans invested in securities based on high ratings and promises by issuers that the securities they were buying offered safety as well as high yields.<sup>7</sup> Given the broad distinction between the political problems involved in funding public benefit funds,<sup>8</sup> and the threats they face from defaults of allegedly safe instruments, this Article will focus primarily on the latter, dealing with issues arising under the securities laws.

Public benefit funds face problems that differ significantly from those faced by their private counterparts. One important distinction is that qualifying private benefit funds are regulated by the Federal Pension Benefit Guaranty Corporation (PBGC),<sup>9</sup> which ultimately provides at least partial compensation to its beneficiaries, should they prove insolvent.<sup>10</sup> The federal Employee Retirement Income Security Act<sup>11</sup> (ERISA) and the regulations adopted thereunder have given these

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5. See *infra* Part II.B.

6. See *infra* notes 64–66 and accompanying text.

7. See *infra* notes 85, 97–103 and accompanying text.

8. See, e.g., Thomas Kaplan & John Eligon, *In Albany, Plan to Cut Pensions Takes Shape; Redistricting Moves Ahead*, N.Y. TIMES, Mar. 15, 2012, at A26 (discussing the bitter political battle over modifications in public pension contributions and benefits). Benefit funds face strong opposition to modifications in required contributions, benefits, and other changes concerning their beneficiaries by the beneficiaries themselves and their representatives such as public employee unions and allied political forces. See *id.*

9. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 4002, 88 Stat. 829, 1004 (codified as amended at 29 U.S.C. §§ 1001, 1302 (2006)). The PBGC was established by ERISA in 1974. See *id.*

10. See Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001(c) (2006).

11. § 4002, 88 Stat. at 1004. ERISA covers both qualifying private pension and health benefit plans, and mandates supervision of funding and investments for such plans, *inter alia*, by the Federal Department of Labor, the Internal Revenue Service, and the PBGC. See *History of EBSA and ERISA*, U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., <http://www.dol.gov/ebsa/aboutebsa/history.html> (last visited Oct. 8, 2012).

funds substantial protection from abuses by financial intermediaries peddling risky financial instruments, although this protection has not been perfect.<sup>12</sup>

Ironically, benefit funds operated by states and their subdivisions are at greater risk. They are largely exempt from investment standards mandated by ERISA and PBGC insurance,<sup>13</sup> and they were afforded minimal protection from federal statutes and regulations until the enactment, after the financial crisis had already taken its toll, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>14</sup> It is not surprising, therefore, that problems are coming to light concerning the value of securities held by this large class of benefit funds,<sup>15</sup> which present state governments with the risk of defaulting on securities they hold, in addition to underfunding based on loss of state revenues due to the continuing national financial crisis.<sup>16</sup> Because major insolvencies at the state level could adversely impact the credit of the country as a whole,<sup>17</sup> large-scale insolvency of state and local benefit

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12. See 29 U.S.C. § 1001(b). The sharp distinction between ERISA-based claims and those brought by public benefit funds is illustrated by the separate settlement by public benefit funds in the Stipulation of Settlement of Securities Action from Ohio Public Employees Retirement System v. Freddie Mac, MDL No. 1584, No. 03-CV-4261 (S.D.N.Y. May 23, 2006) (public benefit funds agreed to settlement of securities class action, stipulating it did not apply to related ERISA class action cases because the actions by public benefit funds relied solely on the securities laws, because they were not subject to protective provisions of ERISA).

13. 29 U.S.C. § 1003(b)(1).

14. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

15. See *2008 State & Local Public-Employee Retirement Systems*, U.S. CENSUS BUREAU (May 15, 2012), [http://www.census.gov/govs/retire/historical\\_data\\_2008.html](http://www.census.gov/govs/retire/historical_data_2008.html). U.S. Census data show that there were about 2,550 state and local benefit funds holding about \$2.2 trillion in total assets—about one-third of all assets held in U.S. benefit funds—as of June 30, 2008, just before the financial crisis reached its peak. Rules of Registration of Municipal Advisers, Dodd-Frank Act Release No. 34-63576, 76 Fed. Reg. 824, 826 (proposed Jan. 6, 2011) (to be codified at 17 C.F.R. pts. 240 & 249).

16. See *infra* note 64–66 and accompanying note.

17. Contagion from the failure of major financial entities often has effects that can spread throughout a national economy or even the rest of the world, particularly when the national or world economy is already in fragile condition. The failure of Lehman Brothers was such an event and helped precipitate the worldwide financial crisis of 2008. See *infra* notes 207, 214–21 and accompanying text. Another example is the threatened default of Greece, which, despite the relatively small size of the Greek economy, threatens to cause a chain reaction to larger economies such as Spain and Italy, and thence to the entire Eurozone and from there to countries outside the Eurozone. See Rachel Donadio & Liz Alderman,

funds could lead to a financial meltdown comparable to the threatened failure of private financial institutions that brought on the 2008 crisis, and hence could require federal intervention despite the lack of formal insurance coverage by ERISA and PBGC under present law.<sup>18</sup>

During the decade leading to the present financial crisis, benefit funds tremendously increased their exposure to risky investments, particularly in the form of complex asset-backed securities.<sup>19</sup> The funds that proved vulnerable to the peddling of these financial instruments—often deceptively marketed as offering safety in addition to high yield—include not only smaller and less sophisticated funds<sup>20</sup> but also large and supposedly sophisticated funds such as the California Public Employees' Retirement System<sup>21</sup> (CALPERS) and the Teacher Retirement System of Texas.<sup>22</sup> These funds experienced pressure from their beneficiaries and political officials to obtain higher rates of return on their investments,<sup>23</sup> at a time when the prevailing low interest rates depressed yields on conventional investments to levels that made it more difficult

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*Talks Under Way to Form a Government in Greece*, N.Y. TIMES, June 19, 2012, at A8; *Eurozone Crisis Explained*, BBC NEWS: BUS. (Aug. 22, 2012), <http://www.bbc.co.uk/news/business-13798000>. This is not a new phenomenon; the 1906 San Francisco earthquake, for example, with its direct effects on the national economy and indirect effects on insurance companies worldwide, helped precipitate the Panic of 1907 and resulting global financial crisis. See ROBERT F. BRUNER & SEAN D. CARR, *THE PANIC OF 1907: LESSONS LEARNED FROM THE MARKET'S PERFECT STORM* 13 (2007).

18. See Whitney, *supra* note 4 (noting that state budget shortfalls, including partly hidden underfunding of pension and other employee obligations, could threaten the national recovery, since state spending makes up 12% of the United States' gross domestic product).

19. See Rules of Registration of Municipal Advisers, 76 Fed. Reg. at 825–26; Christopher Whalen, *Yield to Commission: Is an OTC Market to Blame for Growing Systemic Risk?*, J. STRUCTURED FIN., Summer 2008, at 8, 8; Evans, *supra* note 4.

20. See, e.g., *SEC Hearing on the State of Municipal Securities Market, Birmingham, AL* (2011) (prepared remarks of Andrew Kalotay), available at <http://www.sec.gov/spotlight/municipalsecurities/statements072911/kalotay.pdf>.

21. See, e.g., Michael B. Marois, *Calpers Strips LaSalle of Industrial Real Estate Portfolio, Adds GI, RREEF*, BLOOMBERG (Dec. 1, 2010), <http://www.bloomberg.com/news/2010-12-01/calpers-strips-lasalle-of-industrial-real-estate-portfolio-job.html> (noting that the California Public Employees' Retirement System is the largest state-run public employees' pension fund in the United States).

22. See, e.g., Evans, *supra* note 4.

23. See *Yes, They Can Go Down Too*, ECONOMIST (May 13, 2007, 10:35 PM), [http://www.economist.com/blogs/freeexchange/2007/03/yes\\_they\\_can\\_go\\_down\\_too](http://www.economist.com/blogs/freeexchange/2007/03/yes_they_can_go_down_too) (noting that the Dallas Police and Fire Pension Funds bought high-risk CDOs to boost rates of return).

to fund potential claims for pension, and other, benefits.<sup>24</sup>

The turkeys are now coming home to roost for benefit funds that bought risky instruments that have defaulted or sharply diminished in value.<sup>25</sup> Faced with steep losses, some have commenced lawsuits against the financial advisers and institutions that sold and rated the risky investments.<sup>26</sup> Both the transactions leading to these cases and the process of resolving them lead back to major holes in the federal statutes and regulations that supposedly protect investors against misrepresentations and manipulative conduct in the sale of securities.<sup>27</sup> One of these deficiencies, the exclusion of public funds from ERISA coverage, would require significant new federal legislation to overcome.<sup>28</sup> Given the issues of federalism that this would raise, and the present highly partisan political climate—which seems likely to persist into the indefinite future—the burden of overcoming resistance to such legislation appears insuperable as of this writing.<sup>29</sup>

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24. See, e.g., Evans, *supra* note 4 (noting that the problems with pension funds are similar to Orange County's 1994 bankruptcy at which time "[t]he county was earning 8 percent in what was a 3 1/2 percent world").

25. See John Ryan, *The Greenspan and Bernanke Federal in the Reserve Roles in the Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 461, 461–62 (noting that interest rates set by the Federal Reserve help dictate interest rates across the entire economy, and in particular led to low mortgage interest rates that fed the housing bubble).

26. See *Emps. Ret. Sys. v. Morgan Stanley & Co.*, 814 F. Supp. 2d 344 (S.D.N.Y. 2011) (suit by pension fund against financial adviser seeking \$1.2 billion after default of CDOs sold to pension system); *Complaint, Illinois v. McGraw-Hill Cos.*, No. 12 CH-02535 (Ill. Cir. Ct. Jan. 25, 2012) (suit by State of Illinois against Standard & Poor's seeking compensation for deceptive practices in rating asset-backed securities).

27. See *infra* note 28 and accompanying text.

28. ERISA specifically excludes "governmental plans" from coverage. See 29 U.S.C. § 1003(b)(1) (2006). Government plans include plans for federal employees and those of state governments, agencies, and instrumentalities, as well as those of international organizations, and Indian tribes. *Id.* § 1002(32). This is in part because the stated purpose of ERISA is to protect employees covered by private benefit plans from abuses, *Id.* § 1001(a)–(c), and in part because Congress based its authority to enact ERISA in part on the taxing power, *id.* § 1001(c), a power that raises questions of federalism when applied to the states, as seen in the exemption of interest on the obligations of states and their instrumentalities from taxation. See 26 U.S.C. § 115(1) (2006). In any event, the extension of federal authority to states and their instrumentalities appears to be particularly difficult at this time, when any extension of federal authority faces steep roadblocks in Congress, and possibly in the courts as well. See *infra* notes 32–34 and accompanying text; see also *Alden v. Maine*, 527 U.S. 706, 713–15 (1999) (holding that states retain sovereignty where not limited by Constitutional authority of the federal government).

29. See generally THOMAS E. MANN & NORMAN J. ORNSTEIN, *IT'S EVEN WORSE THAN*

This Article therefore suggests that new rules dealing with securities sold to public benefit funds—both for sales before the financial crisis and for protection against new abuses in the post-crisis world—should focus upon the peddlers of complex financial instruments rather than on the benefit funds they have victimized. To provide a unified federal structure of protection, this approach necessarily will rely largely on regulations based on the securities laws. As we shall see, the Dodd-Frank Act, and regulations being drafted to implement Dodd-Frank,<sup>30</sup> will not suffice for this purpose.<sup>31</sup>

These measures are inadequate for several reasons. First, Dodd-Frank is so large, complex, and riddled with legislative compromises<sup>32</sup> that the agencies charged with enforcing it, which have been systematically underfunded by Congress, have had to delay their drafting of interpretive regulations well beyond the deadlines set by the statute.<sup>33</sup> Moreover, Dodd-Frank continues to face legislative hostility

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IT LOOKS: HOW THE AMERICAN CONSTITUTIONAL SYSTEM COLLIDED WITH THE NEW POLITICS OF EXTREMISM (2012). The new study concludes that the Republican Party in Congress has been taken over by ideological extremists determined and able to obstruct any measure—especially regulatory actions—contrary to their anti-government philosophy. *Id.* at XIV. The book's claims to non-partisanship are supported by Ornstein's membership in the Republican-oriented American Enterprise Institute. See Norman J. Ornstein: Resident Scholar, AMERICAN ENTERPRISE INSTITUTE, <http://www.aei.org/scholar/norman-j-ornstein/> (last visited Sept. 21, 2012).

30. See *SEC's Dodd-Frank Act Implementation Efforts Continue*, FIN. SERVS. INST. (Oct. 20, 2010), <https://www.financialservices.org/page.aspx?id=2886>.

31. See discussion *infra* Part IV.B–E.

32. See Jeffrey H. Birnbaum, *Lawmakers Seek Shortcut in Negotiating Housing Bill*, WASH. POST, June 7, 2008, at D1 (detailing numerous compromises made by congress prior to the passage of the Dodd-Frank Act); David Cho et al., *Lawmakers Guide Wall Street Reform into Homestretch*, WASH. POST, June 26, 2010, at A1.

33. See *Financial Services and General Government Appropriations for 2012: Hearing Before the Subcomm. on Fin. Servs. and Gen. Gov't Appropriations of the H. Comm. on Appropriations*, 112th Cong. 109–17 (2011) (statement of Mary Schapiro, Chairman, U.S. Securities & Exchange Commission); Arthur Levitt Jr., Op-Ed., *Don't Gut the S.E.C.*, N.Y. TIMES, Aug. 8, 2011, at A19. Full implementation of Dodd-Frank for FY 2012 required about 780 new SEC staff, *see id.*, and an increase in funding of \$264 million from FY 2011, U.S. SEC. EXCH. COMM'N, IN BRIEF: FY 2012 CONGRESSIONAL JUSTIFICATION 2 (2011). But the SEC received an increase of \$178 million, Consolidated Appropriations Act, 2012, Pub. L. No. 112-74, 125 Stat. 786, 920 (2011) (\$1.321 billion budget for FY 2012), \$86 million short of the SEC's \$1.407 billion goal for FY 2012. See U.S. SEC. EXCH. COMM'N, *supra*. The Senate Appropriations Committee recently passed a \$1.566 billion budget for the SEC in FY 2013, however, it is unclear whether this budget will be appropriated. See Yin Wilczek, *Ex-Commissioners Say SEC Now Facing Biggest Rulemaking Crunch in Agency History*, 44 SEC. REG. & L. REP. (BNA) No. 28, at 1338 (July 9, 2012); Sarah N. Lynch, *U.S. Senate Panel OKs*

that is likely to make agencies tread carefully in drafting regulations to implement it.<sup>34</sup> In addition, it virtually excludes enforcement actions by parties other than regulatory agencies such as the Securities and Exchange Commission (SEC).<sup>35</sup> This is a major weakness because, as is true for other actions by the SEC and other regulatory agencies, the number of professionals available for federal enforcement falls far short of the number required to deal with the securities law violations involved in the crisis.<sup>36</sup> Although Dodd-Frank provides for the creation of an annual \$100 million reserve fund for the SEC, financed by registration fees paid to the Commission,<sup>37</sup> the House Appropriations Committee, displaying open hostility toward Dodd-Frank and the SEC itself, has sought to nullify the statute by both barring the creation of such a fund in bills making appropriations for the SEC, and by reducing its appropriations well below levels sought by the Executive Branch.<sup>38</sup>

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*Budget Boosts for SEC, CFTC*, REUTERS (June 14, 2012), <http://www.reuters.com/article/2012/06/14/us-senate-cftc-sec-funding-idUSBRE85D1HJ20120614>; *supra* note 32; *infra* note 38, *et seq.* and accompanying text.

34. See R. Christian Bruce, *Wolin Defends Administration's Efforts On Dodd-Frank, Vows to Oppose Repeal*, 43 SEC. REG. & L. REP. (BNA) No. 17, at 868 (Apr. 25, 2011); Levitt, *supra* note 33 (noting that deliberate underfunding by Congressional Republicans has impaired the ability of agencies to draft regulations to enforce Dodd-Frank); Wilczek, *supra* note 33.

35. See *infra* notes 282–83 and accompanying text.

36. See Stephen J. Crimmins, *New SEC Enforcement Unit Focuses on Funds and Advisers*, 42 SEC. REG. & L. REP. (BNA) No. 47, at 2284 (Dec. 6 2010) (noting that the SEC Enforcement Division has “limited resources,” and that the new unit to enforce Investment Advisers Act will comprise only 65 professionals, including both lawyers and accountants). As early as 1963, the SEC advised the Supreme Court in an *amicus* brief that it lacked sufficient personnel to carefully examine the 2,000 proxy statements submitted to it annually, a number that has multiplied many times since then. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). The lack of sufficient personnel not only prevents the agency (and other agencies involved in enforcement such as the CFTC) from bringing enforcement actions in many cases, but has forced the SEC to accept settlements that fail to bring about full disgorgement payments made in transactions violating the securities laws even if the accused wrongdoers, even if subject to injunctions for prior violations, are not required to admit wrongdoing. See, e.g., Edward Wyatt, *Judge Rejects an S.E.C. Deal with Citigroup*, N.Y. TIMES, Nov. 29, 2011, at A1.

37. See Dodd-Frank Act, 15 U.S.C. § 78d(i)(2)(B) (Supp. IV 2011) (noting that the maximum amount that can be deposited per fiscal year is \$50 million, while the maximum balance the account can hold is \$100 million per fiscal year).

38. See James Hamilton, *House Financial Services Appropriations Bill Would Eliminate SEC Reserve Fund*, CCH FIN. REFORM NEWS CTR. (June 16, 2011), <http://financialreform.woiterskluberlb.com/2011/06/house-financial-services-appropriations-bill-would-eliminate-sec-reserve-fund.html>. The partisan hostility to the SEC was illustrated by the Committee's

Congressional failure to fund the SEC at levels required by law has crippled the agency not only in its ability to recruit badly needed new personnel and to conduct enforcement actions, but even to engage in routine examinations, both at the national and at the local levels.<sup>39</sup> Other federal regulatory agencies, such as the Commodities Futures Trading Commission (CFTC),<sup>40</sup> have also suffered Congressional cutbacks, but attacks on the SEC have special impact because the SEC has been the spearhead of federal enforcement of antifraud statutes and regulations.<sup>41</sup>

Therefore, recovery of losses will require measures to enhance the effectiveness of the SEC as presently staffed, and to aid the states in acting on behalf of their benefit funds. While some statutory changes of recent years, such as the Private Securities Litigation Reform Act (PSLRA),<sup>42</sup> have created impediments to actions by parties other than

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statement, notwithstanding the creation of the fund by Dodd-Frank that would be “a slush fund for the SEC for programs that have not been approved by Congress.” *See House Appropriations Bill Funds SEC at \$1.2B, \$222M Less than Obama Request*, 43 SEC. REG. & L. REP. (BNA) No. 25, at 1273 (June 20, 2011). This hostility continues. *See Administration ‘Strongly Opposes’ House Bill to Set SEC’s FY 2013 Budget at \$1.371B*, 44 SEC. REG. & L. REP. (BNA) No. 28, at 1334 (July 9, 2012) (noting that the House Appropriations Committee cleared H.R. 6020, setting 2013 appropriations for the SEC \$195 million less than requested by the White House, and barring the SEC from using its \$50 million reserve fund).

39. *See* Stephen Joyce, *Absence of Self-Funding Presents SEC with Big Challenge, Regional Chief Says*, SEC. L. DAILY (BNA) (Oct. 27, 2011); Stephen Joyce, *Budget Deficiencies Leading to Change in SEC Examination Process, Canellos Says*, SEC. L. DAILY (BNA) (Nov. 22, 2011) (short funding by Congress pushing the SEC to change its examination process “to focus on alleged wrongdoing at the expense of conducting more prudential exams”).

40. *See* Charles Riley, *Broken Budget Process Hurts Wall Street Reform*, CNNMONEY (Feb. 10, 2012), [http://money.cnn.com/2012/02/10/news/economy/cftc\\_sec\\_budget/index.htm](http://money.cnn.com/2012/02/10/news/economy/cftc_sec_budget/index.htm) (noting that Congressional Republicans blocked higher appropriations for CFTC and SEC as part of their general opposition to implementing Dodd-Frank).

41. SEC understaffing has long forced the agency to accept settlements with financial institutions accused of securities violations in which, even in cases of repeat violations, the targets of its actions have been able to avoid any admissions of specific acts of wrongdoing. *See, e.g.*, Wyatt, *supra* note 36 (noting that a study by The New York Times showed fifty-one instances in which the SEC accepted settlements with companies that had previously agreed to injunctions not to commit similar infractions). Settlements of this kind not only result in inadequate compensation of the victims of securities violations through agency action but also leave such victims with no court record on which to base their own actions against the offenders.

42. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in 15 U.S.C. §§ 77 and 78 (2006)) [hereinafter PSLRA].

the SEC,<sup>43</sup> the changes have had a penumbral effect beyond their actual language in deterring private counsel for benefit funds from undertaking actions in the federal courts,<sup>44</sup> even though the funds are expressly exempt from the obstacles posed by the PSLRA,<sup>45</sup> and its parallel statute, the Securities Litigation Uniform Standards Act (SLUSA),<sup>46</sup> which enables defendants in private securities fraud class actions brought in state courts to remove them to federal court, where they can be dismissed without discovery under the PSLRA.<sup>47</sup>

To overcome these problems, the SEC should act to keep securities regulation within a framework centered on federal securities law. In view of the partisan deadlock that now besets Congress and is likely to

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43. The PSLRA was passed with the alleged intent to prevent abusive private class actions under Securities Exchange Act of 1934 § 10(b) and Rule 10b-5. *See id.* It did so, *inter alia*, by raising the pleading requirements that plaintiffs must meet in order to obtain discovery from defendants. *See* Securities Exchange Act of 1934 § 21D(a), 15 U.S.C. § 78u-4 (2006) [hereinafter Exchange Act]; *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

44. PSLRA, Sec. 101(a), § 27(c), 15 U.S.C. § 77z-1(c) (2006); Andrew J. Entwistle & Jonathan H. Beemer, *Approaches to Asset Recovery for Pension Fund Subprime Exposure*, NAPPA REPORT, Feb. 2008, at 4, 4-6 (2008), available at [http://www.entwistle-law.com/news/publications/000041/\\_res/id=sa\\_File1/Approaches%20to%20Asset.pdf](http://www.entwistle-law.com/news/publications/000041/_res/id=sa_File1/Approaches%20to%20Asset.pdf). Part of this effect is probably due not only to the standards imposed for bringing actions, but to sanctions that the PSLRA imposes for allegedly abusive actions under the Exchange Act, which may have a deterrent effect on private attorneys representing benefit funds who are subject to the sanctions in bringing actions on behalf of private plaintiffs. *See* Exchange Act § 21D(c). In fact, however, recent decisions indicate that the PSLRA is having adverse effects on actions by benefit funds—not intended targets of the statute—under the federal securities laws—and increasingly pushing them into state court. *See, e.g.,* *Mississippi Pub. Emps.' Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 78 (1st Cir. 2008) (reversing district court dismissal under PSLRA). Even a large private entity such as AIG, in a securities-based action against two private investment firms, chose to bring the action under state law in New York even though it could have had its case heard in federal court based on facts pleaded in a parallel action by the SEC. *See* Complaint at 1-2, *SEC v. ICP Asset Mgmt.*, No. 10-cv-04791 (S.D.N.Y. 2010); Complaint at 1-2, *AIG Fin. Prods. v. ICP Asset Mgmt.*, No. 651117/2011 (N.Y. Sup. Ct. 2011).

45. *See* Exchange Act § 28(d); Securities Act of 1933 § 16(d)(2), 15 U.S.C. § 77p(d)(2) (2006).

46. Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (codified at 15 U.S.C. §§ 77p(b), 78bb (2006)) [hereinafter SLUSA].

47. SLUSA, Sec. 101(a), § 16(d), 15 U.S.C. § 77p(d) (2006). SLUSA, like the PSLRA, applies only to private class actions, but it applies to all private class actions involving securities fraud, including not only actions under state securities law but even to actions based on causes of actions based on common-law fraud. *Id.*; *see also* THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 303 (6th ed. 2009).

continue into the foreseeable future,<sup>48</sup> it seems unrealistic to propose new legislation at this writing. Instead, the SEC and agencies coordinating with it, especially the CFTC, at the federal level, plus corresponding state attorneys general and securities officials—acting in support of funds sponsored by states and their instrumentalities—should draft regulations based on existing statutes, focusing in particular on enhanced federal–state cooperation.<sup>49</sup>

This Article proposes changes based on revised federal regulations that will be more effective than reliance on poorly understood and enforced state laws that are increasingly employed by aggrieved benefit funds.<sup>50</sup> These regulations will both aid benefit funds in recovering losses incurred as a result of fraudulent practices in the past, and serve to prevent similar abuses in the future. The proposed reforms will, *inter alia*, provide for systematic cooperation between state and federal agencies in enforcing the rights of state benefit funds; reduce the scope of exemptions from registration of new securities under the Securities Act of 1933 (Securities Act);<sup>51</sup> utilize the new tools provided by the Dodd-Frank Act where possible; and give new teeth to older federal securities law, including the long-underused Investment Advisers Act of 1940 (Advisers Act).<sup>52</sup>

To strengthen the enforcement of claims based on fraud, this Article proposes regulations based upon statutes enforceable only by the SEC, including the Advisers Act and certain provisions of the Securities Act and the Securities Exchange Act of 1934 (Exchange Act).<sup>53</sup> For new investments by benefit funds, this Article proposes regulations to be promulgated by the SEC under existing securities law, including the Advisers Act, and significant modifications of Rule 506 (promulgated

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48. See generally MANN & ORNSTEIN, *supra* note 29.

49. See *infra* notes 308–11, 373–75 and accompanying text.

50. See, e.g., Entwistle & Beemer, *supra* note 44, at 6. The chief state law remedies are those for common law fraud, breach of contract and breach of fiduciary duty, and state securities legislation, *see id.*, increasingly including the Uniform Securities Act, 7C U.L.A. 749 (1956), whose section 101 (section 501 in the Revised Uniform Securities Act, *id.* at 150, which has not yet supplanted the original Uniform Securities Act in all states) antifraud provisions track Exchange Act Rule 10b-5 (although case law has yet to establish whether the remedies will be interpreted in the same way as federal courts apply Rule 10b-5). 17 C.F.R. § 240.10b-5(c) (2011).

51. Securities Act of 1933, 15 U.S.C. § 77a (2006).

52. Investment Advisers Act of 1940, 15 U.S.C. § 80b-20 (2006).

53. Exchange Act, 15 U.S.C. § 78a (2006).

pursuant to the Securities Act).<sup>54</sup> These will require improved disclosure of risk factors in the issuance of financial instruments other than traditional corporate and government securities to public benefit funds; reduced dependence on ratings by credit rating agencies that, even after Dodd-Frank, remain lightly regulated;<sup>55</sup> and increased aid to state regulators in establishing sound investment practices for the funds under their supervision.<sup>56</sup>

As noted, regulatory changes to protect benefit funds should focus on improving coordination between the SEC and state regulators, by means such as expanding the SEC's present role in providing training for lawyers in state attorney generals' offices in bringing enforcement actions, and by employing state lawyers to assist thinly staffed SEC enforcement teams in maintaining actions that only the SEC itself has standing to bring.<sup>57</sup> The SEC can also amend current regulations to protect benefit funds going forward by limiting the ability of smaller funds to buy privately placed securities and by applying the SEC's "Plain English" disclosure rules to all securities disclosure, which includes private placement memos.<sup>58</sup>

## II. EXOTIC SECURITIES IN THE NEW GILDED AGE

The last thirty years have been marked by a proliferation of new types of securities, which steadily increased in complexity, risk, and difficulties in understanding the nature of the risk presented.<sup>59</sup> The problem has been aggravated by the deregulation of the financial system,<sup>60</sup> which created a climate of financial recklessness bringing to mind the "Gilded Age" of the late nineteenth century.<sup>61</sup>

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54. 17 C.F.R. § 230.506 (2012).

55. See *infra* notes 280–85, 334–49 and accompanying text.

56. See *infra* notes 307, 348–51 and accompanying text.

57. See *infra* note 196 and accompanying text.

58. Since 1998, the SEC has required disclosure in any prospectus accompanying registered securities to be written in Plain English, making it clear to investors exactly what risks they face. See 17 C.F.R. § 230.420–.421. See generally OFFICE INVESTOR EDUC. ASSISTANCE, U.S. SEC. EXCH. COMM'N, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS (1998).

59. See *infra* Part II.A.

60. See POSNER, *supra* note 1, at 23–28 (noting that the deregulation of financial industry was a major contributor to the escalation of risk in assets leading to financial crisis); *infra* Part III.A.

61. See generally 12 GEORG WILHELM FRIEDRICH HEGEL, VORLESUNGEN ÜBER DIE

At the same time that the nature of the securities made them less comprehensible to potential purchasers and even the financial intermediaries peddling them, the low interest rates on conventional debt securities based on Federal Reserve policy since the turn of the century<sup>62</sup> created an appetite for higher yields, particularly by underfunded benefit funds.<sup>63</sup> Even a benefit fund receiving contributions at levels that previously sufficed to meet eventual beneficiary claims would face eventual underfunding if it followed old patterns of investing in well-understood and traditionally safe instruments such as government securities and corporate bonds.<sup>64</sup> For many benefit funds, whose contribution rates fell well below the amount needed to fund promised benefits even if invested in traditional instruments, the potential deficits ran much higher—threatening cities and other state subdivisions with Chapter 9 bankruptcy,<sup>65</sup> with ripple effects threatening the states themselves and the larger national

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PHILOSOPHIE DER WELTGESCHICHTE 8 (1831) (translated by author) (on file with author) (“Was die Erfahrung aber und die Geschichte lehren, ist dieses, daß Völker und die Regierungen niemals etwas aus der Geschichte lehren . . . haben,” *very roughly translated*, “The only thing we learn from history is that we never learn anything from history”); MARK TWAIN & CHARLES DUDLEY WARNER, *THE GILDED AGE: A TALE OF TODAY* (1873).

62. See POSNER, *supra* note 1, at 122–29; see also E. Scott Reckard, *Despite Paying Record Low Interest Rates, Banks are Awash in Deposits That They Don’t Want*, L.A. TIMES, Sept. 18, 2011, at B1.

63. See Kaplan & Eligon, *supra* note 8; see, e.g., Mary Williams Walsh & Danny Hakim, *Public Pensions Faulted for Bets on Rosy Returns*, N.Y. TIMES, May 28, 2012, at A1 (noting that public pensions operate on estimated yield of 7% to 8% on invested contributions, though actual yields have fallen to 5% to 7% since 2000).

64. See, e.g., *Yes, They Can Go Down Too*, *supra* note 23 (noting that Dallas Police and Fire Pension Funds bought high-risk CDOs to boost rates of return).

65. See Walsh & Hakim, *supra* note 63. Municipalities and other state instrumentalities (though not states themselves) may file for bankruptcy reorganization under 11 U.S.C. § 901. In the current crisis, Stockton, California filed for bankruptcy on June 28, 2012, Complaint at 1, *Ass’n Retired Emps. v. City of Stockton (In re City of Stockton)*, No. 12-32118-C-9, 2012 WL 3193588 (Bankr. E.D. Cal. July 10, 2012), becoming the largest city to file under Chapter 9 to date, see *Stockton, Calif. Files for Chapter 9 Bankruptcy*, NBCNEWS.COM (June 28, 2012), [http://www.msnbc.msn.com/id/48006746/ns/business-us\\_business/#.T\\_MCjpFnU6w](http://www.msnbc.msn.com/id/48006746/ns/business-us_business/#.T_MCjpFnU6w). Significantly, the largest single claim against Stockton is by CALPERS for \$147.5 million in unfunded pension liabilities. *Stockton, Calif. Files for Chapter 9 Bankruptcy, supra*. The Association of Retired Employees of the City of Stockton initiated a class action against the City of Stockton seeking a ruling ordering “the City to keep paying for their health benefits during th[e] chapter 9 case.” *Ass’n Retired Emps. v. City of Stockton (In re City of Stockton)*, No. 12-32118-C-9, 2012 WL 3193588, at \*1 (Bankr. E.D. Cal. Aug. 6, 2012). The bankruptcy court dismissed the retiree’s claim. *Id.* at \*18–19.

economy.<sup>66</sup>

*A. The Onset of Complexity: Asset-Backed Securities*

Low yields on traditional securities helped fuel the growth of new types of securities, which offered higher yields at the cost of rapidly increasing complexity, volatility, and concealed risk. These can be described generically as asset-backed securities, since all of them, from plain-vanilla mortgage-backed Fannie Mae<sup>67</sup> securities to the most complex derivatives based on them, rest on assets—pooled debt instruments—that provide regular streams of payments.

The forerunner of all of these securities was the residential mortgage-backed security (RMBS).<sup>68</sup> Securities backed by pools of mortgages were sold in the U.S. at least as early as the 1880s, but were first issued in their modern form by the Federal National Mortgage Association (Fannie Mae) while it was still a government agency, in 1966.<sup>69</sup> Fannie Mae was split into two entities—the Government

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66. See *supra* notes 17–18 and accompanying text.

67. “Fannie Mae” is the nickname generally used for the Federal National Mortgage Association, founded as a government agency in 1934 and privatized—but with a remaining link to the federal government that has proven costly to taxpayers—in 1968. 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, 1364–66.

68. The SEC, in its proposed rulemaking concerning the Dodd-Frank provisions affecting rating agencies, has divided asset-backed securities into the RMBS, commercial mortgage-backed securities (CMBS), commercial loan obligations (CLOs), asset-backed commercial paper conduits (ABCP), and collateralized debt obligations (CDOs—covering asset-backed securities including miscellaneous collateral, including other asset-backed securities). See Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-64514, 76 Fed. Reg. 33,420, 33,436 n.152–56 (proposed June 8, 2011) (to be codified at 17 C.F.R. pts. 240, 242 & 249). For purposes of this Article, asset-backed securities backed by mortgages will be referred to generically as “collateralized mortgage obligations” (CMOs), as they were when they reemerged on the financial scene in the late 1970s.

69. See Mendales, *supra* note 67, at 1365. Actually, what may have been the earliest form of mortgage-backed security, the Pfandbrief (plural “Pfandbriefe”—German nouns are always capitalized), was introduced by Frederick the Great of Prussia as early as 1769 to help pay the ruinous costs of the Seven Years’ War, and has received a new lease on life during the past few years in the form of “covered bonds” being issued not only in other civil law countries but in the United States as well. See Steven L. Schwarcz, *The Conundrum of Covered Bonds*, 66 BUS. LAW. 561, 563–64 (2011); Stefan Kofner, *The German Pfandbrief System Facing the Financial Crisis*, Prepared for the European Network of Housing Research: International Housing Conference, Prague, Czech Republic, June 28–July 1, 2009, available at [http://www.soc.cas.cz/download/808/paper\\_Kofner\\_01.pdf](http://www.soc.cas.cz/download/808/paper_Kofner_01.pdf). Pfandbriefe continue

National Mortgage Association (Ginnie Mae), which remained a government agency<sup>70</sup>—and the present Fannie Mae, which was largely privatized (but continued to buy mortgages for securitization) in 1968.<sup>71</sup> The Federal National Mortgage Association (Freddie Mac) was created in 1970 as a publicly held corporation, also for the primary purpose of enhancing the market for buying, selling, and securitizing mortgages.<sup>72</sup> Although Fannie Mae and Freddie Mac are privately held, the fact that their securities were exempt from SEC registration, and that they held their charters and emergency lines of credit from the federal government, led participants in the secondary mortgage markets to believe—before the financial crisis—that they enjoyed implicit guaranties from the federal government.<sup>73</sup> They are therefore commonly called “government-sponsored enterprises” (GSEs).<sup>74</sup>

Beginning about 1977, investment banks began to follow the GSEs in buying pools of mortgages and issuing “private label” CMOs that passed through proportionate shares of principal and interest from the underlying mortgages to purchasers.<sup>75</sup> In a basic CMO, a mortgage

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to flourish in Germany, regulated by the Pfandbriefgesetz, a statute that has been continually modernized (most recently in 2009), and their analogues have become popular in other civil law countries. Pfandbriefgesetz, PfandBG [Pfandbrief Act], 2009, Bundesgesetzblatt [BGBL] at Teil I, §§ 1373–93, as amended by Gesetz zur Fortentwicklung des Pfandbriefrechts vom März 2009 (Ger.), available at [http://www.pfandbrief.de/cms/\\_internet.nsf/0/B4DE7DF106F794A8C12579A70030C6E5/\\$FILE/PfandBG\\_BGBI\\_2005\\_I\\_13731393.pdf?OpenElement](http://www.pfandbrief.de/cms/_internet.nsf/0/B4DE7DF106F794A8C12579A70030C6E5/$FILE/PfandBG_BGBI_2005_I_13731393.pdf?OpenElement). Because Pfandbrief are regulated by law that ensures their backing by high-quality collateral, they are safer than their CMO cousins and have weathered the present economic storm far better. See *Advantages of Pfandbriefe*, VERBAND DEUTSCHER PFANDBRIEFBANKEN, [http://www.pfandbrief.de/cms/\\_internet.nsf/tindex/en\\_141.htm](http://www.pfandbrief.de/cms/_internet.nsf/tindex/en_141.htm) (last visited Sept. 13, 2012). Despite the new vogue for “covered bonds,” which employ structural elements borrowed from the Pfandbriefgesetz, American law does not provide the kind of regulation that gives Pfandbriefe their reliability. In fact, fairly drastic changes in U.S. law such as statutorily mandated certification and monitoring of issuers and their collateral would be required to establish a similar level of safety. See, e.g., Pfandbriefgesetz, Teil I, §§ 1373–93.

70. See Mendales, *supra* note 67, at 1365–66.

71. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 536 (codified at 12 U.S.C. § 1717 (2006)).

72. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, 84 Stat. 450, 450 (codified at 12 U.S.C. § 1452 (2006)) (creating an act “[t]o increase the availability of mortgage credit for the financing of urgently needed housing, and for other purposes”).

73. See Mendales, *supra* note 67, at 1366–67.

74. See, e.g., THE BOND MARKET ASSOCIATION, AN INVESTOR’S GUIDE TO PASS-THROUGH AND COLLATERALIZED MORTGAGE SECURITIES 2 (2002), available at [http://www.freddiemac.com/mbs/docs/about\\_MBS.pdf](http://www.freddiemac.com/mbs/docs/about_MBS.pdf); Mendales, *supra* note 67, at 1366.

75. See Mendales, *supra* note 67, at 1367.

originator (originally a bank or thrift institution, but, as the 1990s wore on, increasingly a nontraditional and largely unregulated lender)<sup>76</sup> sells mortgage instruments to an investment bank, which pools mortgages thus obtained and transfers them to an entity legally known as a “special purpose vehicle” (SPV).<sup>77</sup> The SPV then sells securities representing fractional shares of the pool to investors.<sup>78</sup> The investors receive proportionate shares of the total payments of interest and principal by mortgagors on the instruments held in the pool.<sup>79</sup> The advantages to an investor in buying a mortgage-backed security include the purported safety of mortgages as collateral, diversification of risk by using mortgages from different geographic areas in each pool,<sup>80</sup> and, crucial for yield-starved benefit funds, interest rates that were higher than those on similarly rated corporate debt obligations.<sup>81</sup>

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76. Nontraditional mortgage companies were loosely and inconsistently regulated by the states rather than the federal government, which regulated FDIC-insured banks and thrifts. See Martin N. Baily et al., *The Origins of the Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 79, 82. The increasing origination of mortgages by these poorly regulated entities, with the intent to sell them for securitization rather than to keep on the originators’ balance sheets, was a factor in the deterioration of mortgage collateral that contributed to the financial crisis. See *id.* at 79–82.

77. See 26 C.F.R. § 1.901-2(e)(5)(iv)(B)(1) (2012) (providing a formal definition of SPV). SPVs are also, less formally, referred to in finance as “special purpose entities” (SPEs). See Stephen Bryan et al., *Curbing Optimism in Managerial Estimates Through Transparent Accounting*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 361, 361–62.

78. See Mendales, *supra* note 67, at 1367.

79. See *id.* at 1364–67. SPVs have also been used for shady accounting purposes such as removing questionable items from corporate balance sheets in cases such as Enron. See *Enron Aside, Special Purpose Vehicles (SPVs) Are Legal, Innovative and Widely Used*, KNOWLEDGE@WHARTON (May 17, 2006), <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1483>.

80. The apparent safety of diversification may be illusory, since the diversification of an asset portfolio becomes meaningless “if it is duplicated by enough people.” John E. Martinsen, *Four Paradoxes of the 2008–2009 Economic and Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 59, 65.

81. See John D. Martin, *A Primer on the Role of Securitization in the Credit Market Crisis of 2007*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 199, 202. In fact, however, well before the financial crisis precipitated by the bursting of the housing bubble in 2007–2008, it became clear that the risk associated with investment-grade corporate debt was significantly less than that associated with mortgage-backed securities given similar ratings. See *infra* notes 121, 130 and accompanying text.

Safety, at least as measured by ratings issued by the three leading credit rating agencies (SEC-accredited rating agencies are officially known as “nationally recognized statistical organizations,” or “NRSROs”),<sup>82</sup> was vital for CMOs. This was not only a practical sales point, but a legal necessity, because ratings were the key to special treatment under the securities laws based on the 1984 Secondary Mortgage Market Enhancement Act (SMMEA).<sup>83</sup> Under SMMEA, CMO instruments with face amounts above \$250,000 and rated in the top two grades of at least one rating agency accredited by the SEC did not have to be registered under the Securities Act.<sup>84</sup> The pliant SEC of the time established by regulation<sup>85</sup> that SPVs and CMOs would not have to apply to the agency for letter rulings establishing that they did not have to register under the Investment Company Act of 1940,<sup>86</sup> but would be considered automatically exempt from regulation.

Apart from SMMEA’s effect on private label securities, it also authorized Fannie Mae and Freddie Mac to deal in subordinate lien mortgages,<sup>87</sup> making their securities riskier—especially in the absence of effective accounting controls.<sup>88</sup> This, along with the deterioration in

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82. See Exchange Act § 15E, 15 U.S.C. § 78o-7 (2006). Throughout the period in question, ratings were issued by an oligopoly consisting of three credit rating agencies recognized by the SEC: Standard & Poor’s, Moody’s, and a lesser player, Fitch. See Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 648 n.137 (1999).

83. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 101, 98 Stat. 1689 (codified in scattered sections of 12 and 15 U.S.C.).

84. *Id.* § 106.

85. See 17 C.F.R. § 270.3a-7 (2011). As the financial crisis gathered momentum in July, 2008, the SEC, while admitting that it originated the term “NRSRO” in its rules in 1975, claimed that its use of ratings was “for a narrow purpose,” though admitting that ratings had become widely used in state, federal, and even international regulations, and attempted, far too late, to reduce regulatory dependence on ratings by the major rating agencies. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Dodd-Frank Act Release No. 34-58070, 73 Fed. Reg. 40,088 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242 & 249). The proposed rule changes to reduce reliance on ratings were abandoned in 2009, and replaced by new regulations, including some mandated by the Dodd-Frank Act in 2010. See Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-64514, 76 Fed. Reg. 33,420, 33,420 & n.3 (proposed June 8, 2011) (to be codified at 17 C.F.R. pts. 240, 242 & 249).

86. See Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified at 15 U.S.C. § 80a-1 to 80a-64 (2006)).

87. See § 203(a), 98 Stat. at 1693.

88. The GSEs’ freedom from SEC registration fostered weak internal accounting controls which led to a major accounting scandal before the GSEs were actually placed in

standards for even first-lien mortgages purchased and securitized by the GSEs, contributed to the unperceived increase in risk in their securities—and, based on their inventories of these securities—to their own insolvency when the crisis of 2007–2008 struck.<sup>89</sup>

The dependence on ratings was not confined to the U.S. The discovery that ratings did not accurately predict risk for structured instruments helped make the 2008 financial crisis worldwide because instruments purchased based on strong ratings became embedded in the capital of financial institutions around the world.<sup>90</sup> Even the Basel Committee on Bank Supervision made ratings the basis for its proposals on the quality of reserve capital required for major international banks.<sup>91</sup>

CMOs, however, were just the first step in creating a new financial category that became known as “structured finance.” During the 1980s, CMOs became a subclass of a broader class of securities generally known as “collateralized debt obligations” (CDOs).<sup>92</sup> CDOs based their cash flow on debt instruments extending beyond the conventional residential mortgages<sup>93</sup> used to back the original CMOs, to include significantly riskier obligations, including non-conventional mortgages,

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receivership. See Kathleen Day, *Study Finds ‘Extensive’ Fraud at Fannie Mae: Bonuses Allegedly Drove the Scheme*, WASH. POST, May 24, 2006, at A1. A study by the SEC and the Office of Federal Housing Oversight (a title with a double meaning) released in 2006 showed that Fannie Mae alone “misstat[ed] earnings by about \$10.6 billion from 1998 through 2004.” *Id.*

89. See, e.g., Bloomberg, *America’s Fannie Mae & Freddie Mac Tumble on ‘Insolvency’ Fears*, TELEGRAPH (July 10, 2008), <http://www.telegraph.co.uk/finance/2793000/Americas-Fannie-Mae-and-Freddie-Mac-tumble-on-insolvency-fears.html> (noting that GSEs feared insolvency based on fair value accounting because of their large borrowing to purchase mortgage-backed securities for their inventories).

90. See References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 40,088; POSNER, *supra* note 1, at 55 (noting that worldwide distribution of U.S. mortgage-backed securities helped “globalize” what might have been a purely U.S. crisis).

91. See MICHAEL B. GORDY, BD. GOVERNORS FED. RESERVE SYS., MODEL FOUNDATIONS FOR THE SUPERVISORY FORMULA APPROACH 1 (2004).

92. See Peter Cohan, *Behind the \$4 Trillion in CDOs: Sneaky Banks and Worthless Ratings*, DAILY FIN. (Apr. 26, 2010, 10:45 AM), <http://www.dailyfinance.com/2010/04/26/explaining-the-4-trillion-cdo-scam-worthless-ratings-hide-inve/>.

93. “Conventional mortgages” are mortgages which, though not insured by the Federal Housing Authority, meet the statutory standards set for mortgages that Fannie Mae and Freddie Mac are allowed to purchase. See BLACK’S LAW DICTIONARY 1102 (9th ed. 2009). Under Freddie Mac’s statutory charter, these must “meet generally the purchase standards imposed by private institutional mortgage investors.” 12 U.S.C. § 1454(a)(1) (2006).

commercial mortgages,<sup>94</sup> and other, still less secure debt including car loans, student loans, unsecured obligations such as commercial paper, credit card debt, other CDOs,<sup>95</sup> and even derivatives not directly based on collateral pools backing particular CDOs.<sup>96</sup> CDO collateral pools included other asset-backed securities whose safety was assessed based on the less than reliable standards set by credit rating agencies<sup>97</sup>—although mortgages remained the most important instruments underlying CDOs in terms of aggregate value.<sup>98</sup>

CDOs were supposed to be safe because the safety of at least the highest-rated tranches of a CDO pool,<sup>99</sup> as with CMOs, was one of their chief selling points.<sup>100</sup> This presumed safety, which both buyers and regulators imprudently inferred from high ratings given to instruments

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94. See *infra* note 102 and accompanying text (discussing the special risk characteristics of commercial mortgages).

95. A CDO composed of tranches of other CDOs is known as a “CDO squared.” See Whalen, *supra* note 19, at 8–9; *CDO-Squared*, FINANCIAL TIMES LEXICON, [http://lexicon.ft.com/Term?term=CDO\\_squared](http://lexicon.ft.com/Term?term=CDO_squared) (last visited Sept. 13, 2012). Securities of this kind were not registered and sold over the counter to accredited investors under SEC exemptions from registration. Whalen, *supra* note 19, at 8–9. Because of their opacity—a purchaser relied on the ratings of the CDO collateral rather than underlying assets—their sale benefited only their dealers and when general confidence in structured securities faltered, their market collapsed, leaving their purchasers with enormous losses. See Whalen, *supra* note 19, at 8–9; *CDO-Squared, supra*.

96. See Adrian A.R.J.M. van Rixtel & Sarai Criado, *The Contribution of Structured Finance to the Financial Crisis: An Introductory Overview*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 239, 240; Whalen, *supra* note 19, at 8. Fannie Mae and Ginnie Mae underwriting standards were also initially used to assure favorable repayment characteristics for securitized mortgages. See *Problems in Mortgage Packaging: Hearing Before the Subcomm. on Gen. Oversight and Investigations of the Comm. on Banking, Fin., and Urb. Aff.*, 99th Cong. 89–91 (1985) (statement of Laurence D. Fink, Managing Director, First Boston Corporation) [hereinafter Statement of Laurence D. Fink].

97. See *infra* notes 114–24 and accompanying text (concerning rating standards).

98. See Peter L. Swan, *The Global Crisis and Its Origins*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 51, 51–56; *infra* notes 128–43 and accompanying text.

99. See Complaint at 7, SEC v. Steffelin (S.D.N.Y. June 21, 2011) (No. 11-Civ.-4204) (CDO pools were divided into different “tranches” with higher and lower priority claims to the cash flows from the pools for the use of tranches to enhance the ratings given to the highest-priority tranches with interests in a single CDO pool).

100. See Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-to-Fail Problem*, 35 BROOK. J. INT’L L. 707, 724 (2010) (noting that “[i]nvestors relied heavily on credit ratings” for complex instruments because their “complexity . . . made it difficult” for outsiders to determine the level of risk).

in each pool by the three leading credit rating agencies, was originally based on the presumed security of conventional mortgage lending standards,<sup>101</sup> augmented by what were called “credit enhancements” to protect holders against prepayment of standard mortgages, and for less reliable collateral such as commercial mortgages<sup>102</sup> and obligations not secured by mortgages.<sup>103</sup>

The earliest credit enhancements were relatively straightforward. Some resembled the protective features of German *Pfandbriefe*, which, as noted above,<sup>104</sup> were fairly effective in withstanding the financial crisis of 2007–2008.<sup>105</sup> These features included: overcollateralization, including assets in a pool with nominal values greater than the value of securities sold based on interests in the pool; recourse—the requirement that sellers of mortgages into a pool retain at least part of their risk of default;<sup>106</sup> backing by insurance-type arrangements, including standby letters of credit issued by banks to make good on defaulted collateral;<sup>107</sup> and insurance issued by monoline insurance carriers,<sup>108</sup> such as

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101. Statement of Laurence D. Fink, *supra* note 96, at 90–92.

102. Even early securitizers recognized that commercial mortgages had sharply different and less predictable risk characteristics than residential home mortgages. See *Secondary Market For Commercial Real Estate Loans: Hearing Before the Subcomm. on Pol’y Res. and of the H. Comm. on Banking, Fin., and Urb. Aff.*, 102nd Cong. 56 (1992) (statement of Michael L. O’Hanlon, Managing Director, Lehman Brothers); Marc Hochstein & Heather Timmons, *Credit Drought Withering Specialty Finance Firms*, AM. BANKER, Nov. 4, 1998, at 1.

103. See Cohan, *supra* note 92.

104. See *supra* note 69 and accompanying text.

105. See Kofner, *supra* note 69, at 19.

106. Over collateralization and retention of risk by mortgage originators are among the features that give *Pfandbriefe* their safety. See *supra* note 69 and accompanying text. *Pfandbriefe*, however, have additional safety factors such as statutory supervision that have never had a place in Wall Street CMOs. See *supra* note 69 and accompanying text.

107. Standby letters of credit, unlike commercial letters of credit, require the issuing bank to pay a beneficiary only on default by banks customers purchasing the instruments, and thereby act as insurance. See I. Walter Deitch, *Fundamentals of Commercial and Standby Letters of Credit*, NAT’L L. REV. (Dec. 1, 2009), <http://www.natlawreview.com/article/fundamentals-commercial-and-standby-letters-credit>.

108. Monoline insurers engage solely in insuring financial instruments. Dwight Jaffee, *Monoline Restrictions, with Applications to Mortgage Insurance and Title Insurance*, 28 REV. INDUS. ORG. 83, 83 (2006). They emerged in the 1970s, originally insuring municipal securities but soon extending their coverage to asset-backed securities. See Dave Bradford & Johanny Cruz, *Monoline Meltdown*, INSIDER Q., Summer 2008, at 64; see also *Monoline Insurance Companies*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/monolineinsurance.asp#axzz1ht1AiPzj> (last visited Sept. 22, 2012). Their specialization is a result of state

AMBAC.<sup>109</sup> Each of these protective features carried with it expenses that raised the cost to issuers and underwriters, who sought to cut their costs by devising less expensive but unproven protective measures inherent in the structure of the asset-backed securities themselves.<sup>110</sup>

*B. Ratcheting Up Complexity: Derivatives Based on Asset-Backed Securities*

By the mid-1980s, the original forms of credit enhancement appeared too awkward and expensive to the investment banks that structured “private label” asset-backed securities.<sup>111</sup> They therefore devised alternatives based on the structure of the securities themselves that were less expensive to issuers and more flexible in permitting the use of new types of collateral, bearing higher risk than traditional mortgages.<sup>112</sup> Although the credit rating agencies continued to give many of the higher risk mortgages top ratings, the agencies did so by creating untested and undisclosed economic models for safety; the instruments that they gave high ratings, in fact carried significantly higher levels of risk than similarly rated conventional debt securities.<sup>113</sup>

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regulation forbidding traditional insurers from issuing such policies. See Jaffee, *supra*, at 91 & n.15. This absence of diversity in their risk portfolios makes them and their insurance products riskier than traditional insurers and their products.

109. See, e.g., MICHAEL LEA, *SECURITIZATION: A PRIMER ON STRUCTURES AND CREDIT ENHANCEMENT* 8 (2006); Partnoy, *supra* note 82, at 671. In the experience of the author of this Article at Skadden, Arps, Slate, Meagher & Flom in New York during the early days of private label securitization in the 1980s, the first widely-used forms of credit enhancement were recourse, overcollateralization, insurance from monoline insurers, and standby letters of credit from banks. Recourse posed a particular problem because the transfers of mortgages from originators to SPVs were intended to be true sales, making the SPVs remote from any hypothetical bankruptcy of the originator, while significant retention of risk by the issuer created the danger that a bankruptcy court would rule that an intended sale was merely a secured loan, so that the SPV would not be remote from a bankruptcy case involving the issuer.

110. See *supra* notes 177–79 and accompanying text.

111. “Private label” asset-backed securities are those issued by financial institutions other than the so-called government sponsored entities (GSEs), including Fannie Mae and Freddie Mac (the Federal Home Loan Mortgage Corporation), both of which created traditional-style CMOs. See *Mortgage-Backed Securities*, SEC. EXCH. COMM’N (July 23, 2010), <http://www.sec.gov/answers/mortgagesecurities.htm>. Ginnie Mae, the Government National Mortgage Association, remains a government agency, and guaranties mortgages but does not assemble them into pools for slicing and dicing into mortgage-backed securities. *Id.*

112. See Cohan, *supra* note 92.

113. See Wilmarth, *supra* note 100, at 724–25. Although the chief focus on ratings has been on the inaccuracy of high ratings used in the initial sale of securities—especially complex

The credit rating agencies did so at least in part because of a new business model that created a major conflict of interest for them. Prior to 1970, they were paid by subscribers—and even then their ratings, particularly for lower-rated securities, were criticized for unreliability.<sup>114</sup> During the 1970s, however, the agencies began to receive most of their income as fees paid by the issuers of securities that they rated.<sup>115</sup> They made this change just at the time that their ratings became more central to the financial system because government agencies, starting, ironically, with the SEC, began to use them as a basis for judging the quality of securities used as reserves by securities dealers and other moneyed businesses.<sup>116</sup> This augmented the agencies' conflicts of interest by increasing pressure on them by issuers and underwriters to issue high ratings for the issuers' securities.<sup>117</sup>

In no context did this conflict manifest itself more strongly than in the issuance of asset-backed securities.<sup>118</sup> While the agencies used the same letter ratings for these securities as for conventional corporate debt, the new securities had different default characteristics.<sup>119</sup> The agencies did not test their methodologies to assure that a CDO rated AAA possessed the same degree of safety that such a rating would indicate for a conventional corporate bond.<sup>120</sup> Studies done well before the 2008 crash showed that in fact CDOs given investment-grade ratings

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one-off asset-backed securities, a further problem is that the sensitivity of asset-backed securities to changes in the value of collateral requires ratings already issued to be frequently reviewed and, where appropriate, downgraded—and the rating agencies were notoriously slow to downgrade securities based on adverse information. *See The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 110th Cong. 114–15 (2007) (prepared statement of Joseph R. Mason, Associate Professor, Drexel University) [hereinafter Statement of Joseph R. Mason].

114. *See* Partnoy, *supra* note 82, at 647, 652–53.

115. *See* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1679 (2008).

116. *See* Roger Lowenstein, *Triple-A Failure: How Moody's and Other Credit-Rating Agencies Licensed the Abuses That Created the Housing Bubble—and Bust*, N.Y. TIMES MAG., Apr. 27, 2008, at 36, 39.

117. *See* Partnoy, *supra* note 82, at 652–53.

118. *See* Kettering, *supra* note 115, at 1681 (by 2006, Moody's received over 45% of its rating revenues from “structured finance” transactions”).

119. *See* Lowenstein, *supra* note 116, at 41.

120. *Id.* (noting that prior to the failure of the CDO market in 2007, Moody's rated CDOs based on models relying on the securities' structure, using untested assumptions and without conducting due diligence concerning the quality of the underlying collateral).

failed at a much higher rate than conventional corporate debt.<sup>121</sup>

The first technique used to obtain high ratings for asset-backed securities based on structure rather than external credit enhancement was to sell securities with different priority rights to streams of payments from a given pool of debt instruments.<sup>122</sup> Investment bankers, rather than including an excess of collateral or obtaining external support such as insurance for obligations based on a pool of debt instruments, divided securities deriving payments of principal and interest from a given pool into “tranches”—often five or more based on a single pool of debt instruments.<sup>123</sup> A first and sometimes a second tranche would have prior rights to payment over subsequent tranches on income from the same pool of debt instruments,<sup>124</sup> and hence, would benefit from what was called the “waterfall” effect receiving the backing of greater assets than the nominal value of the tranche.<sup>125</sup> This generally sufficed to persuade pliable credit rating agencies to give first (and sometimes second) tranches their top ratings for ability to pay interest and principal<sup>126</sup>—ratings that should have been questionable not only because the agencies’ models were untested but were tainted by the rating agencies’ payment by the issuers of the CDOs they were rating.<sup>127</sup>

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121. See *infra* notes 129–30 and accompanying text.

122. See Lowenstein, *supra* note 116, at 39–41.

123. See, e.g., BOND MARKET ASSOCIATION, *supra* note 74, at 7.

124. Priority gave senior tranches the right to receive payments of principal and interest from a pool of debt instruments to the full amount due the senior tranches on any date payment was due, before any payments could be made to junior tranches. See, e.g., Complaint at 6–7, SEC v. Steffelin, (S.D.N.Y. June 21, 2011) (No. 11-Civ.-4204). Priority could be sequential—based on earlier payment due senior tranches than for junior tranches (a significant factor, since one of the problems faced by holders of mortgage-backed securities consists of prepayments by mortgagors on their underlying debt)—or by contractual subordination of junior tranches. See, e.g., *id.* By analogy to the normal priority of distributions under corporate law, the most junior tranches with rights against any pool were often referred to as the “equity.” See, e.g., *id.* (the “equity” tranches of a CDO are the most subordinate, generally unrated notes secured by a given pool of assets).

125. See *id.* at 7.

126. See, e.g., *Realtex Indus. v. Nomura Sec.*, 939 F. Supp. 572, 576 (N.D. Ohio 1996) (noting that higher priority tranches had prior claims on cash flow from collateral pool, entitling senior tranches to higher ratings); see also *supra* note 124 and accompanying text.

127. The rating agencies were also, unlike other participants in the creation of new securities, largely unregulated by the securities laws until the passage of the totally inadequate Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified at 15 U.S.C. § 78a (2006)). This statute attempted to address agency deficiencies by encouraging the creation of competing agencies, but actually forbade the SEC from

Despite the dubious character of the ratings, they became increasingly important to the buyers of asset-backed securities as the securities became more complex, since the ratings were the only generally accepted way to assess the ability of a new type of security to pay principal and interest.<sup>128</sup> Even before the quality of collateral providing cash flows for CDOs began to decline in the late 1990s, however, it became clear that ratings for structured finance securities did not mean the same thing as the same ratings given to conventional corporate debt: an asset-backed security rated AAA was much more likely to default than a corporate bond with the same rating.<sup>129</sup> During the period 1993–2005, well before subprime mortgages became the chief collateral backing CDOs, CDOs rated Baa by Moody's (the lowest "investment grade" rating given by Moody's) had ten times the default risk of conventional debt with the same rating.<sup>130</sup>

The incommensurability of ratings between asset-backed securities and conventional investments was aggravated during the late 1980s with the creation of an additional level of complexity in structured securities that added derivative obligations to the mix. Derivatives are financial instruments whose values are based on the values of other instruments, including securities and commodities.<sup>131</sup> They are an ancient financial device that can be useful to plan for future swings in prices,<sup>132</sup> originating with commodity futures, where users of commodities hedge against the risk that commodities they use routinely will rise or fall in price by buying contracts to acquire the commodities in question at a future date for a specified price which fits the buyer's risk profile. Thus, an airline can hedge against the risk that aviation fuel will rise sharply in price over a three-month period by buying a contract to acquire a certain amount of that fuel three months after the futures contract is made, at a price that is within limits the airline considers reasonable. On the other side, a producer of grain can hedge against a sharp drop in grain prices six months hence by making a contract to sell a large part of its

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attempting to regulate the rating process. See Mendales, *supra* note 67, at 1385–87.

128. See Partnoy, *supra* note 82, at 648, 651, 664–65.

129. See Lowenstein, *supra* note 116, at 37–38.

130. See Statement of Joseph R. Mason, *supra* note 113, at 3.

131. BLACK'S LAW DICTIONARY, *supra* note 93, at 509. See generally René M. Stulz, *Demystifying Financial Derivatives*, MILKEN INST. REV., Third Quarter 2005, at 20.

132. See, e.g., ARISTOTLE, ARISTOTLE'S POLITICS 47–48 (Benjamin Jowett trans., Clarendon Press 1908).

production of the grain at something approaching present prices six months in the future.<sup>133</sup> Commodities futures are relatively well understood, and the garden variety—chiefly consisting of futures contracts traded on the Chicago Board of Trade—is regulated by the Federal Commodities Futures Trading Commission (CFTC).<sup>134</sup>

During the 1990s, however, derivative securities were developed based on anticipated changes in the values of CDOs, which functioned more to multiply the level of risk than to hedge against rationally anticipated future changes in value.<sup>135</sup> These new derivatives added increasing levels of complexity to what had already become complex financial instruments. The most basic of these derivatives were “credit default swap” (CDS) transactions, in which one financial institution agreed to pay the other if specified CDOs held by the other defaulted, in return for fees corresponding to insurance premiums.<sup>136</sup> The contracts creating rights to receive payments on default, and rights to receive fees for protecting holders of debt-based collateral, both derived value from that collateral, and were thus considered “derivative” securities.<sup>137</sup>

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133. See Stulz, *supra* note 131, at 22; Glyn A. Holton, *Futures*, RISKGLOSSARY.COM, <http://www.riskglossary.com/link/future.htm> (last visited Sept. 22, 2012).

134. See generally *Mission & Responsibilities*, U.S. COMMODITIES FUTURES TRADING COMMISSION, <http://www.cftc.gov/About/MissionResponsibilities/index.htm> (last visited Sept. 22, 2012).

135. See POSNER, *supra* note 1, at 126–27; Cris Sholto Heaton, *The Dangers of Derivatives*, MONEYWEEK (Sept. 27, 2006), <http://www.moneyweek.com/investments/stock-markets/the-dangers-of-derivatives>.

136. Credit default swaps were invented by JPMorgan in 1994. See Matthew Philips, *The Monster That Ate Wall Street: How ‘Credit Default Swaps’—An Insurance Against Bad Loans—Turned From a Smart Bet Into a Killer*, NEWSWEEK: THE DAILY BEAST (Sept. 26, 2008, 8:00 PM), <http://www.thedailybeast.com/newsweek/2008/09/26/the-monster-that-ate-wall-street.html>. The first major CDS deal, involving about \$9.7 billion, was done by Morgan in 1997. *Id.* Their use grew exponentially until the CDS market volume exceeded \$45 trillion by mid-2007, more than twice the value of equities traded on U.S. stock markets. See Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), <http://www.time.com/time/business/article/0,8599,1723152,00.html>. CDS transactions could be described as riskier versions of earlier use of monoline insurance policies—riskier in that swap counterparties are not regulated insurers, and lack diversification in the portfolios of securities that they insured. *Id.* Ironically, JPMorgan itself made 2012 headlines by losing billions of dollars through inappropriate use of CDS transactions. See David Henry & Carrick Mollenkamp, *Analysis: The Core Problems with JPMorgan’s Failed Trades*, REUTERS (May 14, 2012, 2:51 PM), <http://www.reuters.com/article/2012/05/14/us-jpmorgan-trades-idUSBRE84D04X20120514>.

137. See Jonathan C. Lipson, *Enron Rerun: The Credit Crisis in Three Easy Pieces*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC

A CDO based solely on derivative rights is known as a “synthetic” CDO,<sup>138</sup> and the risks incurred by holders of its various tranches—and hence its value—is, because of the added level of complexity, much harder to determine than an asset-backed security collateralized by direct obligations.<sup>139</sup> This was particularly true before the collapse of the housing bubble in 2007, when Moody’s, for example, did not reevaluate the models it used for its ratings before the looming disaster became clear even to the rating agencies.<sup>140</sup>

In part, this was because the instruments used as reference portfolios for CDOs<sup>141</sup> were evaluated for quality largely based on ratings assigned to them by agencies, such as Moody’s, based on mathematical models that relied on unproven assumptions rather than on due diligence as to the soundness of underlying collateral.<sup>142</sup> Moreover, even had due diligence on underlying collateral been performed, the complexity of the new instruments became so great that even those who traded them in huge volume had no way to rationally evaluate their underlying value.<sup>143</sup>

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FAILURE, *supra* note 1, at 43, 43–45, 49 n.5; van Rixtel & Criado, *supra* note 96, at 242.

138. See Sanjeev Arora et al., Computational Complexity and Informational Asymmetry in Financial Products 1 (Princeton Univ., Working Paper 2009), available at <http://www.cs.princeton.edu/~rongge/derivative.pdf> (noting that use of derivatives in financial products increases information asymmetry between sellers and buyers so that even a buyer with substantial information and great computational power cannot adequately compute their value); Michael S. Gibson, *Understanding the Risk of Synthetic CDOs* 1 (Fed. Reserve Bd., Working Paper No. 2004-36, 2004).

139. See Martin, *supra* note 81, at 204; Arora et al., *supra* note 138; Gibson, *supra* note 138, at 1, 18, 21, 23, 25–26 (models used in disclosure of risks in various tranches of CDOs result in systematic failure by CDO sellers to disclose full risks imposed on buyers).

140. See Lowenstein, *supra* note 116, at 39–40.

141. A reference portfolio consists of real assets in other CDOs by which the value of a synthetic CDO is determined, usually linked to the real debt instruments in the other CDOs by credit default swaps. See FITCH RATINGS, SYNTHETIC OVERVIEW FOR CMBS INVESTORS 1, 7 (Sept. 26, 2005), available at [http://pages.stern.nyu.edu/~igiddy/ABS/synthetic\\_cmbs.pdf](http://pages.stern.nyu.edu/~igiddy/ABS/synthetic_cmbs.pdf). Since the buyer of a tranche in a synthetic CDO does not directly own the underlying collateral, but only derivatives based on their assumed likelihood of default, the buyer cannot perform due diligence on the quality of the underlying assets. See *id.* at 1, 7–8.

142. See generally Gibson, *supra* note 138.

143. See Martin, *supra* note 81, at 204. In fact, mathematical models used to determine the probability of default are so complex that they require their users to make substantial, possibly counterfactual assumptions. See generally GORDY, *supra* note 91. The complexity of the computations used by modelers such as Gordy, requiring elaborate numerical integration, suggests that results in terms of the probability of default under any model will be altered with extreme sensitivity based on any deviation from initial data or assumptions—in other words, any change from initial assumptions will cause chaotic, and hence unpredictable,

Since most of them were exempt from registration under the Securities Act because their sales were exempt from registration under SEC Rule 506,<sup>144</sup> most were created in private contracts between institutions and traded over the counter rather than on recognized exchanges.<sup>145</sup> Therefore, central banks such as the Federal Reserve and other regulatory institutions were unable to estimate their volume—which was trillions of dollars worldwide—or what effect defaults in underlying collateral would have on the entire financial house of cards and thus, given the effects on key financial institutions—on the U.S. and world economies.<sup>146</sup>

*C. The Downward Spiral of Quality in Collateral: The Great Debt Bubble of 1998–2006*

While part of the fragility of the CDO market was a function of the

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variations from the results predicted by the model used for the initial rating of a security. Chaotic behavior of this kind is what makes long-term weather prediction impossible even with high-quality data. See JAMES GLEICK, *CHAOS: MAKING A NEW SCIENCE* 8 (1987); see also James K. Galbraith, *The Roots of the Crisis and How to Bring It to a Close*, in *LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE*, *supra* note 1, at 37, 38 (noting that Mandelbrot's new mathematics of fractal geometry—the field of mathematics that has become known as “chaos”—challenged traditional economic models). The intractability of this problem is further supported by the failure of sophisticated mathematical methods to prevent the insolvency of Long-Term Capital Management, a large hedge fund that employed Nobel laureates in economics. See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2000); POSNER, *supra* note 1, at 131–32 (“[I]t’s impossible to calculate the exact conditions that will precipitate collapse, and this uncertainty makes it impossible to predict the collapse with any precision.”). LCTM failed despite sophisticated mathematical models because sensitive dependence on initial conditions made it impossible for the models to predict failure when actual conditions varied from their assumptions. POSNER, *supra* note 1, at 131–32

144. 17 C.F.R. § 230.506 (2012).

145. See Whalen, *supra* note 19, at 9 (explosive growth of demand for non-transparent OTC instruments, where risk could not be modeled except by dealers who sold them and not by buyers or rating agencies, helped create the global financial crisis when dealers stopped providing a secondary market for them in 2007).

146. See *Implementing Derivatives Reform: Reducing Systemic Risk and Improving Market Oversight: Hearing Before the S. Comm. on Banking, Hous., and Urb. Aff.*, 112th Cong. 1–3 (2012) (statement of Gary Gensler, Chairman, CFTC), available at [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=10c178ef-a902-4842-9972-ca169eaceb7d](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=10c178ef-a902-4842-9972-ca169eaceb7d) (noting that the notional value of the global market for swaps, largely unregulated before the 2008 crisis, now exceeds \$700 trillion); Bruce I. Jacobs, *Tumbling Tower of Babel: Subprime Securitization and the Credit Crisis*, in *LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE*, *supra* note 1, at 225.

complexity of the instruments traded in that market,<sup>147</sup> an even more significant factor arose with the increasing burdens of debt borne both by individuals and institutions, originating in stagnating individual incomes and fed by easy credit, that led to the housing bubble, which took off after the turn of the century.<sup>148</sup> Consumer debt began rising as early as the 1970s, in part to replace actual income—median per capita income in the U.S. leveled off in 1973,<sup>149</sup> and consumers substituted debt for increasing income to maintain expected standards of living.<sup>150</sup> This long-term structural problem was aggravated by events in the financial sector.

A preliminary crisis, which should have warned participants in the market for complex securities of the larger crisis to come, was the failure of a hedge fund called Long-Term Capital Management in 1998.<sup>151</sup> The hedge fund had based its investing strategy on complex mathematical models, which failed it both because of the complexity of the instruments in which the fund invested and because of the weakness in the collateral underlying those instruments.<sup>152</sup> The Federal Reserve, fearing that the failure could trigger a recession, cut interest rates to near-record lows.<sup>153</sup> The Federal Reserve's action was based not only on

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147. See Kettering, *supra* note 115; Lipson, *supra* note 137, at 43–44; *supra* Part II.B. and accompanying text.

148. See Edward Luce, *The Dream That Died: The Crisis of Middle-Class America*, FT WEEKEND MAG., July 31–Aug. 1, 2010, at 18, 22 (stating that incomes of bottom 90% of U.S. families essentially flat since 1973, with lost increases in wage income made up by increasing debt).

149. See *id.*

150. See *id.*

151. See POSNER, *supra* note 1, at 126. A hedge fund is an investment company—i.e., a fund that invests in securities or other assets of other businesses—that, because most of its investors are “accredited” for purposes of SEC Rule 506 (most benefit funds are accredited investors for purposes of Rule 506, see *infra* note 282, 333 and accompanying text), is usually not required to register with the SEC. See *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, U.S. SEC. EXCH. COMM’N, <http://www.sec.gov/answers/hedge.htm> (last visited Sept. 23, 2012). Hedge funds, originally small investment vehicles used by wealthy individuals, came to control major assets by the 1990s, and their risky investment strategies made them a factor in world financial instability. See Duff McDonald, *The Running of the Hedgehogs*, N.Y. MAG., Apr. 16, 2007, at 42–44. By 2007, this destabilizing potential had grown tenfold from the 1990s, with over \$2 trillion under hedge fund management. *Id.*

152. See Hershey H. Friedman & Linda Weiser Friedman, *The Global Financial Crisis of 2008: What Went Wrong?*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 31, 31–32.

153. See Steve Schifferes, *Financial Crises: Lessons from History*, BBC NEWS (Sept. 3,

the failure of Long-Term Capital at home, but on the bursting of financial bubbles overseas that helped to kill Long-Term Capital, including sovereign default crises in Asia, Russia, and Latin America, and the bursting of the “dot-com” stock market bubble in the U.S. which, continuing through 2002, helped motivate the Federal Reserves to keep down interest rates.<sup>154</sup> These low rates, which were reflected in loans made throughout the U.S. economy, including the markets for government and corporate debt and the home mortgage market, helped lead to the outsized housing bubble of the new century.<sup>155</sup>

The low yields on conventional debt had two significant effects. On one side, investors, particularly benefit funds that needed higher yields to fund eventual demands by beneficiaries, began to chase higher yields in new types of financial instruments, despite their poor understanding of the risks inherent in these investments.<sup>156</sup> On the other side, low prevailing interest rates made it easier for debtors, especially home mortgagors, to afford homes previously beyond their ability to acquire, helping to inflate a housing bubble that was further aggravated by relaxed lending practices.<sup>157</sup>

The reduction in the general cost of credit, which itself played an important role in inflating the housing bubble that followed the turn of the century, accompanied successive and dramatic lowering of the standards of creditworthiness required of mortgagors. The federal government played a major part in this, by steadily lowering the minimum down payments required for FHA insurance, and pressuring Fannie Mae and Freddie Mac to lower their creditworthiness requirements for mortgages they would purchase.<sup>158</sup> The government’s

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2007), <http://news.bbc.co.uk/2/hi/business/6958091.stm>.

154. See CARMEN M. REINHART & KENNETH S. ROGOFF, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* 162, 171, 206–07 (2009).

155. See ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 13–14, 40–41 (2d ed. 2005); Lipson, *supra* note 137, at 46 (noting that the “persistent, artificially low prevailing rate of interest” was a central cause of the financial crisis). During the bubble, the Case-Shiller housing price index, as compared to increase in GDP and the consumer price index, increased faster and farther than any previous housing bubble since 1891, the starting point for the Case-Shiller index. See REINHART & ROGOFF, *supra* note 154, at 207.

156. See Roger Lowenstein, *Looking for the Next Crisis?: Public Pension Funds Are Massively Short of Money*, N.Y. TIMES MAG., June 27, 2010, at 9; Walsh & Hakim, *supra* note 63.

157. See POSNER, *supra* note 1, at 46–49 (lower mortgage rates increased housing prices and leverage, increasing systemic risk to the entire economy).

158. See *id.* at 241–42.

purpose was to make housing more available to Americans of limited means, a goal that, while not without superficial appeal, was fraught with financial peril, as easier lending standards led home prices in the U.S. to rise 52% between 1997 and 2004, a rate significantly higher than the increase in median income.<sup>159</sup>

While standards for conventional mortgages were eased, mortgage underwriting standards were further relaxed by private lenders, many of whom were now unlicensed and used a lending model based on originating mortgages to sell them for packaging into securities, rather than holding them and the risk attendant upon them.<sup>160</sup> The result was a proliferation of “Alt-A” mortgages—mortgages to borrowers who could not quite meet the standards imposed on holders of conventional mortgages<sup>161</sup>—and, worse yet, “subprime” loans—loans backed by mortgages extended to borrowers who did not even approach the relaxed federal standards for creditworthiness, documentation, and other qualifications, such as substantial down payments that were required for conventional mortgages during the 1990s.<sup>162</sup> “Subprime” mortgages were often originated by poorly regulated mortgage brokers on an originate-to-sell business model, so that their originators lacked the incentive to assure their quality that would have existed had they kept the loans on their balance sheets.<sup>163</sup> This in itself set them off from traditional mortgages backing loans by institutions such as banks and thrifts, which started with a model of loans kept on their balance sheets and therefore had some incentive to assure that they were likely to be repaid. “Subprime” mortgages began to proliferate before the turn of

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159. See SHILLER, *supra* note 155, at 12–13.

160. See Danielle DiMartino & John V. Duca, *The Rise and Fall of Subprime Mortgages*, ECONOMICLETTER, Nov. 2007, at 2.

161. See FRANK J. FABOZZI, *FIXED INCOME SECURITIES* 286 (2nd ed. 2002); *Alt A Mortgages*, CITYTOWNINFO.COM, <http://www.citytowninfo.com/mortgage-articles/specialty-mortgages/alt-a-mortgages> (last visited Sept. 23, 2012) (noting that Alt-A mortgages were traditionally mortgages to borrowers who could meet conventional mortgage standards, but lacked certain documentation; but the designation became a fuzzy term applying to mortgages just short of conventional mortgage quality but ranking above “subprime” mortgages).

162. See FABOZZI, *supra* note 161, at 284.

163. See Baily et al., *supra* note 76, at 79, 80–83 (noting that when mortgage lenders originated mortgages intending to sell them for securitization, the mortgages were not kept on their balance sheets, so they lacked incentive to guard against potential defaults).

the century, and exploded in volume from 2003 through 2006.<sup>164</sup>

“Subprime” mortgages included several characteristics that made them, and financial instruments for which they served as, collateral financial time bombs. Many included specific features that set them ticking, such as low “teaser” interest rates that mortgagors could barely afford at the time they signed on the dotted line, but which would automatically reset to far higher rates—likely to be beyond the mortgagors’ ability to pay—at dates in the near future.<sup>165</sup> Other subprime mortgages whose default could readily have been predicted at the time they were made included “liar loans,” where the mortgagors’ creditworthiness was deliberately misrepresented or totally undocumented, or where the value of the mortgaged property was deliberately inflated;<sup>166</sup> interest-only loans, where mortgagors would not have to begin repaying principal until a specified time in the future;<sup>167</sup> and home equity loans based on the equity acquired by the upward spiral of home values based on artificially low credit.<sup>168</sup>

Relaxed standards led to a proliferation of new mortgage lending to borrowers who represented not merely heightened risks that could be

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164. See, e.g., Abol Jalilvand & A.G. (Tassos) Malliaris, *Sequence of Asset Bubbles and the Global Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 139, 141 (noting that the Federal Reserve contributed to the housing bubble by setting low interest rates in 2003 intended to deal with low economic growth); Ben S. Bernanke, Chairman, Fed. Reserve Sys., Speech at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition: The Subprime Mortgage Market (May 17, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm> (noting that subprime mortgage lending, defined as lending to borrowers with high credit risk, proliferated as a result of securitization).

165. See REINHART & ROGOFF, *supra* note 154, at 213; Bernanke, *supra* note 164, at 2–3 (pointing out that “seasoned” adjustable rate mortgages—those that have been paid on for several years—have higher delinquency rates); *supra* note 164 and accompanying text.

166. See John Hechinger, *Shaky Foundation: Rising Home Prices Cast Appraisers in a Harsh Light*, WALL ST. J., Dec. 13, 2002, at A1 (brokers and developers systematically induced real estate appraisers to put unrealistically high values on real estate, with frauds resulting in legal actions well before the actual topping out of real estate prices in 2006); Lowenstein, *supra* note 116, at 38.

167. See David Streitfeld, *The House Trap: As an Exotic Mortgage Resets, Payments Skyrocket*, N.Y. TIMES, Sept. 9, 2009, at B1 (noting that interest-only loans, which are scheduled to reset to begin amortizing principal, pose threat of large-scale mortgage defaults in wake of bursting of housing bubble).

168. See Forrest Pafenberg, *The Single-Family Mortgage Industry in the Internet Era: Technology Developments and Market Structure*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 163, 171.

estimated with actuarial models based on prior data, but to borrowers who were virtually certain to default. This qualitative transformation could have been recognized from earlier experience if regulators, rating agencies, and other participants in the issuance of asset-backed securities had paid attention to it.<sup>169</sup> The net effect was to invalidate the waterfall model on which the rating agencies based the high ratings they assigned to senior tranches of asset-backed securities: while higher-risk collateral could still permit repayment of senior tranches if there was enough of it and it paid something, zero-value collateral, regardless of its nominal value, could not yield any payment to a senior tranche regardless of its level of seniority.<sup>170</sup>

### III. THINGS FALL APART: THE FINANCIAL CRISIS

The threat that benefit funds face based on pre-crash transactions has two dimensions: (1) states and state subdivisions such as cities, hospitals, and associations of public employees have invested far too little in their benefit funds to meet predictable demands;<sup>171</sup> and (2) the investments that they have made are subject to high risk of default because they include instruments such as CDOs backed by underlying loans that have defaulted, are in grave risk of default, or cannot currently be valued at all because it is unclear what their base-level collateral is worth in terms of the capacity of obligors to make payments, or, in the absence of such payments, on foreclosure.<sup>172</sup> The issues of underfunding and investment uncertainty are closely linked, since many funds made improvident investments in order to improve yields on the funds they received in order to be able to make future

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169. See Baily et al., *supra* note 76, at 83 (noting that market participants and regulators failed to manage risk at every stage of securitization); Joseph R. Mason, *The (Continuing) Information Problems in Structured Finance*, J. STRUCTURED FIN., Spring 2008, at 7–8 (noting that mortgage-backed securities will not make “subsequent recoveries that will restore investors”); Lowenstein, *supra* note 116.

170. See Jeffrey A. Lenobel & Gregory P. Pressman, *Mortgage-Backed Security Process Undergoes Change*, N.Y. L. J., Mar. 29, 1999, at S1 (AAA-rated senior tranche holders will receive reduction in income to the extent that losses cannot be absorbed by subordinate tranches); Gibson, *supra* note 138, at 9–11 (noting that cash CDOs require cash flow to fund all tranches—and even senior tranches may be subordinate to deal structuring fees).

171. See Joseph De Avila, *Pension Overhaul is Urged*, WALL ST. J., Sept. 15, 2012, at A15 (noting that Connecticut, for example, is the third lowest state in pension funding, with enough savings to cover a mere 53% of its obligations).

172. Evans, *supra* note 4.

payments to their beneficiaries.<sup>173</sup>

The CDO crisis, and effective measures both to deal with its lingering fallout and to prevent future crises of similar origin, can be understood only in terms of the regulatory system in place both in the U.S. and in other countries to protect investors and financial institutions against such events. This Article will deal particularly with U.S. securities regulation, established in the wake of the Crash of 1929 and the subsequent Great Depression, whose partial dismantling under the guise of deregulation, beginning in the 1970s, helped to set the stage for the current crisis.

*A. The Crumbling Firewall: Deregulation and the Financial Crisis*

Investments by benefit funds in risky securities are subject to three major federal statutes governing the sale of securities: the Securities Act,<sup>174</sup> the Exchange Act,<sup>175</sup> and the Investment Advisers Act.<sup>176</sup> Each is hedged about with regulations promulgated by the SEC and by a framework of judicial interpretation.

Since the 1970s, deregulation, motivated largely by political ideology,<sup>177</sup> led to the weakening of protective statutes and regulations, and judicial decisions that limited the scope and force of existing regulatory law, with the result of pulling some of the teeth from the aging tiger of securities regulation.<sup>178</sup> Ironically, the SEC itself began the process, first by accepting securities receiving top ratings from the credit rating agencies as part of the capital of the brokerages that it regulated,<sup>179</sup> and then, even more significantly, by its regulatory

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173. See *supra* notes 19–24, 62–64 and accompanying text.

174. Securities Act 15 U.S.C. § 77a (2006).

175. Exchange Act § 78a.

176. Investment Advisers Act § 80b-20.

177. See POSNER, *supra* note 1, at 134–36. It is significant that Judge Posner, once a strong advocate of deregulation, agrees on this point with his one-time ideological opponent, Paul Krugman, a Nobel Prize-winning economist. See *id.*; Paul Krugman, Op-Ed., *Reagan Did It*, N.Y. TIMES, June 1, 2009, at A21 (noting that the financial crash largely caused by explosion of private debt due largely to financial deregulation based on political ideology beginning in the 1980s).

178. See David S. Bieri, *Regulation and Financial Stability in the Age of Turbulence*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 327, 331 (banking crises of the last 30 years largely due to ineffective and complacent regulation shaped by the interference of special interests).

179. See Exchange Act Rule, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F)(1) (2011); Definition of

expansion of the small business exemptions for registration of securities into exemptions that went well beyond the Securities Act's purposes in authorizing such exemptions.<sup>180</sup>

Congress accelerated financial deregulation during the 1970s. This began with the lifting of some key regulations on savings and loan institutions (thrifts), at that time among the most important originators of mortgages, which were regulated separately from banks.<sup>181</sup> The toxic effect of this deregulation was felt in the massive failures of deregulated institutions, which caused a national financial crisis that spanned the 1980s,<sup>182</sup> but this crisis did not slow the deregulatory juggernaut.

The hallowed separation between commercial and investment banking,<sup>183</sup> which was the most conspicuous example of this

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Nationally Recognized Statistical Rating Organization, Exchange Act Release Nos. 33-8570 & 34-51572, 70 Fed. Reg. 21,306 (proposed Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240).

180. See Mendales, *supra* note 67, at 1373–74. See generally *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (noting that exemptions apply where there is no practical need for protection of the 1933 Act or where its benefits are too remote).

181. This deregulation was largely accomplished by the Garn-St. Germain Depository Institutions Act, Pub. L. 97-320, 96 Stat. 1469 (1982), which removed Depression-era limitations on savings and loan institutions, leading to massive failures of savings and loans beginning in the mid-1980s. See Krugman, *supra* note 177.

182. More financial institutions failed during the savings and loan crisis than at any time since the Great Depression. From 1986 through 1995, the Federal Savings & Loan Insurance Corporation (which was itself wound up as a result of its liabilities from the crisis) and the Resolution Trust Corporation (established by Congress to deal with the crisis) combined closed 1,043 thrift institutions with \$519 billion in assets, and the number of federally insured thrifts in the U.S. declined by about 50%. See Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV., No. 2, 2000, at 26. The savings and loan crisis was the most famous part of a larger banking crisis in which more than 1,600 FDIC-insured banks were closed or required financial assistance from the FDIC. See 1 FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 3 (1997).

183. Commercial and investment banking were separated by one of the statutory foundations of New Deal regulation, the Glass-Steagall Act, formally titled the Banking Act of 1933. Pub. L. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). Glass-Steagall did far more than accomplish this separation; it included other measures to restore confidence in the financial system, shaken by the Great Depression, such as establishing the Federal Deposit Insurance Corporation (FDIC). *Id.* § 12B(a). The wisdom of separating commercial and investment banking has, in the context of the current world economic crisis, been recognized outside the U.S. See Ali Qassim, *U.K. Must Separate Retail From Investment Banking to Encourage Change in Culture*, INT'L BUS. & FIN. DAILY (July 3, 2012), <http://www.bloomberglaw.com/ms/document/XLVBTFG5GVG0> (noting that Mervyn King, the Governor of the Bank of England, has recognized the need for such a separation in the U.K.).

deregulation, was abolished by the Gramm-Leach-Bliley Act of 1999,<sup>184</sup> exposing commercial banks to the risks involved in underwriting and dealing in securities, including the new complex breeds of securities, and adding to risks to the entire financial system by promoting the growth of too-big-to-fail financial institutions.<sup>185</sup> The mischief wrought by Gramm-Leach-Bliley, which manifested itself in the financial crisis, went well beyond ending the long-standing Berlin Wall between commercial and investment banking: notably, for example, it barred the SEC from regulating securities-based swap agreements beyond the general antifraud provisions of the securities laws.<sup>186</sup> The shackles on federal regulation of derivatives were tightened further by the Commodity Futures Modernization Act of 2000,<sup>187</sup> which barred the Commodity Futures Trading Commission from regulating swaps not based on securities, notably including credit default risk swaps.<sup>188</sup>

Beyond legal limitations placed on its authority by statute during the thirty years preceding the financial crisis, the SEC has been chronically starved for legal and accounting firepower, limiting its ability to assure

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184. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §101, 113 Stat. 1338, 1341 (1999) (codified at 12 U.S.C. § 1811) (repealing sections 20 and 32 of Glass-Steagall). The Gramm-Leach-Bliley Act was formally titled the Financial Services Modernization Act of 1999. *Id.* Gramm-Leach-Bliley's destruction of the wall between commercial and investment banking has been modified by the incorporation of the "Volcker Rule" in Dodd-Frank section 619, which at first glance appears to bar federally insured banking institutions from engaging in proprietary trading. Dodd-Frank Act § 619(a)(1), 12 U.S.C. § 1851(a)(1) (Supp. IV 2011). However, the section, read as a whole, is so permeated with the typical Dodd-Frank foam of compromise that its real effectiveness is uncertain. Of particular concern for purposes of this Article, Dodd-Frank section 619(g)(2) states that the section should not be construed to prohibit an affected institution from engaging in securitization of loans. *See id.* § 619(g)(2). Despite the questionable efficacy of the provision, it has come under strong partisan attack in Congress which (a) makes it unclear whether the drafting of implementing regulations will be funded, and (b) makes its long-term survival uncertain. *See, e.g.,* Josh Boak, *Volcker Rule Shredded by Republicans*, POLITICO (Jan. 18, 2012, 12:56 PM), <http://www.politico.com/news/stories/0112/71602.html> (noting that after agencies charged with enforcing rule released 300 pages of proposed regulations, key Republicans attacked the rule itself as a "self-inflicted wound").

185. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 ILL. L. REV. 215, 303–04, 446.

186. Dodd-Frank Act §§ 761–763, 766, 768.

187. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 101, 114 Stat. 2763, 2763A-452. This limitation has also been repealed, subsequent to the financial crisis. *See* Dodd-Frank Act §§ 713–15.

188. Commodity Futures Modernization Act app. § 3A; *see* Dodd-Frank Act §§ 713–15.

compliance with the securities laws in the face of rapidly expanding securities markets.<sup>189</sup> It has therefore generally welcomed the judicial recognition of private rights of action for violations of securities statutes and regulations, particularly Securities Exchange Act sections 10(b)<sup>190</sup> and 14(a),<sup>191</sup> and the SEC's Rules 10b-5<sup>192</sup> and 14a-9<sup>193</sup> (the antifraud provision of the SEC's Proxy Rules promulgated pursuant to 14(a)).<sup>194</sup> After initially recognizing these rights of action, however, the courts quickly reversed course, refusing to permit parties other than the SEC to redress violations of other provisions of the securities laws through litigation, unless such rights were expressly conferred by statute.<sup>195</sup> Judicial decisions have not only refused to imply new rights of action for violation of the securities laws, but have increasingly curbed the ability of parties other than the SEC to maintain actions under the statutes and regulations for which private rights of action have already been recognized.<sup>196</sup>

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189. See Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (SEC stated in *amicus* brief that while securities markets had greatly expanded as of 1983, its own enforcement resources had declined); Barbara Black, Stoneridge Investment Partners v. Scientific-Atlanta, Inc.: *Reliance on Deceptive Conduct and the Future of Securities Fraud Class Actions*, 36 SEC. REG. L.J. 330, 338 (2008) (stating that empirical studies show the SEC cannot by itself enforce the law against all wrongdoers); Crimmins, *supra* note 36; Mike Ferullo, *Experts Say Missed Dodd-Frank Deadlines Increasingly Common; Lawmakers Accept It*, 43 SEC. REG. & L. REP. (BNA) No. 19, at 965, 965-66 (May 9, 2011) ("Some of the regulators have a budget problem, but all of them face a talent problem in finding and hiring new staff.").

190. 15 U.S.C. § 78j(b) (2006).

191. *Id.* § 78n(a).

192. 17 C.F.R. § 240.10b-5 (2011).

193. See *Id.* § 240.14a-9.

194. See *J. I. Case Co. v. Borak*, 377 U.S. 426, 430-31 (1964) (holding that shareholder had a private right of action under the § 14(a) and the Proxy Rules). The private right of action under § 10(b) and Rule 10b-5 was recognized by lower federal courts as early as 1946. *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). However, it was not recognized by the Supreme Court until 1971. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13-14 (1971).

195. The Supreme Court expressly refused to recognize a private right of action under the Investment Advisers Act. See *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979). The Court has also refused to recognize private rights of action under other provisions of the securities laws such as section 17(a) of the Exchange Act. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 569 (1979) ("§ 17(a) . . . does not, by its terms, purport to create a private cause of action in favor of anyone.").

196. The Supreme Court began to restrict the ability of private plaintiffs to bring actions under Rule 10b-5 almost immediately after recognizing it. See *Affiliated UTE Citizens v.*

*B. Prelude: The Credit Bubble Reaches Its Limits*

Warnings that the housing bubble was unsustainable appeared at least as early as 2004.<sup>197</sup> The bubble continued to inflate, however. Benefit funds, trying to obtain 8% yields in a world where conventional investments were paying 3%, continued to invest in complex instruments that appeared to promise the yields they sought and sold based on high ratings and dealers' deceptive promises of safety.<sup>198</sup> The total volume of complex structured instruments being created continued to expand dramatically.<sup>199</sup> As the bubble reached the peak of its expansion, clear signs of an impending financial crisis appeared late in 2006, when U.S. housing prices first leveled off and then began to decline.<sup>200</sup> The implications of this beginning of the long slide toward economic disaster for asset-backed securities were quickly felt. By June,

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United States, 406 U.S. 128, 154 (1972) (requiring plaintiff to show "causation in fact"). More recently, it has drawn not only upon the text of the PSLRA but on Congressional intent in adopting the PSLRA to reduce the ability of plaintiffs other than the SEC to bring actions under Exchange Act 10(b). See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314, 323–24 (2007). Even where the PSLRA does not apply, the present majority on the Court has sharply restricted implied rights of action under the securities laws to the point where the Court has implied that it accepts their existence only because of *stare decisis*. See *Janus Capital Grp v. First Derivative Traders*, 131 S.Ct. 2296, 2301–03 (2011) (noting that though existence of private right of action under Exchange Act § 10(b) and Rule 10b-5 "remains the law," it must be given narrow scope).

197. See SHILLER, *supra* note 155, at 40–41; see also Yuliya Demyanyk, *Ten Myths About Subprime Mortgages*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 87, 91 (noting that as early as 2001–2005, "signs of the crisis brewing . . . were hidden behind a mask of rising house prices").

198. See Lowenstein, *supra* note 116, at 40–41 (Moody's was slow to announce it was changing its model for rating asset-backed securities, and actually lowering ratings, though it was aware of the securities' deterioration in quality); Evans, *supra* note 4 ("The county was earning 8 percent in what was a 3 1/2 percent world . . ."). Because most asset-backed securities sold to benefit funds were unregistered, they were not subject to the SEC's Plain English disclosure rules, and dealers in the securities enjoyed substantial benefits from asymmetrical information sold even to large and sophisticated funds. See Whalen, *supra* note 19, at 8; Arora et al., *supra* note 138, at 1. See generally OFFICE INVESTOR EDUC. ASSISTANCE, *supra* note 58.

199. See Barth et al., *supra* note 1, at 97; Jon A. Garfinkel & Jarjisu Sa-Aadu, *A Decade of Living Dangerously: The Causes and Consequences of the Mortgage, Financial, and Economic Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 103, 103–04.

200. See Ashok Bardhan, *Of Subprimes and Sundry Symptoms: The Political Economy of the Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 17, 18.

2007, the investment banking firm Bear Stearns, which had been particularly aggressive in generating CDOs despite the deteriorating quality of the underlying collateral, was forced to bail out two of its affiliated hedge funds because of the sharp deterioration of their CDO assets.<sup>201</sup>

### C. *The Financial Crisis: The Crash of 2008*

Over the next year, the depth of the developing crisis became apparent as Bear Stearns itself spiraled toward insolvency. On March 14, 2008, the Federal Reserve provided emergency financial assistance to keep Bear Stearns out of bankruptcy, and two days later, in an exercise of its powers not employed since the crises of the 1930s, provided \$30 billion in backing as the venerable Wall Street firm was sold at a fire-sale price to Morgan Stanley.<sup>202</sup>

Despite signs of impending crisis that had multiplied during 2007, work-around measures by the Federal Reserve and private financial institutions working with it to save troubled institutions such as Bear Stearns kept the slide toward world financial crisis slow and largely below the radar of the financial markets until the third quarter of 2008.<sup>203</sup> By that time, subprime mortgages, which had increased from 9% of newly securitized mortgages in 2001 to 40% in 2006,<sup>204</sup> began to cascade into default; it became apparent to the financial community that CDO ratings were meaningless, and the solvency of the institutions holding them was therefore itself questionable.

The crisis came to a head with the failure of Lehman Brothers in 2008. Lehman was “too big to fail,” both in the sense that it was so large a component of the international financial condition that its failure entailed severe consequences,<sup>205</sup> and that it was too big for the Federal

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201. See Matthew Goldstein, *Bear Stearns' Subprime Bath*, BLOOMBERG BUSINESSWEEK (June 12, 2007), <http://www.businessweek.com/stories/2007-06-12/bear-stearns-subprime-bathbusinessweek-business-news-stock-market-and-financial-advice>; Corey Hajim & Adam Lashinsky, *How Bear Stearns Lost Its Way*, CNNMONEY (Aug. 21, 2007, 5:59 AM), [http://money.cnn.com/2007/08/20/magazines/fortune/bear\\_stearns.fortune/index.htm](http://money.cnn.com/2007/08/20/magazines/fortune/bear_stearns.fortune/index.htm).

202. See Associated Press, *In Bear Bailout, Fed Says It Tried to Avert Contagion*, N.Y. TIMES, June 28, 2008, at C4 (Federal Reserve assistance in bailing out Bear Stearns was “unprecedented”).

203. See, e.g., POSNER, *supra* note 1, at 118–26 (warnings about housing bubble were initially ignored).

204. See DiMartino & Duca, *supra* note 160.

205. See, e.g., GEORGE SOROS, REFLECTIONS ON THE CRASH OF 2008 AND WHAT IT

Reserve to bail out with the resources it had at hand.<sup>206</sup> The Federal Reserve was unable to find a purchaser for the firm, and allowed it to file for bankruptcy—the largest bankruptcy in dollar terms in U.S. history.<sup>207</sup> At this point, financial markets all over the world slid downward at a pace threatening to rival the Great Crash of 1929, as it became clear that many large financial institutions around the world held much of their capital in financial instruments that were either worthless or impossible to value.<sup>208</sup> Interbank lending, the lifeblood of international commerce, froze because institutions worried that their borrowers—even in the “too big to fail” class—might be insolvent. With financial institutions around the world unable to engage in routine short-term lending to each other, the real threat emerged as a worldwide economic collapse comparable to the Great Depression of the 1930s.<sup>209</sup>

As noted below, governments and central banks acted quickly and drastically in attempts to contain the crisis.<sup>210</sup> Their efforts, however, fell short of dealing in full with the exigencies of the crisis, both in terms of expenditures and in terms of regulations to stabilize the financial environment and to prevent further crises from springing up from seeds planted in the years leading up to the initial crisis.<sup>211</sup> It is therefore

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MEANS: AN E-BOOK UPDATE TO THE NEW PARADIGM FOR FINANCIAL MARKETS 161 (2009) (Lehman was a major issuer of and market-maker for commercial paper).

206. See Abigail Field, *Why the U.S. Balked at Bailing Out Lehman*, DAILYFINANCE (Mar. 15, 2010, 7:00 PM), <http://www.dailyfinance.com/2010/03/15/why-the-u-s-balked-at-bailout-out-lehman/>.

207. Lehman filed its bankruptcy petition with about \$613 billion in scheduled debt, nearly six times as much as in the largest previously filed bankruptcy case. See Sam Mamudi, *Lehman Folds with Record \$613 Billion Debt*, MARKETWATCH (Sept. 15, 2008, 10:11 AM), <http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt>. Almost simultaneously with the Lehman Brothers bankruptcy, another “too big to fail” institution, Merrill Lynch, was pushed by the Treasury Department into acquisition by Bank of America in order to avert a similar fate. See Andrew Ross Sorkin, *Merrill is Sold: Failing to Find Buyer, Lehman Set to File for Bankruptcy*, N.Y. TIMES, Sept. 15, 2008, at A1.

208. See Posner, *supra* note 1, at vii–ix.

209. See Austin Murphy, *The Making and Ending of the Financial Crisis of 2007–2009*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 125, 127–29. Judge Richard A. Posner (among others) has argued that the continuing “economic downturn” following the 2007–2008 crisis should in fact be characterized as a “depression.” See POSNER, *supra* note 1, at vii–x.

210. See *infra* notes 220–28 and accompanying text.

211. An example of the continued unfolding of the financial disaster that began in 2007 is the crisis, still unfolding as of this writing, involving both institutional and sovereign debt in the countries that have adopted the euro as a common currency. See, e.g., *Timeline: The*

necessary to discuss what has been accomplished, and what measures are still required to deal with the damage already done and to minimize future harm resulting from the excesses of the bubble years.

#### IV. THE SECURITIES LAWS AND INVESTMENTS BY BENEFIT FUNDS

##### A. *Ad Hoc Responses: Trying to Contain the Crisis*

The bankruptcy of Lehman Brothers was a “fire-bell in the night”<sup>212</sup> that precipitated a financial crisis of breadth and depth, which had not been seen since the great Crash of 1929.<sup>213</sup> Every sector of the U.S. economy was affected, beginning with the credit and equity markets.<sup>214</sup> In late 2008, stocks plummeted from the all-time high levels reached in 2007, much as they had done in 1929.<sup>215</sup> The most widely followed stock index, the Dow Jones Industrial Average, dropped almost 2,400 points in eight trading days.<sup>216</sup> Even more seriously, credit markets all over the world froze.<sup>217</sup> Because financial institutions held large portions of their capital in the form of once highly rated CDOs, which now were worth substantially less than their nominal value, or whose value could not be computed at all, the institutions making up the system were reluctant to make the short-term loans to each other that the world financial system requires to function effectively.<sup>218</sup> That, in turn, threatened to dry up

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*Unfolding Eurozone Crisis*, BBC NEWS: BUS. (Jun. 13, 2012, 10:08 AM), <http://www.bbc.co.uk/news/business-13856580>.

212. Letter from Thomas Jefferson to John Holmes (April 22, 1820), in 4 MEMOIRS, CORRESPONDENCE, AND PRIVATE PAPERS OF THOMAS JEFFERSON 332–33 (Thomas Jefferson Randolph ed., 1829) (stating that the controversy over slavery in U.S. territories alarmed him “like a fire-bell in the night”).

213. See POSNER, *supra* note 1, at vii–x, 10–17; REINHART & ROGOFF, *supra* note 154, at xli–xlv, 203–22, 233–39 (labeling current crisis as “the Second Great Contraction” comparable to that following the Crash of 1929).

214. See Posner, *supra* note 1, at vii–ix.

215. See *id.* at ix–x.

216. See Kirk Shinkle, *The Crash of 2008: How Bad Is It, and When Will It End?*, U.S. NEWS AND WORLD REPORT (Oct. 17, 2008), <http://money.usnews.com/money/personal-finance/investing/articles/2008/10/17/the-crash-of-2008>.

217. See, e.g., David Goldman, *Credit Freeze: What Lehman Wrought*, CNNMONEY (Nov. 16, 2008, 7:24 PM), [http://money.cnn.com/2008/11/14/news/economy/two\\_months\\_since\\_lehman/index.htm](http://money.cnn.com/2008/11/14/news/economy/two_months_since_lehman/index.htm).

218. See POSNER, *supra* note 1, *passim*; Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, *supra* note 1, at 69, 69–70.

credit to businesses around the world that depended on the institutions for credit to keep running.<sup>219</sup>

The result was a quick sequence of major interventions by Congress, the Federal Reserve, the U.S. Treasury, and corresponding institutions of other major financial powers to shore up endangered private financial institutions that were “too big to fail,” and to restore liquidity to the international financial system.<sup>220</sup> The level of commitment by governments, central banks, and major private institutions to this end was unprecedented in scope, size, and the level of international cooperation involved, continuing across national elections that transferred power from one political party to another.

As the U.S. government struggled to keep the national economy from collapse, one of its first formal measures was to establish the Troubled Asset Relief Program (TARP).<sup>221</sup> This program was enacted by Congress as a monumental appropriation—\$700 billion—to be used to purchase toxic assets from the financial institutions that had embedded them in their capital.<sup>222</sup> The urgency of the crisis, however, made this gradual approach appear too slow to avoid the failure of at least some of the institutions concerned, and so the TARP was transformed into a fund for protecting the solvency of troubled institutions by directly extending credit to them or, in many cases, purchasing equity interests in them.<sup>223</sup> The toxic assets, however, remained part of their capital, and continued to be a latent threat both to the institutions holding them and counterparties to swap transactions in which the counterparties agreed to assume at least part of the risk of

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219. See Goldman, *supra* note 217.

220. Arguably, major benefit funds, which have thousands of beneficiaries and hundreds of billions of dollars in assets, are also “too big to fail.” Defaults by major funds, cities, or possibly even states would have ripple effects that, like the failure of Lehman Brothers, would threaten the already fragile national economic recovery.

221. TARP was created as the central part of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (codified at 12 U.S.C. § 5201 (Supp. IV 2011)).

222. See *id.* § 115(a)(3). Dodd-Frank Act reduced the amount of troubled assets the Department of Treasury could purchase to \$475 billion. See Dodd-Frank Act § 1302, 12 U.S.C. § 5225(a)(3) (Supp. IV 2011).

223. The Treasury purchased more than \$150 million in equity from fifty-two financial institutions with TARP funds from the creation of the TARP on October 3, 2008 through November 25, 2008. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-161, TROUBLED ASSET RELIEF PROGRAM: ADDITIONAL ACTIONS NEEDED TO BETTER ENSURE INTEGRITY, ACCOUNTABILITY, AND TRANSPARENCY 16 (2008).

the assets involved. This continues to be a significant threat to the world economy in recovering from the crisis of 2008.<sup>224</sup>

In the U.S., government agencies also attempted to redraft the regulations which had embedded ratings issued by the conflicted credit rating agencies in the issuance of asset-backed securities.<sup>225</sup> As the financial crisis moved toward its climax in 2008 and the rating agencies scrambled to lower their high ratings on securities based on defaulting mortgages, the SEC, for example, acknowledged that its prior use of ratings had been ill-advised and proposed amendments to its regulations that would limit their use going forward.<sup>226</sup> These proposals, however, were limited in scope. They were never implemented because the Dodd-Frank Act, enacted in 2010 to deal with some of the problems leading to the crash of 2008,<sup>227</sup> superseded them both with self-executing provisions and with elaborate requirements for new, far more extensive regulations to be drafted by the SEC and other agencies dealing with ratings to limit their use and to make them, so far as they continued to be used, more reliable.<sup>228</sup>

*B. Incomplete Answers: The Dodd-Frank Act and Preliminary Attempts at Regulation*

With the Dodd-Frank Act of 2010,<sup>229</sup> Congress attempted to deal

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224. See Murillo Campello et al., *The Long-Term Cost of the Financial Crisis, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE*, *supra* note 1, at 571, 577.

225. See Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-61051, 74 Fed. Reg. 63,866 (proposed Dec. 4, 2009) (to be codified at 17 C.F.R. pts. 240 & 249b) (proposing rules more strictly regulating rating agencies, offered for comment before passage of Dodd-Frank); see also Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-64514, 76 Fed. Reg. 33,420, 33,421 (proposed June 8, 2011) (to be codified at 17 C.F.R. pts. 240, 242 & 249) (SEC had deferred consideration of original rules imposing stricter regulation of rating agencies and was now proposing new ones in response to Dodd-Frank).

226. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Dodd-Frank Act Release No. 34-58070, 73 Fed. Reg. 40,088 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242 & 249).

227. See Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

228. See Rules for Nationally Recognized Statistical Rating Organizations, Fed. Reg. at 33,420 & n.2 (the Commission had deferred considering action on its original proposed regulations in 2009, and was now proposing new rules mandated by Dodd-Frank Title IX, Subtitle C, Pub. L. No. 11-203 §§ 939, 939D-939F).

229. 124 Stat. at 1376.

comprehensively with many of the problems underlying the financial crisis. Dodd-Frank, together with regulations being drafted by the SEC, the CFTC, and other regulatory agencies to interpret the new statute and to give new force to prior regulatory statutes, contain some valuable provisions trapped within a mountain of verbiage.<sup>230</sup> While, as we shall see, Dodd-Frank has major limitations, it is helpful to begin by reviewing the more effective provisions by which it attempts to deal with the problems discussed in this Article. First, Dodd-Frank repeals Gramm-Leach-Bliley's bar to the SEC regulation of swap agreements,<sup>231</sup> and gives the SEC and CFTC jurisdiction to establish regulations that, *inter alia*, require participants in swap agreements to clear them on recognized exchanges rather than, as before, simply creating them over the counter without public records.<sup>232</sup> Regulations such as these will help regulators to ascertain the value of swaps outstanding, and thereby help to curb the volatility of financial markets generally—though derivatives such as swaps are inherently volatile and hard to value long-term<sup>233</sup>—so that it is unlikely that any regulatory scheme can make instruments that include them as collateral suitable to be offered for sale to vulnerable parties such as benefit funds.

Dodd-Frank also imposes some limits on securitization which, while limited, improve upon prior law. The most important of these is that it requires federal banking and securities regulators to formulate regulations to require the sellers of asset-backed securities to retain part of the risk of the assets such as mortgages that provide cash flow for the securities.<sup>234</sup> There are several important problems with this section,

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230. *See id.*

231. *See* Dodd-Frank Act, 12 U.S.C. § 1851 (Supp. IV 2011).

232. *Id.* § 8302. Dodd-Frank Act Title VII gives the SEC jurisdiction over security-based swaps; the CFTC jurisdiction over non-security based swaps such as those based on currencies; and the two have joint jurisdiction over instruments involving both securities and non-security-based swaps. *Id.* The agencies have begun promulgating the extensive regulations required to do so. *See, e.g.*, Interpretive Guidance for Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (proposed July 12, 2012) (to be codified at 17 C.F.R. chp. I) (CFTC guidance on the Dodd-Frank Act's regulation governing cross-border credit default and interest rate swap agreements); *see also* Silla Brush, *CFTC Proposes Swaps Clearing Determinations Under Dodd-Frank*, BLOOMBERG (July 25, 2012), <http://www.bloomberg.com/news/2012-07-24/cftc-proposes-swaps-clearing-determinations-under-dodd-frank-act.html>; *Derivatives*, U.S. SEC. EXCH. COMM'N (July 11, 2012), <http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml>.

233. *See, e.g.*, Friedman & Friedman, *supra* note 152, at 33.

234. Dodd-Frank Act, 15 U.S.C. § 78o-11 (Supp. IV 2011).

however: it is not self-executing, and requires regulations to be drafted by several different regulatory agencies to take effect. Moreover, it specifies that the amount of risk retained is to be at least 5%, hardly enough to deter investment banking firms who took on enormous levels of risk during the period leading up to the 2008 debacle.<sup>235</sup> Worse yet, the retention requirement does not apply to “qualified residential mortgages,” a term which the statute leaves to the agencies to define by regulation, but which presumably will include conventional mortgages.<sup>236</sup> As we have seen, the failure of mortgage-backed securities that triggered the financial crisis was caused not just by the use of “subprime” mortgages, but by the steady relaxation of standards required for “conventional” mortgages.<sup>237</sup>

The SEC, in reliance on Dodd-Frank,<sup>238</sup> has for the first time extended Regulation AB to cover privately placed asset-backed securities as well as those that are publicly registered.<sup>239</sup> This small step forward, however, comes to grief, like so many provisions of Dodd-Frank, in the discretion that it gives to those whom it purports to

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235. See Friedman & Friedman, *supra* note 152, at 33 (noting that after SEC agreed to let investment banks monitor their own risks in 2004, they assumed enormous new risks, with Bear Stearns taking on a leverage ratio of 33:1 by the time of its failure).

236. Exchange Act § 15G(c)(1)(B)(ii), 15 U.S.C. § 78o-11(c)(1)(B)(ii) (Supp. IV 2011)).

237. See *supra* notes 159–63 and accompanying text. By contrast, the German Pfandbriefgesetz, see *supra* note 69 and accompanying text, requires strict supervision of financial institutions permitted to issue Pfandbriefe and of the collateral that backs the instruments. *Inter alia*, issuing institutions retain all risk on the Pfandbriefe that they are permitted to issue, and if mortgages collateralizing a Pfandbrief become riskier than at the time the Pfandbrief was issued, independent trustees (“Treuhänder”) must replace them with instruments that adequately cover the obligations evidenced by the Pfandbrief. See, e.g., Pfandbriefgesetz, PfandBG [Pfandbrief Act], 2009, Bundesgesetzblatt [BGBl] at Teil I, §§ 1–4, 12–16, 27–28. Pfandbriefe survived the 2007–2009 crisis far better than their CMO cousins. Ironically, the only significant crisis affecting Pfandbriefe during the world financial crisis occurred late in 2008 not because of failure of mortgages collateralizing Pfandbriefe, but because a leading issuer, the Hypo Real Estate Pfandbrief Bank, became enmeshed in a crisis concerning its corporate parent, the Hypovereinsbank, because of the parent’s failed investment in the Depfa Bank in Ireland, requiring the German government to bail out the corporate parent. See Kofner, *supra* note 69, at 23–25.

238. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

239. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Dodd-Frank Act Release Nos. 33-9175 & 34-63741, 76 Fed. Reg. 4489 (effective Mar. 28, 2011) (to be codified at 17 C.F.R. pt. 229, 232, 240 & 249).

regulate. New Rule 15Ga-1<sup>240</sup> requires securitizers—the assemblers of pools of assets used to collateralize asset-backed securities<sup>241</sup>—to report incidents in which they are required to repurchase or replace collateral that proves defective.<sup>242</sup> The SEC itself, however, somewhat ruefully stated that this obligation will be triggered only if a securitizer subjects itself to a contractual obligation to repurchase or replace assets that prove defective, and that commentators on the proposing release had noted it was unlikely to have significant effects.<sup>243</sup>

Dodd-Frank also makes an elaborate but, in the last analysis, limited attempt at protecting buyers of complex financial instruments such as benefit funds by imposing more controls on rating agencies and the use of their output than previous legislation.<sup>244</sup> Most significantly, it requires the SEC, banking regulators, and other federal agencies, to end the required use of ratings for matters as varied as qualifying for short-form registration of securities, and quality of required capital for financial organizations ranging from broker-dealers to banks.<sup>245</sup>

Furthermore, since Dodd-Frank accepts that ratings will continue to be widely used in evaluating the quality of securities, it attempts to

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240. 17 C.F.R. § 240.15Ga-1 (2011).

241. See Exchange Act § 15G(a)(3). A securitizer is either: “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” *Id.*

242. 17 C.F.R. § 240.15Ga-1 (2011).

243. See Disclosure for Asset-Backed Securities, 76 Fed. Reg. at 4489–91.

244. See Dodd-Frank Act, 15 U.S.C. § 78o-9 (Supp. IV 2011).

245. Dodd-Frank Act § 939A requires federal agencies, within a year after enactment of the statute, to review all use of ratings used in their regulations. *Id.* § 78o-7. While this has in fact taken far longer than the time required, the SEC has already adopted extensive amendments to its rules and forms, effective September 2, 2012, which remove virtually all use of ratings in its rules and forms, such as the use of ratings to qualify for use of the simplified forms S-3 and F-3 for registering securities for public distribution. See Security Ratings, Dodd-Frank Act Release Nos. 33-9245 & 34-64975, 76 Fed. Reg. 46,603, 46,607 (effective Sept. 2, 2012) (to be codified at 17 C.F.R. pts. 200, 229, 230, 232, 239, 240 & 249). The changes also include the elimination of former 17 C.F.R. section 230.134(a)(17), which had provided a “safe harbor” for issuers to use credit ratings in communications not subject to the rules governing prospectuses. *Id.* at 46,603, 46,612. As the SEC noted in removing the “safe harbor,” the change will probably have little effect because issuers will still be able to use ratings in free writing prospectuses, and, as we will see, the new rules that are supposed to improve the accuracy of ratings leave almost no room for an investor to sue an issuer or rating agency based on an inaccurate rating. See *id.*; see also *infra* notes 295–97 and accompanying text.

assure greater objectivity in credit ratings by requiring rating agencies, as a condition for registration with agencies such as the SEC, to create their own systems of internal controls to establish procedures and methodologies to produce consistent and accurate ratings.<sup>246</sup> Dodd-Frank requires the agencies to appoint compliance officers to assure that each agency, in formulating its ratings, is in compliance with its own policies, and requires the chief executive officer of each agency to attest to its compliance with these policies.<sup>247</sup>

Additionally, Dodd-Frank requires rating agencies to disclose their methodologies, including mathematical models, data used to formulate the ratings, limitations on the reliability of the ratings, and information concerning the past performance of the ratings.<sup>248</sup> These are to be provided, on standard forms to be developed by the agencies themselves, to users of the ratings.<sup>249</sup> These forms are supposed to be “easy to use and helpful for users of credit ratings to understand the information contained in the report.”<sup>250</sup>

All of this sound and fury signifies next to nothing, however, for a number of reasons. Even if Dodd-Frank provides for rules imposed by a body other than the agencies themselves,<sup>251</sup> and is enforceable by users of the ratings as well as the SEC, the reports it prescribes to accompany the ratings would not likely be materially helpful to unsophisticated users, for whom, as the experience of the last decade shows, the ratings themselves are surrogates for due diligence on the quality of complex securities. In the assembly of collateral for CDOs, as previously noted, complexity led even sophisticated investment bankers to rely solely on ratings for evaluating the chances of default on the securities based on that collateral.<sup>252</sup>

Even if users actually make use of the new reports required by

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246. See 15 U.S.C. § 78o-7(c)(3).

247. See *id.* § 78o-7(c)(3) to 7(j).

248. See *id.*

249. See *id.* § 78o-7(s).

250. *Id.* § 78o-7(s)(2)(a).

251. Broker-dealers, for example, are regulated by independent organizations such as Financial Industry Regulatory Authority (FINRA) and the New York Stock Exchange as well as the SEC. See *About the Financial Industry Regulatory Authority*, FINRA, <http://www.finra.org/AboutFINRA/> (last visited Oct. 6, 2012); *infra* note 257 and accompanying text.

252. See *supra* notes 70–75, 97–98 and accompanying text.

Dodd-Frank, however, agencies face little deterrence against formulating rules that favor themselves at the expense of their customers, because (a) enforcement of the provisions is left exclusively to the already understaffed SEC,<sup>253</sup> and (b) the SEC's authority is merely to prescribe rules under which the agencies are to regulate themselves, and its power to sanction misbehavior by a rating agency is largely confined to suspension or disbarment if an agency fails to conform to its own rules.<sup>254</sup>

Dodd-Frank and the regulations being drafted to implement it offer no remedy at all for the problems faced by benefit funds holding once highly rated complex financial instruments that are now worthless, sharply diminished in value, or currently impossible to value.<sup>255</sup> Furthermore, they do not address important issues concerning the prevention of a similar debacle in the future.

Dodd-Frank, whatever its use going forward, does nothing to remove barriers to actions by parties other than federal agencies based on transactions already completed.<sup>256</sup> It therefore does not aid benefit funds and their state sponsors in bringing actions for frauds committed before the financial crisis. Moreover, it adds little to the enforcement powers of the SEC, other federal regulators, and self-regulating organizations such as FINRA in bringing such actions.<sup>257</sup>

More basically, Dodd-Frank, as it currently stands, is immensely complex, running 2,300 pages.<sup>258</sup> In attempting to deal with the multitude of problems that became manifest with the 2008 financial crisis, it incorporates provisions that deal with matters ranging from

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253. See 15 U.S.C. § 78o-7(q)-(s); Levitt, *supra* note 33.

254. See 15 U.S.C. § 78o-7(c)-(d).

255. See generally Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

256. See *Landgraf v. USI Film Products*, 511 U.S. 244, 270, 280 (1994) (noting that there is a strong presumption against retroactive application of a statute unless retroactivity is expressly stated by Congress). A SEC administrative law judge, addressing an initial attempt by the SEC to apply Dodd-Frank, held that substantive provisions of Dodd-Frank do not apply retroactively. See Lawton, Release No. 419, File No. 3-14162 (ALJ Apr. 29, 2011) (initial decision).

257. The Financial Industry Regulatory Authority is an independent corporation (the successor to the National Association of Securities Dealers), which, under the general supervision of the SEC, acts as a self-regulatory organization for securities brokers and dealers. See Carrie Johnson, *SEC Approves One Watchdog for Brokers Big and Small*, WASH. POST, July 27, 2007, at D1.

258. See Levitt, *supra* note 33.

consumer protection to the regulation of rating agencies. Because of this attempt at being comprehensive, and the compromises that went into achieving its wide scope, it lacks the conciseness and consistent legislative architecture that have made legislation such as the Securities Act and the Sarbanes-Oxley Act of 2002<sup>259</sup> effective tools for securities regulation,<sup>260</sup> and often falls short of real effectiveness in matters of concern to this Article, such as regulation of the rating agencies. Dodd-Frank, and particularly the sections of its Title IX that apply to rating agencies, are so prolix, indirect, and lacking in force<sup>261</sup> as to fit the Court of Claims' characterization of the 1959 Life Insurance Company Income Tax Act as a "conspiracy in restraint of understanding."<sup>262</sup> Moreover, to an even greater degree than earlier securities law, Dodd-Frank depends upon interpretive regulations, which are being drafted—with considerable difficulty—by multiple administrative agencies, for its enforcement.<sup>263</sup> It is also subject to ongoing hostility in Congress that could result in the revision or repeal of some of its provisions, and which could also deter administrative agencies from drafting interpretive regulations as forceful as regulations already in effect under older federal statutes concerning securities.<sup>264</sup> Because of this, it adds little to the protection given to future buyers of complex securities by previously enacted statutes.

Dodd-Frank, more than prior legislation, gives the appearance of attempting to deal with the problems associated with the credit rating agencies.<sup>265</sup> It requires the SEC to establish within itself an Office of

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259. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 (Supp. IV 2011).

260. In a current compilation, the entire 1933 Act, including almost eighty years of amendments, runs approximately forty-seven pages. HAZEN, *supra* note 47, at 1–47.

261. See *supra* notes 258–60 and accompanying text.

262. Lincoln Nat'l Life Ins. Co. v. U.S., 582 F.2d 579, 583 n.1 (Ct. Cl. 1978).

263. The CFTC, for example, voted to delay its rulemaking for key portions of Dodd-Frank (other than those that are self-executing) until at least the end of 2011, more than six months after the deadline in the Act. See *CFTC Proposes Six-Month Delay for Bulk of Dodd-Frank Swaps Rulemaking*, SEC. L. DAILY (BNA) (June 15, 2011).

264. See Levitt, *supra* note 33 (Congressional Republicans, as part of their general hostility to the securities laws, have deliberately underfunded the S.E.C.'s statutorily required efforts to promulgate regulations for enforcement of Dodd-Frank); see, e.g., T.W. Farnam, *Payday Lenders Writing Bigger Checks to Candidates*, WASH. POST, Apr. 19, 2012, at A13; Newt Gingrich, Opinion, *Reagan Had the Recipe for Success. Let's Follow It*, WALL ST. J., December 29, 2011, at A15; Peter J. Wallison, Opinion, *How Regulators Herded Banks into Trouble*, WALL ST. J., December 3–4, 2011, at A17.

265. See Dodd-Frank Act, 15 U.S.C. § 780-7 (Supp. IV 2011).

Credit Ratings to administer the rules that it authorizes the SEC to draft concerning credit rating agencies, and to “promote accuracy” in the ratings.<sup>266</sup> It also contains some useful provisions for disclosure by rating agencies on their practices in formulating ratings.<sup>267</sup> These provisions, however, lack real teeth.

Dodd-Frank provides, somewhat deceptively, for regulatory agency input in supervising what is essentially a scheme of self-regulation by the credit rating agencies. To do so, *inter alia*, it mandates the creation within the SEC of an Office of Credit Ratings.<sup>268</sup> Substantively, however, though it anticipates that ratings will continue to be used, particularly in privately placed offerings, it approaches abuses by credit rating agencies obliquely rather than directly.<sup>269</sup> Its immense complexity is a source of weakness rather than strength. It is partly self-executing, and partly relies on studies to be made and regulations to be promulgated by eight different federal agencies—the Treasury, Federal Reserve, SEC,<sup>270</sup> CFTC,<sup>271</sup> FDIC,<sup>272</sup> FHFA,<sup>273</sup> NCUA,<sup>274</sup> and the Office of the Comptroller of the Currency, plus a new Bureau of Consumer Protection.<sup>275</sup>

Worse yet, though it gives the SEC some authority over the credit rating agencies, an important point for the concerns of this Article,<sup>276</sup> it

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266. *Id.* § 78o-7(p)(1)(A)(ii).

267. *See supra* notes 225–33, 245–50 and accompanying text.

268. *See* 15 U.S.C. § 78o-7(p)(1).

269. *See supra* notes 222–32, 253–54 and accompanying text.

270. 15 U.S.C. § 8302(a)(2).

271. *Id.* § 8302(a)(1).

272. Dodd-Frank Act, 12 U.S.C. § 5391(d) (Supp. IV 2011).

273. The Federal Housing Finance Administration, successor agency to the Office of Federal Housing Oversight and conservator for the formerly independent Fannie Mae and Freddie Mac following their insolvency. *See About FHFA*, FED. HOUS. FIN. AGENCY, <http://www.fhfa.gov/Default.aspx?Page=4> (last visited Sept. 23, 2012).

274. The National Credit Union Administration is given authority by the Federal Credit Union Act, enacted by Congress in 1934. Federal Credit Union Act of 1934, 12 U.S.C. § 1751 (2006).

275. Dodd-Frank requires the SEC alone to establish 5 new offices, conduct more than 20 studies, and draft more than 100 sets of rules. *See Oversight of Dodd-Frank Implementation: A Progress Report by the Regulators at the Half-Year Mark: Hearing Before the S. Comm. on Banking, Hous., and Urb. Aff.*, 112th Congress 1 (2011) (statement of Mary L. Schapiro, Chair, U.S. Securities & Exchange Commission).

276. *See generally* Dodd-Frank Act, 15 U.S.C. § 78o-7 (Supp. IV 2011).

leaves in place Exchange Act section 15E(c)(2),<sup>277</sup> inserted by the retrograde Credit Rating Agency Reform Act of 2006 (CRARA),<sup>278</sup> which bars not only the SEC but any State from regulating the agencies' procedures, methodologies, or the substance of credit ratings, except in indirect ways.<sup>279</sup> While Dodd-Frank has elaborate provisions requiring rating agencies to establish procedures for formulating ratings, and requires that these procedures be documented and disclosed,<sup>280</sup> it does not permit regulatory agencies to play a direct role in formulating the ratings that the agencies place upon securities.<sup>281</sup> Moreover, it preserves the exclusive authority given to the SEC by CRARA to enforce provisions of the securities laws dealing with rating agencies, if the agencies materially fail to conform to the procedures for rating securities prescribed by Dodd-Frank and other litigation.<sup>282</sup>

Dodd-Frank does allow a private right of action against rating agencies under extremely limited circumstances: where the complainant

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277. *Id.* § 78o-7(c)(2).

278. *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 15E(c)(2), 120 Stat. 1332 (codified at 15 U.S.C. § 78o-7 (2006)).

279. *See* Exchange Act § 15E(c)(2), 15 U.S.C. § 78o-7(c)(2) (2006); Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-64514, 76 Fed. Reg. 33,420, 33,429 (proposed June 8, 2011) (to be codified at 17 C.F.R. pts. 240, 242 & 249); *see also*, Mark Twain ("A lie is like a cat. It never comes at you straight."). Mark Twain is one of my favorite writers, and I have read so much of his writing (and reminiscences by people who knew him) that I cannot pinpoint the specific sources of this quote, although I am confident of its accuracy. In fairness, Twain was intensely fond of cats, something that could not be said of his feelings toward Congress. *See* CONNIE ANN KIRK, MARK TWAIN: A BIOGRAPHY 117 ("Reader, suppose you were a member of Congress. And suppose you were an idiot. But I repeat myself.").

280. *See* Dodd-Frank Act, 15 U.S.C. § 78o-7(c)(3)(A) (Supp. IV 2011); Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg. at 33,421-22.

281. *See* 15 U.S.C. § 78o-7(c)(2). While Dodd-Frank states that the SEC *may* prescribe factors that an NRSRO should take into consideration in establishing, maintaining, enforcing, and documenting, an effective internal control system, the SEC's role is permissive rather than mandatory, and the primary responsibility is still placed with the rating agency itself. *See id.* § 78o-7(c)(3)(A). This sharply contrasts with the direct role played by the SEC in overseeing regulation of broker-dealers by independent agencies such as securities exchanges and FINRA. *See* Exchange Act § 4, 6, 19. The SEC, as of August 8, 2011, deferred such prescription indefinitely pending observation of actual formulation by the rating agencies of their own internal control structures, illustrating in part the futility of doing so, given the complexity of the task in proportion to SEC resources, and the ultimate self-regulatory authority allowed the agencies under Dodd-Frank. *See* Rules for Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg. at 33,420-22.

282. *See* Exchange Act § 15E(c)(1) (preserving any action "by the Commission" under antifraud provisions of the federal securities laws).

is injured by a rating that was prepared by an agency in knowing or recklessly disregarding its own procedures for formulating ratings, or of information used in rating a security.<sup>283</sup> It is, however, even more restrictive than the PSLRA in establishing high barriers that pleadings in such actions must overcome to allow them to proceed to discovery, making the right almost meaningless.<sup>284</sup> In the first place, the pleading barrier applies not just to class action plaintiffs, but to all plaintiffs, including public benefit funds.<sup>285</sup> Secondly, it bars any action from proceeding as far as discovery unless the plaintiff's pleadings establish "a strong inference" that the agency, in preparing the rating, failed to comply with its own procedures, or to obtain "reasonable verification" of factual elements of the rating from sources other than the issuer or underwriter "that the credit rating agency considered to be competent" concerning the security being rated.<sup>286</sup> The near-complete discretion given agencies to choose the methods and facts they use to rate securities makes it difficult to envision circumstances under which a plaintiff could overcome the pleading barrier to state a claim.

While Dodd-Frank requires federal agencies to remove formal

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283. New SEC Rule 17g-7 requires NRSROs to disclose, as part of the report accompanying their ratings of asset-backed securities, any representations, warranties, and enforcement mechanisms available to investors under the rating agencies' own internal procedures, and how they differ from the representations, warranties, and enforcement mechanisms under similar securities—but since these are left almost entirely to the discretion of the agencies themselves, the rule is deceptively meaningless. *See* Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Dodd-Frank Act Release Nos. 33-9175 & 34-63741, 76 Fed. Reg. 4504 (effective Mar. 28, 2011) (to be codified at 17 C.F.R. pt. 229, 232, 240 & 249).

284. Dodd-Frank § 939G, at first glance, seems to give non-agency claimants stronger claims against NRSROs for misleading ratings by repealing 1933 Act Rule 436(g). Dodd-Frank Act § 939G. This rule provided that when a rating was referred to in a registration statement for securities, the NRSRO that issued it would not be considered an expert participating in the registration process for purposes of liability under 1933 Act section 11. *See* 17 C.F.R. § 230.436(g) (2012). Dodd-Frank, in repealing Rule 436(g), established that NRSROs would not be considered experts for purposes of section 11 liability unless they file a written consent to the inclusion of the rating in the registration statement. Dodd-Frank Act § 929P. This is likely to have little impact because (1) most of the securities this Article addresses are exempt from registering, and (2) the rating agencies have indicated they will not give the requisite consents. *See* Gregory A. Fernicola et al., *Dodd-Frank Act Rescinds Exemptions Under Rule 436(g)*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (July 23, 2010), <http://www.skadden.com/Index.cfm?contentID=51&itemID=2172>.

285. *See* Exchange Act § 21D.

286. Dodd-Frank Act, 15 U.S.C. § 78u-4(b)(2)(B) (Supp. IV 2011).

requirements that ratings be used in evaluating the creditworthiness of securities, it leaves individual federal agencies to provide for substitutes by regulation.<sup>287</sup> The SEC and other regulatory agencies have begun to comply with this directive by promulgating new rules to remove references to ratings by the NRSROs from their regulations,<sup>288</sup> but they have not come up with adequate substitutes, nor is it clear that it is possible to do what the ratings purported to do—i.e., to predict performance by complex securities over more than a short period of time.<sup>289</sup>

Moreover, Dodd-Frank and its regulatory progeny do little to protect investors such as benefit funds who rely on ratings for their investments. Its treatment of the conflicts of interest created by the agencies' payment by the issuers of securities they are rating is typical of its soft approach to hard problems. Instead of taking as its model the stringent provisions created by the Sarbanes-Oxley Act in dealing with conflicts of interest by auditors,<sup>290</sup> it merely provides for a paper-thin separation between the agency employees who sell their agencies'

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287. The SEC, *inter alia*, has removed investment grade ratings as requirements for the registration of primary offerings of non-convertible, non-equity securities for cash on short forms S-3 and F-3 (as compared to the much longer forms S-1 and F-1 used for offering non-qualifying securities), and substituted a requirement that the issuer have issued at least \$1 billion in non-convertible, non-equity securities registered under the 1933 Act over the prior three years, or meet certain other transaction history requirements. See 17 C.F.R. §§ 230.405, 239.13 (2012); Security Ratings, Dodd-Frank Act Release Nos. 33-9245 & 34-64975, 76 Fed. Reg. 46,603, 46,606–10 (effective Sept. 2, 2012) (to be codified at 17 C.F.R. pts. 200, 229, 230, 232, 239, 240 & 249); SEC, Form F-3: Registration Statement Under the Securities Act of 1933, General Instructions, § I.B.2; SEC, Form S-3: Registration Statement Under the Securities Act of 1933, General Instructions, § I.B.2.

288. See, e.g., Security Ratings, 76 Fed. Reg. at 46,603 (removing references to security ratings from rule and form requirements under the 1933 Act and the Exchange Act per Dodd-Frank § 939A); Risk-Based Capital Guidelines: Market Risk, 77 Fed. Reg. 53,060, 53,061–62 & n.9 (Aug. 30, 2012) (to be codified at 12 C.F.R. pts. 3, 208, 225 & 325) (a joint final rule removing references to ratings for evaluating creditworthiness per Dodd-Frank § 939A).

289. Many comments made to the Office of the Comptroller of the Currency on its proposed rules to replace ratings with complex economic models noted that most community and regional banks did not have systems and staff capable of performing analyses at the level of credit rating agencies—and the same is, if anything, more true of all but the most sophisticated benefit funds. See Risk-Based Capital Guidelines, 77 Fed. Reg. at 53,062–63.

290. See Sarbanes-Oxley Act of 2002 §§ 103, 208(b), 15 U.S.C. § 7213, 7233 (2006) (making it unlawful for a registered public accounting firm or any person associated therewith to prepare or issue an audit report concerning an issuer of securities if subject to a conflict of interest as defined in Exchange Act § 10A(g)).

services and those who actually rate securities.<sup>291</sup> It takes little analytic skill to see that agency employees who formulate ratings are aware that their agencies are paid by the issuers of the securities they are rating. Thus, these agencies depend on good relations with the small circle of financial institutions that underwrite the securities for their revenues, whether or not they have direct contact with those who sell the agencies' services. It is this systemic conflict of interest, rather than the individual conflicts of interest of agency employees that Dodd-Frank seeks to control, which provided the incentive for the deceptively positive ratings issued for complex financial instruments such as CDOs by the rating agencies during the New Gilded Age.<sup>292</sup>

Another Dodd-Frank provision that superficially appears to encourage agency objectivity in formulating ratings similarly falls short of real effectiveness. This is the requirement that an agency, in formulating a rating, shall rely on information from a source that it considers reliable other than the security's issuer or underwriter.<sup>293</sup> This is deceptively meaningless because the source must be one that the rating agency itself considers credible—and by leaving the decision on credibility to the agency itself, renders virtually unenforceable a claim that the agency failed to rely on truly objective evidence. The vaporous nature of the provision is highlighted by considering what third-party sources a rating agency could rely upon to provide such information—given that the only parties likely to have the resources to perform the kind of “due diligence” to which the statute refers, in the context of examination by agencies of third-party data,<sup>294</sup> are the small circle of financial institutions that share a mutual interest in assuring that

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291. See Dodd-Frank Act, 15 U.S.C. § 78o-7(h)(3)(A) (Supp. IV 2011); Rules for Nationally Recognized Statistical Rating Organizations, at 33,426.

292. See Complaint at 11–19, *Illinois v. McGraw-Hill Cos.*, No. 12 CH-02535 (Ill. Cir. Ct. Jan. 25, 2012); Michael Bologna, *Illinois AG Accuses S&P of Fraud in Ratings of Structured Finance Securities*, 44 SEC. REG. & L. REP. (BNA) No. 5, at 231 (Jan. 30, 2012) (Illinois sued S&P in state court under the Illinois Consumer Fraud Act and Uniform Deceptive Practices Act, claiming that, in the ratings it gave structured finance securities sold to state agencies, S & P systematically misrepresented its credit analysis of the securities as objective when it in fact ignored their true risks to secure business from the securities' underwriters).

293. Dodd-Frank Act, 15 U.S.C. § 78o-7(v) (Supp. IV 2011).

294. Exchange Act § 15E(s)(4), 15 U.S.C. § 78o-7 (Supp. IV 2011). The statute's use of the term “due diligence” is itself deceptive in that it falsely implies that providers of such information will be subject to the kind of liability to which an underwriter would be subject under Securities Act section 11(a) and (b), 15 U.S.C. § 77a, 77k(b) (2006), for failure to perform due diligence, when Dodd-Frank in fact does not impose such liability.

complex securities receive good ratings.

Even the requirement that the SEC prescribe a short form on which rating agencies are to be required to provide ratings users with the assumptions and methodologies underlying the procedures used in formulating ratings, and the data used in preparing particular ratings,<sup>295</sup> may ironically prove counterproductive. Given the complexity of the mathematical models used to formulate ratings, one can be sure that they will add little or nothing to the ability of fiduciaries for all but the largest benefit funds to understand what the ratings mean,<sup>296</sup> and smaller fund fiduciaries are more likely to simply look at the rating itself, and erroneously take confidence from the analytical apparatus provided by the forms that the rating can be relied upon.<sup>297</sup>

#### V. WHERE DO WE GO FROM HERE?

Two problems must be addressed in dealing with losses incurred by public benefit funds before the losses escalate into a new dimension of the financial crisis that could prove comparable to or even more severe than the failure or threatened failure of great private financial institutions.<sup>298</sup> The first is to enable them to recover losses by rescinding transactions or recovering damages from financial institutions that led them down the primrose path to improvident investments. The second is to put in place a framework of regulation that will make it more difficult for benefit funds to put themselves in this kind of financial jeopardy in the future.

Recoveries of losses—both those already realized and those that are still latent—will require enforcement of statutes and regulations

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295. Exchange Act § 15E(s).

296. Even the most sophisticated investors may be unable to overcome the high level of information asymmetry they suffer as against sellers of complex financial instruments. See Arora et al., *supra* note 138 (noting that the use of derivatives in financial products increases information asymmetry between sellers and buyers so that even a buyer with substantial information and great computational power cannot adequately compute their value).

297. See Elisabeth Rosenthal, *I Disclose . . . Nothing*, N.Y. TIMES, Jan. 22, 2012, at SR1 (noting that elaborate required disclosure is rarely read by its intended recipients, and instead tends to be used by its providers to show compliance with disclosure law and thereby avoid legal liability).

298. As this Article has previously noted, the ripple effects of large-scale insolvencies of public benefit funds could lead to a national financial crisis on the order of the threatened failure of major private financial institutions in 2008. See *supra* notes 15–18 and accompanying text.

designed for this purpose. Given the comparatively small size of the SEC's Enforcement Division,<sup>299</sup> this enforcement will require actions by states and individual funds as well as federal agency actions under the securities laws. This, in turn, will require clarifying regulations designed to encourage meritorious actions being brought by benefit funds under the federal securities laws, dispelling the penumbra of deterrence created by the PSLRA that has driven securities fraud actions into the uncertain and inconsistent forums provided by the state courts. The regulations should also make it possible for benefit funds to maintain actions in the federal courts based on statutory provisions that have heretofore been the exclusive preserve of the SEC. The fact that the benefit funds are sponsored by states, state instrumentalities, and organizations of state employees will be useful in drafting regulations that gain effectiveness by furthering collaboration between the SEC and state agencies.

*A. Enforcement: Regulations in Aid of Benefit Funds for Pre-Crisis Investments*

The first concern in addressing the problems faced by benefit funds with respect to investments in complex instruments, which are now non-performing and either worthless or at least unsalable is to recover losses incurred when their purchase of the instruments in question was based on material misrepresentations or omissions by their vendors. There are good arguments for addressing such wrongs through action by the SEC. These include the special expertise of the SEC's Enforcement Division; the fact that the SEC can make use of statutes such as the Advisers Act, which are not privately enforceable;<sup>300</sup> and the fact that enforcement by the SEC would create more uniform national rules. Unfortunately, as has been noted, the SEC lacks staffing and financial resources to address all but the most serious cases of securities fraud.<sup>301</sup>

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299. See *supra* note 36 and accompanying text.

300. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195–97, 203 (1963) (noting that Advisers Act section 206(2), 15 U.S.C. § 80b-6, imposes a fiduciary duty on investment advisers requiring them to disclose all material information to clients and prospective clients—including public benefit funds).

301. See, e.g., *supra* note 36.

*B. Enforcement: Giving Statutes Regulatory Teeth*

The SEC has—unfortunately well after much of the damage was done—taken action against abuses by investment advisers who allegedly fattened themselves in violation of the Advisers Act during the period leading up to the financial crisis.<sup>302</sup> It has brought actions against parties accused of violating the Act, and formed a new unit within the Enforcement Division to specialize in violations of the Act.<sup>303</sup> Nonetheless, the unit consists of a total of just sixty-five professionals—enough to bring some high-profile cases but not nearly enough to deal with abuses during the prelude to the crisis, let alone the future.<sup>304</sup>

Dodd-Frank, despite the weaknesses described above,<sup>305</sup> suggests a viable approach, even though the legislation only takes some preliminary steps in that direction: The SEC can multiply the effectiveness of its professionals by working with the states. Dodd-Frank does this, *inter alia*, by amending section 203A of the Advisers Act to provide that investment advisers with less than \$100 million under management must be registered with and examined by their home states, and barring advisers in this group from registering with the SEC.<sup>306</sup> More significantly, the Advisers Act authorizes the SEC to provide training and other reasonable assistance to state authorities in connection with the regulation of investment advisers.<sup>307</sup> These provisions, however, are limited by barring the states from bringing enforcement actions against larger advisers that are required to register with the SEC, except for “fraud, pricing, and reporting violations,” implying that state enforcement in these cases requires proof of *scienter*, a requirement to which the SEC is not subject.<sup>308</sup>

This suggests that more systematic cooperation between the SEC and the states across the entire spectrum of securities regulation would provide an effective way to allocate scarce resources to protect state instrumentalities such as benefit funds. A first step in establishing a

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302. *See id.*

303. *See id.*

304. *See id.*

305. *See supra* notes 223–25, 263–73, 279–86 and accompanying text.

306. *See* Dodd-Frank Act § 410, 15 U.S.C. § 80b-3a(a) (Supp. IV 2011); Advisers Act § 203A, 15 U.S.C. § 80b-3 (2006).

307. Advisers Act § 203A(d).

308. *See* SEC v. Steadman, 967 F.2d 636, 643 & n.5 (D.C. Cir. 1992).

closer working relationship between the SEC and the states would be to split off a new Office of State Coordination from the SEC's present Office of Legislative and Intergovernmental Affairs, which presently engages in the largely futile exercise of attempting to conduct liaison with Congress.<sup>309</sup> The new office would amplify the effectiveness of the SEC staff by arranging for it to coordinate the drafting of regulations for the protection of state instrumentalities such as benefit plans, providing training in securities enforcement for state professionals, and coordinating enforcement actions on behalf of such agencies with state attorneys general and other legal officers. Moreover, it would help state agencies by providing regular procedures to notify the SEC of the need for enforcement action, thereby helping to place the investigative powers of the SEC at their disposal, and enabling the state agencies to make use of enforcement powers reserved by current law to the SEC, such as those created by the Advisers Act<sup>310</sup> and other federal statutes such as section 17(a)(2) and (3) of the Securities Act.<sup>311</sup>

In addition to multiplying the effectiveness of SEC enforcement, this coordination strategy would also help to ensure uniformity in the creation and enforcement of antifraud regulations affecting state benefit funds, by centering them on common federal standards rather than relying on inconsistent state legislation and state court interpretations of such legislation.<sup>312</sup> More effective enforcement, based on uniform

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309. See *Office of Legislative and Intergovernmental Affairs*, U.S. SEC. EXCH. COMM'N (Mar. 6, 2007), <http://www.sec.gov/about/offices/olia.htm>.

310. See Investment Advisers Act of 1940 § 206(2), 15 U.S.C. § 80b-6 (2006) (imposing a fiduciary duty on investment advisers requiring them to disclose all material information to clients and prospective clients—including public benefit funds); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-97 (1963). The SEC has made use of the Advisers Act to obtain settlements from dealers who fail to disclose risks in complex financial instruments—including conflicts of interests on the part of dealers who had taken short positions on the instruments they were selling—to clients. See *Credit Suisse Alt. Capital, LLC*, SEC Securities Act of 1933 Release No. 9268, Investment Advisers Act of 1940 Release No. 3302, at 13-14 (ALJ Oct. 19, 2011).

311. 15 U.S.C. § 77q(a)(2)-(3). The SEC has found section 17(a)(2) and (3) to be effective weapons against misrepresentations in the issuance of securities because, unlike the more famous section 10(b) of the Exchange Act and Rule 10b-5, based on § 10(b), they allow relief without requiring the agency to prove *scienter*—willful or reckless misrepresentations or omissions. See *Aaron v. SEC*, 446 U.S. 680, 695-700 (1980).

312. State enforcement actions based on securities violations rose by 51% from 2009 to 2010 alone. See *State Enforcement of Securities Violations in 2010 Up 51 Percent over Previous Year*, 43 SEC. REG. & L. REP. (BNA) No. 43, at 2228 (Oct. 31, 2011). Lack of uniformity in the application of state law to actions based on alleged securities fraud is a

standards, will not only help benefit funds recover losses from prior investments, but should have a deterrent effect against future abuses.

*C. Rethinking Exemption from Registration for Asset-Backed Securities*

One of the basic problems created by deregulation beginning in the 1970s, which helped lead unsophisticated managers of state and local benefit funds down the primrose path to the purchase of asset-backed securities, is that securities may be privately placed with such funds—exempt from registration with the SEC,<sup>313</sup> and therefore, from the stringent disclosure and due diligence obligations imposed on participants in the issuance of securities by the Securities Act.<sup>314</sup> The exemptions have been created both by the Securities Act itself<sup>315</sup> and pursuant to SEC regulations based on the statute.<sup>316</sup>

Rule 506 is the final part of the SEC's Regulation D, the most important of several regulations exempting the sale of certain securities from the general requirement that new securities be registered with the SEC before they can be sold.<sup>317</sup> The Regulation D exemptions, based on the less specific exemptions provided by Securities Act sections 3 and 4,<sup>318</sup> have a dual purpose: to relieve small and startup businesses from the considerable burden of registering their securities under the Securities Act, and to relieve the already overtaxed SEC staff from the need to review the offering materials for securities not intended for general distribution for registration.<sup>319</sup> Like the other exemptions from registration, it was not intended to make serious inroads upon the Act's primary purpose—to insure full and fair disclosure concerning new securities to protect unsophisticated investors from the kind of securities

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problem not only in cases involving public benefit funds but also for private class actions, the primary target of the PSLRA, which have been brought in state courts in increasing numbers—a trend that has accelerated since 2005. *See Study: More M&A Class Actions Filed in State Courts than in Federal Courts*, 43 SEC. REG. & L. REP. (BNA) No. 25, at 1277 (June 20, 2011) (abstract available at <http://ssrn.com/abstract=1856695>).

313. *See supra* notes 179–80, 314–17, 322–23 and accompanying text.

314. *See* Securities Act of 1933, 15 U.S.C. § 77k (2006).

315. *See id.* § 77d(4).

316. *See* 17 C.F.R. §§ 230.501(a)(1), .506(a) (2012).

317. *See id.* § 230.506.

318. HAZEN, *supra* note 47, at 185.

319. *See infra* notes 336–40 and accompanying text; *see also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (noting that exemptions apply where there is no practical need for protection of the 1933 Act or its benefits are too remote).

fraud which was discussed in ample detail by the Congress that enacted the Securities laws in the wake of the great stock market crash of 1929.<sup>320</sup> Rather, it was designed to facilitate the sale of securities by small and start-up businesses without requiring the substantial time and expense required for registration under the Securities Act.<sup>321</sup>

Rule 506 differs from the other exemptive provisions of Regulation D (Rules 404 and 405) in that it allows the issuance of unregistered securities without regard to their aggregate offering price if all persons to whom they are sold are accredited investors, as defined in Rule 501(a).<sup>322</sup> It is here that the devil gets into the details: First, public benefit funds with assets of \$5 million or more, who are currently considered accredited investors by Regulation D,<sup>323</sup> are not necessarily more sophisticated than the general public in their ability to assess the risk of securities offered to them. Andrew Kolotay, a financial advisor with a Ph.D. in mathematics, testified at an SEC hearing that most municipal decision makers did not have sufficient skills to evaluate even comparatively simple swap transactions, and were therefore, even in the absence of fraud by their vendors, frequently overcharged by swap advisers and dealers.<sup>324</sup>

Moreover, including smaller benefit funds in the class of persons to whom securities can be offered without meeting the requirements for registration does not serve the chief purpose of the Securities Act's intent in providing exemptions of this kind. This is to allow investors in small and startup businesses—both the founders of such businesses and venture capitalists who are able to understand the risks of such investments and, unlike benefit funds, able to absorb them—the chance to invest in such businesses without incurring the substantial costs of registration.<sup>325</sup>

Regardless of the exemption employed, smaller benefit funds suffer

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320. See Securities Act of 1933, Pub. L. No. 111-229, 48 Stat. 74 (codified as amended in scattered sections of 15 U.S.C.).

321. See JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION: CASES & MATERIALS* 78–79, 332–33 (12th ed. 2012).

322. 17 C.F.R. § 230.501(a).

323. See *id.* § 230.501–506.

324. See *SEC Hearing on the State of Municipal Securities Market*, *supra* note 20, at 1–2, 7. On the other hand, large funds, such as CALPERS, have substantial expertise concerning complex securities, although even they are subject to pressures by beneficiaries and political officials to seek higher yields at the expense of safety. See, e.g., Evans, *supra* note 4.

325. See HAZEN, *supra* note 47, at 187–88, 202–07.

from several vulnerabilities in being allowed to purchase unregistered securities. First, as noted above,<sup>326</sup> their managers lack the sophistication to understand the risks of complex securities that are difficult even for experts to evaluate. Generally, the only basis they have had for judging the quality of their investments has been ratings, which have proven unsatisfactory for reasons already explained,<sup>327</sup> and whose deficiencies are not adequately addressed by Dodd-Frank and agency regulations based on it.<sup>328</sup>

The exemption from registration also means that issuers and persons involved in the issuance of complex securities are not bound by the due diligence requirements of Securities Act section 11,<sup>329</sup> nor are they subject to more than minimal disclosure requirements.<sup>330</sup> Since they are not subject to the SEC's Plain English Rules,<sup>331</sup> the disclosure of risks in any security privately placed with them pursuant to the exemptions, even in the absence of deliberate fraud, can be hidden in obfuscatory language that can be puzzling even to specialists in securities law. Moreover, of particular concern to smaller funds, unregistered securities are less liquid than registered securities, even if they are later registered or are resold pursuant to one of the SEC's exemptions permitting the resale of unregistered securities.<sup>332</sup>

There are three possible ways to remedy this situation.<sup>333</sup> The first would be to exclude benefit funds entirely from the class of investors to

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326. *See id.*

327. *See supra* notes 113–30, 138–42 and accompanying text (analyzing the unreliability of ratings).

328. *See supra* notes 251–97 and accompanying text (analyzing why Dodd-Frank and regulations based thereon are inadequate to assure that ratings will provide accurate assessments of the risks in complex financial instruments being rated).

329. *See* Securities Act, 15 U.S.C. § 77k(b) (2006).

330. *See id.* § 77k(b)(3).

331. Plain English Disclosure, 63 Fed. Reg. 6370, 6370 (Feb. 6, 1998) (to be codified at 17 C.F.R. pt. 228, 229, 230, 239, 274).

332. *See* 15 U.S.C. § 77e. Even if public funds qualify for a resale exemption such as that in 1933 Act § 4(1), which is less than clear under case law, *see, e.g., SEC v. Guild Films Co.*, 279 F.2d 485, 489–90 (2d Cir. 1960), they would still be illiquid for lack of a ready market.

333. Dodd-Frank gives backhanded recognition to the problems inherent in offering exemptions to accredited investors by repealing the 1933 Securities Act § 4(a)(5), 15 U.S.C. § 77d(5), *see* Dodd-Frank § 944(a)(1), but that exemption, which applied solely to the offering of securities with aggregate values of less than \$5 million to accredited investors, was far less significant than the exemption of securities without limitations on value established by Rule 506.

whom securities may be sold without registration under the Securities Act. This would require two changes: the definition of accredited investor in Rule 501(a)(1) would be amended by striking the language “any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000.”<sup>334</sup> To complete this exclusion, Congress would need to amend Rule 506(b)(2)(ii) to eliminate the accreditation of this category of purchaser, without regard to the value of its assets, from those purchasers to whom an offering could be made subject to the exemption.

An alternative approach would be to permit only the largest, and presumably the best-advised and most sophisticated, funds, to take advantage of the exemption, while barring its use by smaller and less sophisticated funds. This could be done, for example, by raising the lower limit for fund assets to \$100 million, a level that would support the retention of bond counsel by the funds. Doing this would further one of the original purposes of Rule 506—to reduce the number of SEC filings.<sup>335</sup> This approach, however, would be less satisfactory than the first. This is because experience has shown that even the most sophisticated funds, such as CALPERS and the Texas Teachers Fund, suffered losses from improvident investments in complex financial instruments.<sup>336</sup> This is partly due to the opacity of disclosure private placement memoranda for securities not subject to registration, and perhaps more because even the largest funds are subject to political pressures and pressures from their beneficiaries to raise yields on their investments—possibly to unreasonably high levels—in order to reduce required contributions by state agencies and beneficiaries.<sup>337</sup>

A third and simpler approach would be to design a special exemption for benefit funds, while barring the private placement of securities with them under Rule 506. Under this approach, “well-known seasoned issuers”<sup>338</sup> would be permitted to make private placements of

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334. 17 C.F.R. § 230.501(a)(1) (2012).

335. *See supra* notes 54–56 and accompanying text.

336. *See supra* notes 20–22 and accompanying text.

337. *See supra* notes 4–5, 23–24, 62–66 and accompanying text.

338. “Well-known seasoned issuers” are defined by Rule 405 under 17 C.F.R. section 230.405, as large, experienced issuers with a worldwide market for their securities, which have a history of compliance with the securities laws.

conventional debt and equity securities with larger benefit funds,<sup>339</sup> but would be required to make the same kind of Plain English disclosure of risks now required on registration statements under the Securities Act.<sup>340</sup> Plain English disclosure of risks in order of the degree of danger they pose to investors will provide significantly more information to potential purchasers than simple ratings. This approach would be a substantial improvement over reliance on ratings in aiding potential purchasers to understand the risks posed by complex financial instruments, giving them more of the security provided by purchasing registered securities, while also serving the Regulation D purposes of facilitating capital formation and relieving the SEC of the burden of having to review an augmented number of registration statements.

*D. Amplifying Disclosure: Borrowing from the FDA*

The credit-rating agencies have clearly proven themselves inadequate to give benefit funds adequate warning of unsuitable risks in the CDO market. CRARA did not even attempt a meaningful reform of the agencies' business model, in which they are paid by the issuers of the securities that they rate,<sup>341</sup> and Dodd-Frank does not adequately deal with this problem. While it would prove helpful to give the agencies a due diligence obligation in formulating their ratings that resembles that assumed by other participants in the issuance of securities,<sup>342</sup> there are three obstacles that stand in the way of making such duties effective in protecting public benefit funds against unwise investments in unconventional securities: (1) many of these securities may be sold to benefit funds without registration under the Securities Act,<sup>343</sup> a problem that would be addressed by the reform of Regulation 506 described

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339. While, as we have seen, size alone does not guarantee sophistication on the part of a benefit fund, a fund managing at least \$500 million in assets is better able to afford the risks inherent in holding unregistered securities than the present, ludicrously low limit of \$5 million in current Rule 506. Of course, state legislatures and regulators would also be free to require that state-affiliated benefit funds hold only registered securities. 17 C.F.R. § 230.501.

340. See *supra* note 58 and accompanying text.

341. See Mendales, *supra* note 67, at 1385–87; David Ellis, *Rating the Rating Agencies*, CNNMONEY (Apr. 14, 2009), [http://www.money.cnn.com/2009/04/14/news/companies/rating\\_agencies/index.htm](http://www.money.cnn.com/2009/04/14/news/companies/rating_agencies/index.htm) (critics asserted—before enactment of Dodd-Frank—that attempted reforms of the credit rating agencies had not fixed the industry).

342. See Mendales, *supra* note 67, at 1412–13.

343. See SEC, Form S-8: Registration Statement Under the Securities Act of 1933, General Instructions; see also 17 C.F.R. § 230.501–.506.

above; (2) present national politics indicate that it is not legislatively possible to amend the Securities Act so as to include credit rating agencies among the parties required to perform due diligence in the issue of new securities—a step that Dodd-Frank carefully avoids; and (3) the credit rating agencies' pockets are not deep enough to make whole public benefit funds injured by cutting corners in the rating process.

Realizing this, the SEC has, in its proposed rulemaking authority under Dodd-Frank, proposed to eliminate ratings by the agencies from the process of issuing asset-backed financial instruments wherever possible.<sup>344</sup> Not only is this required by Dodd-Frank,<sup>345</sup> but it makes sense as a matter of policy. This is true both because instruments more complex than basic RMBS may not be susceptible to meaningful rating, even in the absence of the conflicts faced by rating agencies,<sup>346</sup> and so the use of ratings, however formulated, may be inherently deceptive as to the risks inherent in a rated security. Disposing with ratings, however, leaves open the question of how benefit funds, especially smaller and less sophisticated ones, are to deal with the problem of correlating yield with risk when offered new instruments with temptingly high yields. As suggested above, a first step would be to amend Rule 506 to eliminate smaller and less sophisticated funds from eligibility for private placements, which would have the dual effect of making them eligible for relief for material misstatements and omissions in offering materials under the more relaxed standards of the Securities Act, and to give their investments the additional liquidity provided by SEC registration.<sup>347</sup> This leaves the problem of protecting larger funds, which despite their size have still been victimized by material misrepresentations and omissions in deliberately opaque offering memoranda.<sup>348</sup>

The traditional approach of requiring full and fair disclosure under the 1933 and Exchange Acts suggests a promising approach to this

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344. *See supra* notes 244–45 and accompanying text.

345. *See supra* notes 244–45 and accompanying text.

346. This is because the complexity of the mathematical models used in formulating ratings may be chaotic in nature. This would make any deviation from initial assumptions used in the rating process in the performance of the collateral and structure of a complex financial instrument lead to unpredictably large changes in the probability of eventual default. *See Arora, et al., supra* note 138, at 2.

347. *See supra* notes 333–34 and accompanying text.

348. *See supra* notes 20–22 and accompanying text.

thicket of political and practical problems. The sellers of derivative obligations to municipal entities would be required to follow the SEC's Plain English rules, governing disclosure in prospectuses issued to investors since 1998,<sup>349</sup> in describing how the securities worked and how the benefits derived by all entities concerned with their issuance. This would include clearly drafted "Risk Factor" sections that would clearly identify risks in the order of their severity.<sup>350</sup> This would make it easier for prospective buyers: (1) to identify conflicts of interest on the part of sellers of securities being offered; (2) to identify clear risks involved in the purchase of instruments being offered, while barring sellers from hiding major risks in a thicket of verbiage detailing minor risks; and as a result (3) to make more effective risk-benefit analyses connected with any purchase. Moreover, the clarity of disclosure would make it easier to state causes of action under the securities laws in the event of material misstatements or omissions of material facts, since it would make it more clear that such deceptions were made with the element of *scienter* required for stating claims under Exchange Act section 10(b) and Rule 10b-5.<sup>351</sup>

Moreover, following disclosure practices required by the Food and Drug Administration (FDA) for prescription drugs, the disclosure would be required to include risk models based on experience with similar collateral, or, in the case of complex securities, to include experience-based risk models for the instruments in the pool on which the securities were based.<sup>352</sup>

A further useful borrowing from the FDA would be to require, in disclosure dealing with high risk structures and/or collateral, or with securities on which little or no experience-based data is available, that issuers place such disclosure within bold black borders—the equivalent of "black box" disclosure on prescription drugs.<sup>353</sup> Risks of this kind would include concrete risks of sudden and complete or near-complete loss of value in a security, such as that imposed by the existence of a

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349. See generally Plain English Disclosure, 63 Fed. Reg. 6370, 6370 (Feb. 6, 1998) (to be codified at 17 C.F.R. pt. 228, 229, 230, 239, 274); see also 17 C.F.R. § 230.420–421 (plain language principles must be used to enhance the "readability" of a prospectus).

350. This would track present Regulation S-K, Item 503(c), 17 C.F.R. § 229.503(c), now required for securities registered under the 1933 Act.

351. See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

352. Prescription Drug Advertising, 21 C.F.R. § 202.1(e)(3)(iii) (2012).

353. See *id.* § 201.57(a)(4).

“trigger” enabling a holder of a senior tranche to liquidate all the collateral underlying a security on occurrence of an event such as a downgrade by a credit rating agency.<sup>354</sup> Securities would also be subject to this treatment if their complexity makes it reasonably impossible for a party other than the dealer selling them to evaluate their risks, including securities whose collateral includes tranches of other securities or derivative instruments.<sup>355</sup>

Three desirable results would flow from black box disclosures. First, it would enable state governments to enact legislation barring their benefit funds and those of their subsidiary entities from buying direct or indirect interests in “black boxed” securities—thereby protecting them from pressure by beneficiaries and politicians to seek yield beyond that compatible with a reasonable degree of safety.<sup>356</sup> Second, it would force sellers of securities with such characteristics to disclose them in an unmistakable format or face liability. Third, even in cases where state legislatures fail to act, it would focus the minds of unsophisticated benefit fund administrators on the danger of the instruments they were considering and the possibility of being personally subject to litigation based on breach of fiduciary duty.

*E. Regulations with New Teeth: Working with Dodd-Frank and Making Better Use of Earlier Statutes to Protect Benefit Funds*

The SEC, the CFTC, and other federal agencies have begun the task imposed upon them by Dodd-Frank to propose regulations to prevent

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354. See Gibson, *supra* note 138, at 17.

355. See *supra* notes 138–39 and accompanying text. The European Central Bank has gone beyond the traditional disclosure-oriented U.S. approach to securities regulation, with a new directive that it will accept asset-backed securities as collateral for its loans to banks of EU member states only if they are collateralized by single classes of assets that can be documented at the level of individual loans in their underlying asset pools. See Press Release, European Central Bank, ECB Announces Implementation of Loan-Level Data Reporting Requirements for Asset-Backed Securities (July 6, 2012), available at <http://www.ecb.europa.eu/press/pr/date/2012/html/pr120706.en.html>; *ECB to Require More Data on ABS Starting This Year*, REUTERS (July 6, 2012), <http://www.reuters.com/article/2012/07/06/ecb-assetbackedsecurities-idUSL6E8I691G20120706>.

356. This would be in line with the approach adopted by the European Central Bank, *supra* note 355 and accompanying text, except that it would go somewhat farther by simply barring state instrumentalities from investing in securities lacking readily assessable risk. Considerations of federalism require this kind of provision to be made at the state level. See *supra* note 28 and accompanying text.

new financial crises of the kind with which we are still dealing.<sup>357</sup> Proposed regulations based on Dodd-Frank have been slow in emerging from the agencies, however. Because the statute they interpret is huge,<sup>358</sup> combines an unrealistically large number of objectives,<sup>359</sup> and is riddled with compromises that rob it of directness and force, it does not provide the firm foundation for regulations provided by more straightforward statutes such as the Securities Act and the Sarbanes-Oxley Act.<sup>360</sup>

The deficiencies of the new statute and regulations based on it to date are both substantive and procedural. Substantively, the statute does require the removal of ratings from substantially all regulations promulgated by federal agencies, from the SEC to the Comptroller of the Currency.<sup>361</sup> However, it does not establish a satisfactory substitute for the rating process. Moreover, since there is no uniform substitute for the rating process established by the statute and regulations, it is inevitable that ratings will continue to be used, particularly in private placements, by buyers of securities in evaluating their quality—and here, Dodd-Frank not only leaves in place the prohibition of substantive regulation of the rating process by the SEC established by CRARA, but retains CRARA's requirement that in formulating regulations to enforce the limited rules that Dodd-Frank establishes for the rating agencies, regulatory bodies such as the SEC are to construe the limits on

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357. Rules of Registration of Municipal Advisers, Dodd-Frank Act Release No. 34-63576, 76 Fed. Reg. 824, 824 (proposed Jan. 6, 2011) (to be codified at 17 C.F.R. pts. 240 & 249).

358. See Levitt, *supra* note 33.

359. Dodd-Frank also deals with other complex issues such as the coordination of the federal agencies jointly charged with its administration, *see* Dodd-Frank Act, 12 U.S.C. § 712 (Supp. IV 2011), the regulation of previously unregulated financial entities such as hedge funds, *see id.* § 619, problems associated with preventing financial institutions from becoming “too big to fail,” *see* Dodd-Frank Act, Pub. L. 111-203, pmb1, 124 Stat. 1376 (2010), the receivership of large financial institutions, *see* 12 U.S.C. § 5382, the public clearing of heretofore unregulated financial instruments such as swaps, *see* 15 U.S.C. §§ 8301–25 (encapsalating Tittle VII Subtitle A—Regulation of Over-the-Counter Swaps Markets—of the Dodd-Frank Act), and the protection of consumers from abuses by financial institutions. *See* pmb1., 124 Stat. at 1376.

360. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 7201 (2006)) (officially known as The Public Company Accounting Reform and Investor Protection Act).

361. *See* Dodd-Frank Act, 12 U.S.C. § 1817 (Supp. IV 2011).

the rating agencies narrowly.<sup>362</sup>

Procedurally, Dodd-Frank and the regulations based on it are far less helpful than they appear at first sight for vindicating the rights of benefit funds sold paper of dubious quality because Dodd-Frank looks chiefly toward agency enforcement, and in fact raises a bar against private actions based on misleading ratings even higher than that set by the PSLRA for more traditional actions for securities fraud.<sup>363</sup> As we have seen, even with the combined forces of federal regulatory agencies, staffing has not been sufficient to prevent abuses under prior law. In view of this, and since Congress has blocked the funding provisions built into Dodd-Frank to expand agency staffing,<sup>364</sup> it is unreasonable to expect the agencies to be fully effective in enforcing the vastly more complex regulatory structure that Dodd-Frank, as implemented by regulations still being drafted, will create. This Article therefore proposes a strategy to deploy existing resources in a way that will more fully take advantage not only of the vast, nebulous, and untried regulatory structure created by Dodd-Frank, but of older, more clearly drafted statutes such as Securities Act securities 17(a)(2) and (3),<sup>365</sup> and the Advisers Act,<sup>366</sup> which heretofore have been enforced exclusively by the SEC.<sup>367</sup>

The key to more efficient deployment of existing resources will be to pool and make the best allocation of scarce federal and state securities regulatory capability by establishing, pursuant to regulations to be promulgated by the SEC, a framework under which states, whose

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

363. See *supra* notes 283–85 and accompanying text.

364. See *supra* notes 38–41 and accompanying text.

365. See 15 U.S.C. § 77q(a)(2)–(3); *supra* note 311 and accompanying text. These provisions authorize the SEC to order the disgorgement of funds obtained by misrepresentation or omission of material facts, without the need to prove *scierter* as under Rule 10b-5. See Complaint at 3, SEC v. J.P. Morgan Sec., Inc., 11-Civ.-4206 (S.D.N.Y. 2011); SEC Litigation Release No. 22008, June 21, 2011 (noting that J.P. Morgan agreed to pay \$153.6 million to settle charges that it failed to disclose to investors, including a not-for-profit beneficial organization, that securities pooled in a CDO sold to the investors were in part selected by a hedge fund that held a short position in those securities).

366. See Complaint at 7, SEC v. Steffelin (S.D.N.Y. filed June 21, 2011) (No. 11-Civ.-4204) (noting that employees of investment advisory firm that marketed CDO to investors and failed to disclose that securities underlying CDO that it marketed were subject to a short position held by a large hedge fund charged with violations of Advisers Act, with relief sought including disgorgement of profits, injunctive relief, and civil penalties).

367. See 15 USC § 78a.

subdivisions and agencies are the primary sponsors of the benefit funds discussed by this Article, can work directly with federal agencies (including not only the SEC but also the CFTC, the FDIC, and the Comptroller of the Currency) in enforcing laws and regulations that heretofore have been the exclusive preserve of the federal agencies. The SEC, which has the greatest experience in bringing enforcement actions among the federal agencies involved in this sphere, should take the lead by creating within itself an Office of State Coordination. This office would serve as a regular channel for state instrumentalities to the SEC to request help by its Enforcement Division in obtaining relief for violations of the federal securities laws. It would also provide for standardization of SEC training for state professionals in bringing their own securities law enforcement actions (now being done on an *ad hoc* basis), and would locate and assign SEC personnel to lead teams of state professionals in bringing enforcement actions under statutes such as the Advisers Act, which may now be enforced only by the SEC.<sup>368</sup>

#### *F. Indirect Consequences of Effective Regulation*

Effective regulatory reform will have healthy consequences going beyond its direct purposes. It will, as with Dodd-Frank's provisions dealing with "too big to fail" financial institutions,<sup>369</sup> help to stabilize the nation's overall financial system. For the benefit funds who are its primary beneficiaries, it will not only reduce the level of risk to beneficiaries, but, by making risk easier to estimate, it will encourage measures to establish fund contributions at realistic levels.

Legally, it should reduce the penumbra of unnecessary deterrence of meritorious actions by benefit funds under the federal securities laws by the PSLRA, and encourage bringing them in federal court.<sup>370</sup> This is desirable not only because the federal courts are generally more experienced in dealing with securities law cases than the state courts, but it will produce greater national uniformity in dealing with securities law issues,<sup>371</sup> and in turn make it easier for transactional lawyers in and out of the U.S. to effectively advise their clients on minimizing the risk of

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368. See *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979) (Investment Advisers Act § 206, 15 U.S.C. § 80b-6, creates no private cause of action).

369. See Dodd-Frank Act, 12 U.S.C. §§ 5311–5323 (Supp. IV 2011).

370. See *supra* note 44 and accompanying text.

371. See *supra* notes 308–12 and accompanying text.

litigation resulting from securities transactions.

It will also have broader effects on world financial markets. By providing more effective deterrence against deceptive promises of safety combined with unrealistically high yield, it will reduce the volume of exotic securities with dubious value, and thereby help to stabilize financial markets generally. Moreover, by reducing the availability of exemptions from registration to securities and purchasers to those actually intended by the drafters of the Securities Act, and compelling more extensive and clearer disclosure even for securities exempt from registration, it will increase the transparency of the securities markets for financial institutions both in the U.S. and overseas. This transparency will help both to prevent new freeze-ups of world credit markets such as occurred in 2008, and encourage investment in productive activity as opposed to mere trading.

## VI. CONCLUSION

The potential losses faced by government-sponsored benefit funds from improvident investments in unconventional securities is a major matter of concern not only for the funds' beneficiaries, but for the credit of the states they serve, and ultimately the U.S. economy as a whole. This Article has focused on threading through the present politics of deadlock to (1) aiding recovery of losses by benefit funds on pre-crisis investments made based on misrepresentations by the peddlers of unconventional securities; (2) multiplying the effectiveness of relatively understaffed regulators by facilitating federal-state collaboration both on recoveries from past fraud and prevention of future fraud; and (3) doing so by regulations that avoid reliance on the dysfunctional political process that now obstructs meaningful legislation.

The most effective mechanism for recovering losses on pre-crisis benefit fund investments, particularly in view of the Supreme Court's increasingly restrictive views of private rights of action under the federal securities laws,<sup>372</sup> will be to make the best use of scarce SEC resources by coordinating SEC enforcement efforts with state agencies under

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372. In *Janus Capital Grp. v. First Derivative Traders*, the majority implied that it continued to accept implied rights of action by non-agency persons under the securities laws based only on its reluctance to entirely demolish the precedents establishing such rights, and that it would therefore construe such rights as narrowly as possible. See 131 S. Ct. 2296, 2302 (2011); *supra* note 195 and accompanying text.

provisions of the federal securities laws that would not be available to the states acting without SEC authority. The establishment of an Office of State Coordination within the SEC will help to train state and municipal lawyers in making effective use of the securities laws against abuses already committed, help the SEC pick targets worthy of its direct attention, draw the SEC's attention to abuses best addressed by statutes enforceable only by SEC action, such as the Investment Advisers Act, and thereby not only redress past securities violations but enhance general deterrence against such conduct in the future.

Going forward, the protection of benefit funds from improvident investment will require the amendment of SEC rules. First, smaller and less sophisticated funds should be taken out of the accredited investor category that has enabled them to buy unregistered securities.<sup>373</sup> This will benefit them in at least three ways: (1) it will improve disclosure to them of the risks of their investments; (2) it will provide them with greater liquidity for their investments; and (3) in the event that disclosure documents concerning their investments include materially misleading statements and omissions, particularly concerning risk, it will enable them to obtain redress through the less stringent standards of Securities Act section 11,<sup>374</sup> rather than forcing them through the higher hurdles required for actions based on Exchange Act section 10(b) and Rule 10b-5.

Secondly, the SEC should make its Plain English rules mandatory for all securities-related disclosure, including disclosure in private placement memoranda. These rules will require risks to be stated

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373. As noted above, *supra* notes 209–12, 238–43 and accompanying text, Dodd-Frank section 943 and new SEC rules and forms based thereon purport to apply to unregistered as well as registered asset-backed securities for the first time—but their coverage is limited to requiring securitizers who have assumed contractual duties to replace or repurchase defective assets in pools collateralizing securities to report when they have done so, a requirement that even the SEC does not expect to have very much impact. See Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Dodd-Frank Act Release Nos. 33-9175 & 34-63741, 76 Fed. Reg. 4489, 4489–51 (effective Mar. 28, 2011) (to be codified at 17 C.F.R. pt. 229, 232, 240 & 249).

374. Securities Act, 15 U.S.C. § 77k(a) to (b) (2006). Section 11(a) and (b) impose liability on issuers, underwriters, and other persons participating in the issuance of securities for inaccuracies in registration statement, and, by requiring them to establish their due diligence as a defense, requires plaintiffs to merely prove negligence to recover, rather than the higher burden of proving *scienter* (knowing or reckless misrepresentation) required to establish liability in private actions under Exchange Act § 10(b) and Rule 10b-5. *Supra* notes 308, 329 and accompanying text.

plainly and in order of their importance by issuers and underwriters, who are better situated to be aware of them than even sophisticated investors receiving disclosure documents,<sup>375</sup> and will, by forcing issuers to focus on risks, reduce their ability to engage in fraudulent practices such as “lulling” investors by concealing risks in a mass of optimistic-sounding verbiage.<sup>376</sup> There is no utility in permitting issuers to conceal risks known to them in thickets of obscure language, and even in the real paradigm for allowing the placement of unregistered securities—enabling investors to buy into new businesses not yet ready to go public—clear disclosure of risk should promote rather than discourage investment.<sup>377</sup>

For public benefit funds, the Plain English rules will, by forcing issuers to clearly describe inherent risks in order of severity, furnish a more realistic way to judge investment quality than ratings. The rules will help deter deception by making it more difficult to hide material misstatements and omissions behind obfuscatory language,<sup>378</sup> and easier for plaintiffs to prove that material deceptions and omissions were made with the *scienter* required for buyers to bring successful actions under the federal securities laws. They will also make it easier for fiduciaries running large funds that remain accredited to resist political pressures and pressures from beneficiaries to put higher paying but risky privately placed securities in their portfolios. This would be further amplified by requiring issuers to “black box” major risks, which would enable state legislatures to simply bar state instrumentalities from investing in instruments carrying such “black box” warnings.

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375. See generally Arora et al., *supra* note 138.

376. “Lulling” consists of communications to investors to lead them to believe that their investments are secure, contrary to the knowledge of the communicators, and thus constitutes an intentional violation of the federal securities laws that can give rise to criminal as well as civil liability. See *U.S. v. Love*, 535 F.2d 1152, 1159 (9th Cir. 1976).

377. See Michael Schroeder, *Caveat Entrepreneur: The Latest Stock Scams Prey on New, Nonpublic Outfits*, BUSINESSWEEK, Oct. 14, 1996, at 114–15 (noting that inadequate disclosure in privately placed securities puts investors at special risk of securities fraud); Whalen, *supra* note 19, at 8–10 (information asymmetry gives dealers in OTC securities a substantial advantage over buyers and rating agencies).

378. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195–96 (1976); Exchange Act § 10(b); 17 C.F.R. § 204.105-b (2011).