January, 2014

Synthetic CDOs, Conflicts of Interest, and Securities Fraud

Jennifer O'Hare

SYNTHETIC CDOS, CONFLICTS OF INTEREST, AND SECURITIES FRAUD

Jennifer O'Hare *

I. INTRODUCTION

Following the financial crisis, the synthetic collateralized debt obligation ("CDO")—a complex derivative that received little mainstream attention prior to the housing meltdown—became big news.[1] Journalists wrote numerous articles explaining how synthetic CDOs spread the contagion of toxic assets throughout the financial system, nearly bringing down the global economy.[2] Government hearings exposed the ugly conflicts of interest inherent in the structuring of synthetic CDOs, as big investment banks created, sold, and invested in synthetic CDOs and often bet against their clients.[3] Some of the world's largest financial institutions, who faced bankruptcy when their investments lost value, bitterly complained that these synthetic CDOs had been "designed to fail" so that the investment banks could profit at their expense.[4] Greedy investment banks were seen as the problem,

* Professor of Law, Villanova University School of Law. J.D., 1990, The George Washington Law School; B.S.E., 1986, The Wharton School of the University of Pennsylvania. The author gratefully acknowledges that research for this article was supported by a summer stipend from the Villanova University School of Law. The author is also thankful for the exceptional research assistance of Christopher Chuff.

1. *See, e.g.*, Bloomberg News, *JPMorgan in Talks to Settle S.E.C. Inquiry Into Securities*, N.Y. TIMES, May 7, 2011, at B2; Gretchen Morgenson & Louise Story, *Banks Bundled Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1.

2. *See, e.g.*, Kenneth E. Scott & John B. Taylor, *Why Toxic Assets Are So Hard to Clean Up*, WALL ST. J., Jul. 20, 2009, at A13; Robin Sidel, *Toxic CEOs Beset FDIC As Banks Fail*, WALL ST. J., May 18, 2010, at C1; Aline van Duyn & Nicole Bullock, *Lehman Ruling Creates New Doubts for CDOs*, FIN. TIMES (Feb. 8, 2010, 7:27 PM), http://www.ft.com/cms/s/0/feff1b24-14e5-11df-8f1d-00144feab49a.html#axzz2kio3EnlZ.

3. See STAFF OF S. COMM. ON HOMELAND SEC. AND GOV. AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 7, 12, 398 (2011) [hereinafter SENATE STAFF REPORT], *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112shrg57323/pdf/CHRG-112shrg57323.pdf.

4. NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S., FIN.

not the synthetic CDOs themselves.

As a result, the Securities and Exchange Commission ("SEC") sued several of the highest profile investment banks for fraud, and some investors in synthetic CDOs brought their own private actions for fraud against the investment banks.[5] Calls for increased regulation of synthetic CDOs resulted in legislation prohibiting investment banks from engaging in certain conflicts of interest in the sale of synthetic CDOs.[6]

This article shows that focusing primarily on the misconduct by investment banks or on the corresponding harm suffered by investors has caused regulators to miss the real issue: the sale of the synthetic CDO. Outrage over the extraordinary greed and sometimes outrageous misconduct by investment banks in the sale of synthetic CDOs is understandable. However, it was not the bad behavior of the investment banks that furthered the financial crisis; it was the use of the synthetic CDO itself. Because the regulators focused on the wrong problem, the dangers caused by synthetic CDOs still exist and must be addressed through additional regulation.

Part II of this article defines the synthetic CDO and explains how it is structured and sold. The article also explains how the synthetic CDO operates to spread risks throughout the financial system. Part III of this article describes the role of the synthetic CDO in the financial crisis and summarizes two of the more notorious synthetic CDOs that were created and sold shortly before the subprime-mortgage meltdown.

Part IV discusses the antifraud actions that have been brought against investment banks for the sale of synthetic CDOs. An examination of the cases shows that private plaintiffs, overall, have been unsuccessful in their efforts to recover. In addition, the article summarizes the enforcement actions brought by the SEC that have been criticized for both over and under reaching in these

CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 40 (2011) [hereinafter FCIC Report], *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

5. *Id*. at 226, 237, 265.

6. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, § 621 (codified at 15 U.S.C. § 77z-2a (2012)); Barack H. Obama, President of the United States, Remarks by the President on 21st Century Financial Regulatory Reform (Jun. 17, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/.

cases. Part V summarizes the conflict of interest rules that have been proposed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Part VI argues additional regulation of synthetic CDOs is necessary. First, the article demonstrates that relying on antifraud provisions to manage synthetic CDOs will not be sufficient. Although the conventional wisdom is that the investment banks that sold the synthetic CDOs defrauded investors, the article shows that, in general, this was not the case. It will often be difficult for large, sophisticated, and well-counseled institutional investors to establish that they reasonably relied on any false or misleading statements made by an investment bank in the heavily negotiated sale of a synthetic CDO. Although investment banks may have engaged in misconduct, in most cases, the misconduct did not constitute fraud. Moreover, the article shows that the antifraud provisions will not adequately regulate synthetic CDOs because even fraud-free synthetic CDOs present dangerous risks to the financial system. The article also questions the deterrence value of SEC enforcement actions brought against investment banks. Next, the article shows that because Congress was primarily concerned with investment bank misconduct, it enacted conflicts of interest legislation that does not adequately address the true danger of synthetic CDOs. The article concludes by urging regulators to give serious consideration to banning the sale of all synthetic CDOs.

II. BACKGROUND

A. *Introduction to Synthetic CDOs*

A synthetic CDO is a type of derivative security created by matching investors who believe a group of securities will increase in value with investors who believe that the same group of securities will default.[7] It is referred to as a "synthetic" security because the investors do not actually own the securities referenced by the synthetic CDO.[8] Instead, investors will receive cash flows replicating the cash flows that they would have received had they

7. *See* FCIC REPORT, *supra* note 4, at 142.
8. *See id.*

actually owned the referenced securities.[9] Synthetic CDOs, then, are often described as securities permitting investors to make side-bets on the performance of the underlying securities.

As discussed later in this article, creating a synthetic CDO is a complicated process.[10] Understanding a synthetic CDO requires an understanding of the financial instruments that make up the synthetic CDO. Moreover, there is a tendency to refer to these instruments by abbreviations. To understand a synthetic CDO, one must become familiar with abbreviations such as "CDS," "RMBS," and "CDO," which have become part of the global vocabulary of the financial crisis. What follows is a greatly simplified explanation of these financial instruments.

1. Credit Default Swap ("CDS")

A credit default swap, or "CDS," is essentially insurance that protects an investor against the default of a corporate note or bond.[11] For example, assume that an investor purchases a note for $10 million. This investor might like to be able to protect himself from loss—that is, hedge his risk—should the corporation default on the note. To protect himself, the investor could find some sort of entity—typically a hedge fund, insurance company, or investment bank—that would be willing to assume the risk of default in return for a series of payments made by the investor.[12] The investor, referred to as the "protection buyer,"[13] and the entity, referred to as the "protection seller,"[14] then enter into a contract in which the protection buyer agrees to make a series of periodic premium payments for the term of the note to the protection seller.[15] If the note defaults, the protection seller is required to pay the protection buyer the par value of the note.[16]

Although CDSs can be used to hedge an investor's risk, they

9. *See id.*
10. *See infra* Part II.A.4.
11. *See generally* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1023–27 (2007) (explaining the benefit of credit default swaps). For a more detailed discussion of credit default swaps, see FRANK J. FABOZZI ET AL., INTRODUCTION TO STRUCTURED FINANCE 48–54 (2006).
12. *See* FCIC REPORT, *supra* note 4, at 50.
13. *See* FABOZZI, ET AL., *supra* note 11, at 48.
14. *See id.*
15. *See id.*
16. *Id.* at 49.

can also be used to speculate on corporate debt by investors who do not actually own the specific corporate debt.[17] For example, assume that an investor believes that X Corporation will default on its notes. This investor can buy a CDS on X Corporation's notes, without actually owning any of the notes. This is referred to as a "naked CDS."[18] If X Corporation defaults, the investor will receive the par value of the notes. The naked CDS permits the investor to take a short position on notes without having to expend the funds to buy the notes.

2. Residential Mortgage Backed Securities ("RMBSs")

Residential mortgage backed securities, or "RMBSs", are bonds representing a claim on the cash flows created by a portfolio of residential mortgages.[19] When a homeowner borrows money and obtains a mortgage from a bank to purchase a home, the bank immediately sells the mortgage.[20] The purchaser of the mortgage, often referred to as a special purpose entity ("SPE") or special purpose vehicle ("SPV"), pools thousands of mortgages and then issues securities in the form of bonds to investors.[21] This process is referred to as "securitization."[22] Principal and interest payments made by the homeowners to the SPV are then used to pay the principal and interest due on the RMBS bonds.[23]

Investment banks are the driving force behind RMBSs.[24] They

17. *See* FCIC REPORT, *supra* note 4, at 50 (noting that a CDS purchaser can speculate on the default of a loan that they do not own); *see also* SENATE STAFF REPORT, *supra* note 3, at 326 (stating that some investors purchase CDS contracts as a way to profit from securities that are predicted to "lose value or fail").

18. *See* FCIC REPORT, *supra* note 4, at 50.

19. *See generally* SENATE STAFF REPORT, *supra* note 3, at 18, 28 (explaining the general definition of RMBSs, how they are created, and how they function).

20. *See, e.g.*, Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securitization*, 59 WASH. & LEE L. REV. 127, 139–40 (2002); *see also* SENATE STAFF REPORT, *supra* note 3, at 20, 24–25, 41–42, 239 (generally referencing this practice of immediate resale on the secondary market for profit and specifically referencing Fannie Mae and Freddie Mac's practice, which encouraged poor quality, high risk home loans that contaminated the secondary market and introduced a great deal of risk to the U.S. financial system).

21. Steven L. Schwarcz, *The Future of Securitization*, 412 CONN. L. REV. 1313, 1316 (2009); *see also* Nash, *supra* note 20, at 140 (referring to these purchasers of SPVs as "promoters" or "conduits").

22. SENATE STAFF REPORT, *supra* note 3, at 18.

23. *See* FCIC REPORT, *supra* note 4, at 42, 73 (noting that investors receive investment returns funded by the principal and interest payments from the loans).

24. *See* SENATE STAFF REPORT, *supra* note 3, at 8, 11.

create the SPV, they identify the mortgages that will be purchased by the SPV, and they locate purchasers for the RMBSs.[25] They structure the terms of the RMBSs, including the risk and return of each bond.[26] Specifically, RMBS bonds are sold in a series of classes or "tranches" that represent different risks and promise different fixed returns.[27] The safest tranches are the senior tranches because they are entitled to be paid first, before the other tranches are paid.[28] Then the mezzanine tranches are entitled to be paid.[29] Finally, if there is any cash left over, the "equity" tranche will be paid.[30] Many commentators use a waterfall analogy to explain how the cash flows are distributed in a RMBS.[31]

The securitization process allows investment banks to create bonds with different risks and returns.[32] Credit rating agencies are retained to assign ratings to the different tranches.[33] Senior tranches of RMBSs typically receive ratings of AAA or AA, while mezzanine tranches receive lower ratings of AA or B.[34] Obviously, because the senior tranches are paid first, they have the lowest risk and the lowest yield.[35] Investors seeking safe investments, such as pension funds, would be the likely purchasers of the AAA-rated senior tranches.[36] Investors looking for higher returns, such as hedge funds, would be more likely to purchase the riskier B-rated mezzanine tranches.[37] The equity tranche, which has the highest return, might be difficult to sell because of the level of risk.[38] If investment banks are not able to sell equity tranches,

25. *See id*. at 8, 118–19.

26. *See id*. at 8, 250–51.

27. *Id*. at 28.

28. *Id*. at 28, 250–51.

29. *Id*. at 28.

30. *Id*.

31. *E.g.*, FCIC REPORT, *supra* note 4, at 43 ("Bankers often compared it to a waterfall; the holders of the senior tranches—at the top of the waterfall—were paid before the more junior tranches. And if payments came in below expectations, those at the bottom would be the first to be left high and dry.").

32. *See id*.

33. *See* SENATE STAFF REPORT, *supra* note 3, at 251, 253, 254.

34. FCIC REPORT, *supra* note 4, at 73 fig. 5.3.

35. *Id*.; SENATE STAFF REPORT, *supra* note 3, at 28.

36. *See* SENATE STAFF REPORT, *supra* note 3, at 26–28.

37. *See id.* at 17, 325 (stating that hedge funds often make risky investments for higher returns and describing mezzanine tranches as B-rated and more susceptible to loss).

38. *Id*. at 28.

they are retained by the investment banks.[39]

The RMBS was an important innovation.[40] It allowed commercial banks to shift the risk that homeowners would default on their mortgages, and freed up capital to permit banks to lend more money, thereby encouraging home ownership.[41] It also created the opportunity for investors to choose the most appropriate investment for their needs. Investors seeking a "safe" investment would buy the AAA-rated tranche, while investors seeking an investment with a higher return would buy a lower-rated tranche.[42] Unfortunately, what started out as a beneficial financial innovation eventually morphed into a well-documented financial disaster.

3. Collateralized Debt Obligation ("CDO")

A CDO is similar to an RMBS.[43] Like the RMBS, the payments received by CDO holders are from the principal and interest payments on the portfolio.[44] Like the RMBS, the CDO bonds are issued in a series of tranches.[45] Like the RMBS, the tranches of the CDO are rated by credit rating agencies.[46] The main difference is that, rather than purchasing mortgages, the SPV of a CDO purchases other types of bonds, including RMBS bonds.[47] In a sense, the CDO re-securitizes RMBSs.

CDOs were initially seen as a positive development because they were thought to diversify the risk of RMBSs.[48] However, in

---

39. Alternatively, the investment banks could bundle these risky RMBSs into CDOs that could then be sold as safe investments to investors. *See infra* Part III.A.3.

40. *See* FCIC REPORT, *supra* note 4, at 43 (describing the benefits of securitization to commercial banks).

41. *See id.*; SENATE STAFF REPORT, *supra* note 3, at 17, 28.

42. SENATE STAFF REPORT, *supra* note 3, at 28.

43. *See* Partnoy & Skeel, *supra* note 11, at 1027–31. For a more detailed discussion of CDOs, see FABOZZI ET AL., *supra* note 11, at 119–31.

44. *See* SENATE STAFF REPORT, *supra* note 3, at 28–29; Partnoy & Skeel, *supra* note 11, at 1027 (stating that CDOs are "backed by . . . fixed income assets").

45. SENATE STAFF REPORT, *supra* note 3, at 29.

46. *Id.*

47. *See* MARK ZANDI, FINANCIAL SHOCK: A 360° LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS 117 (2009) (describing a CDO as "essentially just a mutual fund for bonds and loans.").

48. *See* FCIC REPORT, *supra* note 4, at 128 ("The securities firms argued—and the rating agencies agreed—that if they pooled many BBB-rated mortgage-backed securities, they would create additional diversification benefits.").

the years running up to the financial crisis, CDOs served other interests as well. In particular, CDOs became a vehicle for investment banks to off-load risky tranches of RMBSs that they could not sell.[49] The investment bank could re-package and sell these lower-rated RMBSs in CDO tranches with investment grade credit ratings.[50] For example, a CDO might be created from numerous BBB-rated RMBSs. However, because of the "waterfall" analogy previously discussed most of the CDO's tranches would be given a rating of AAA by a credit rating agency, making them easier to sell to investors.[51] Moreover, the higher yields on these CDOs made them very attractive to investors.[52]

4. Synthetic Collateralized Debt Obligation

A synthetic CDO is a CDO with a portfolio consisting entirely of credit default swaps.[53] Unlike the so-called cash CDO just described, a synthetic CDO does not own any bonds.[54] Instead, the synthetic CDO is structured so that it mimics the cash flow of a CDO that *does* own bonds.[55] How is this accomplished?

A synthetic CDO is created by bringing together investors who believe that a specific group of RMBSs--called the reference portfolio--will increase in value ("long" investors) and investors who believe that the reference portfolio will default ("short" investors).[56] While long investors can initiate synthetic CDOs, during the financial crisis, investors wanting to take a short position also initiated the creation of synthetic CDOs.[57] For example, assume that a hedge fund believes that certain RMBSs will default and wants to buy $2 billion worth of protection on these RMBSs. The hedge fund might approach an investment bank to create a synthetic CDO. The investment bank will then seek out long inves-

49. *See id*. at 127–29 ("[T]he CDO became the engine that powered the mortgage supply chain.").

50. *Id*. at 127.

51. *See* SENATE STAFF REPORT, *supra* note 3, at 28–29.

52. *See id*. at 30 ("Higher rates of return, combined with AAA ratings, made subprime RMBSs and related CDOs especially attractive investments.").

53. *See id*. at 29. For a good illustration of a synthetic CDO, see FCIC REPORT, *supra* note 4, at 144 fig. 8.2. For a more detailed discussion of synthetic CDOs, see FABOZZI ET AL., *supra* note 11, at 133–54.

54. SENATE STAFF REPORT, *supra* note 3, at 29; FCIC REPORT, *supra* note 4, at 142.

55. SENATE STAFF REPORT, *supra* note 3, at 29.

56. FCIC REPORT, *supra* note 4, at 142.

57. *See id*. at 145.

tors who believe the reference portfolio will not default.

The selection of the reference portfolio is a key part of the creation of the synthetic CDO. Some synthetic CDOs employ a "collateral manager" or "portfolio selection agent," who is typically described to investors as an independent market professional with the skills necessary to choose a reference portfolio appropriate for long investors.[58]

After the long investors are identified, an SPV will be created and will issue notes in tranches rated by a credit rating agency. The SPV will place the proceeds from the sale of notes in safe investments. The SPV will then sell $2 billion worth of protection to the hedge fund by entering into CDSs on the reference portfolio with the hedge fund. The hedge fund will pay quarterly premiums to the SPV, which will be used by the SPV to pay the principal and interest payments to the note holders.

The sale of notes relating to the synthetic CDOs is structured to avoid registration under the Securities Act of 1933.[59] In general, investment banks have sold synthetic CDOs in reliance on Rule 144A, which requires, among other things, that the purchasers of notes must be "qualified institutional buyers."[60] This requirement ensures that the long investors of a synthetic CDO are large, presumably sophisticated market professionals, such as banks, insurance companies, hedge funds, and pension plans.

In addition to the note holders, there is another player necessary to complete the long side of the synthetic CDO. Synthetic CDOs are not fully funded. In other words, although $2 billion of protection might be purchased by the hedge fund in a synthetic CDO, the SPV does not sell $2 billion of notes to long investors. For example, in a $2 billion synthetic CDO, the SPV might only

58. For example, in the Goldman Sachs ABACUS synthetic CDO, twenty-seven pages of the sixty-five page "flipbook" were devoted to a discussion of the attributes of its portfolio selection agent, ACA Management LLC. *See infra* Part III.B.2.

59. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012); Ed O'Connell et al., *An Overview of CDO Transactions*, 41 REV. SEC. & COMMODITIES REG. 73, 76 (2008).

60. *See* 17 C.F.R. § 230.144A(d)(1) (2013). The term "qualified institutional buyer" includes, inter alia, (1) any insurance company, investment company, pension plan, corporation, or investment adviser, so long as they "own[] and invest[] on a discretionary basis at least $100 million in securities"; (2) any dealer who "owns and invests on a discretionary basis at least $10 million of securities"; and (3) any bank that "owns and invests on a discretionary basis at least $100 million in securities . . . and that has an audited net worth of at least $25 million." *Id.* § 230.144A(a)(1).

sell \$200 million of notes, which would appear to leave the SPV exposed to substantial risk if there should be a credit event. However, the risk of the unfunded portion of the synthetic CDO, called the "super senior" tranche, is transferred by the SPV via a credit default swap to another financial entity, often an insurance company.[61] In return for a series of payments, the insurance company would agree to pay the SPV the amount of any default in excess of \$200 million (the funded amount). Because the funded tranches are subordinate to the super senior tranche, the super senior tranche is considered to be extremely low risk.[62] Therefore, the premiums paid by the SPV to the insurance company are correspondingly lower than the interest that must be paid to the synthetic CDO note holders.

If there are no defaults in the reference portfolio, the hedge fund will receive nothing and will in fact have made a losing bet; the hedge fund will be out of pocket for the premium payments. On the other hand, if there is a default, the SPV is obligated to pay the hedge fund as much as \$2 billion. If a credit event were to require the SPV to pay \$2 billion to the hedge fund, the long investors would certainly lose their \$200 million investment in the synthetic CDO. In addition, the insurance company that sold the protection on the super senior tranche would have to pay up to \$1.8 billion. The hedge fund would have won its \$2 billion bet that that the reference portfolio would default.

B. *Why Do Synthetic CDOs Exist?*

Initially, synthetic CDOs were created to help banks reduce their regulatory capital costs.[63] Under U.S. and international banking regulations, banks are required to comply with certain capital rules. The synthetic CDO allowed banks to transfer the risk of certain assets on their books without actually having to transfer the assets to an SPV, thereby reducing the amount of capital they were required to hold by banking regulations.[64] This could be accomplished if the bank's assets comprised the reference portfolio, and the bank was the protection buyer in the CDS.

61. *See* FABOZZI, ET AL., *supra* note 11, at 136.
62. *See id*. at 134–35.
63. *See* Laurie S. Goodman, *Synthetic CDOs: An Introduction*, 9 J. DERIVATIVES 60, 62–63 (2002) (describing the history of synthetic CDOs).
64. *See id*. at 60, 62–63, 65.

This kind of synthetic CDO is called a "balance sheet" synthetic CDO.[65] Thus, regulatory arbitrage was the motivation behind the creation of synthetic CDOs.

After banks started to use synthetic CDOs to reduce their regulatory capital costs, other types of entities recognized that synthetic CDOs could be used to hedge and manage risks.[66] And, then finally, synthetic CDOs morphed into a means to speculate. Thus, more recently, the primary use of synthetic CDOs has been to allow side bets on the performance of the securities in the reference portfolio. Short investors would be gambling that the reference portfolio would default, while long investors would be gambling that the reference portfolio would not default.[67]

C. *Criticisms of Synthetic CDOs*

The housing crash and financial crisis revealed a particular danger of the synthetic CDO: synthetic CDOs amplify and spread risk in a unique and dangerous way.[68] To understand the unique danger, it is helpful to compare a non-synthetic ("cash") CDO with a synthetic CDO. To create a cash CDO, the SPV must purchase RMBSs to securitize.[69] Once purchased for use in the cash CDO, these RMBSs cannot be included in any other cash CDO.[70] Thus, if the RMBSs default, the loss will be limited to the investors in that one particular cash CDO. In effect, the contagion is stopped at that point.

---

65. *See* FABOZZI ET AL., *supra* note 11, at 124.

66. *See* FCIC REPORT, *supra* note 4, at 191–92.

67. *See id.* at 145. In addition, traditionally, purchasers of notes in synthetic CDO transactions have enjoyed higher yields. *See* Partnoy & Skeel, *supra* note 11, at 1028–29 ("Synthetic CDOs are regarded as 'pure' arbitrage opportunities, because their tranches typically are priced at higher yields relative to other similarly rated fixed income investments").

68. *See* FCIC REPORT, *supra* note 4, at 155 ("By layering on correlated risk, [synthetic CDOs] spread and amplified exposure to losses when the housing market collapsed."); SENATE STAFF REPORT, *supra* note 3, at 328 ("Synthetic CDOs magnified the risk in the mortgage market because arrangers had no limit on the number of synthetic CDOs they could create."); *see also* Morgenson & Story, *supra* note 1, at A1 ("The creation and sale of synthetic C.D.O.'s [sic] helped make the financial crisis worse than it might otherwise have been, effectively multiplying losses by providing more securities to bet against."); Joe Nocera, *A Wall Street Invention Let the Crisis Mutate*, N.Y. TIMES, Apr. 16, 2010, at B1 ("[S]ynthetic C.D.O.'s [sic] made the crisis worse than it would otherwise have been.").

69. *See supra* Part II.A.3.

70. *See* SENATE STAFF REPORT, *supra* note 3, at 28–29 (stating that, while cash CDOs contain real RMBSs, synthetic CDOs only reference existing assets and do not contain actual mortgages).

However, in synthetic CDOs, RMBSs are not purchased by an SPV; they are simply named as part of the reference portfolio.[71] That means that more than one synthetic CDO can reference the same RMBS, which spreads the risk throughout the financial system.[72] For example, if a $15 million tranche of an RMBS were to be included in the reference portfolio of three different synthetic CDOs, the losses attributable to that RMBS would increase from $15 million to $60 million. As the author Michael Lewis noted in his book *The Big Short*, "[t]he market for 'synthetics' removed any constraint on the size of risk associated with subprime mortgage lending."[73] The contagion could be spread throughout the system without limitations.

Given this danger, following the financial crisis, numerous commentators have questioned the use and utility of synthetic CDOs. For example, well-known investor and philanthropist George Soros noted that the synthetic CDO "clearly ha[s] no social benefit."[74] According to Mr. Soros, the synthetic CDO "did not finance the ownership of any additional homes or allocate capital more efficiently; it merely swelled the volume of mortgage-backed securities that lost value when the housing bubble burst. The primary purpose of the transaction was to generate fees and commissions."[75] Professor Frank Partnoy, who has written extensively on derivatives, stated that synthetic CDOs are "dangerous and of little or no social value."[76] The *New York Times* financial columnist Andrew Ross Sorkin has also questioned the use of synthetic CDOs,[77] as have other prominent journalists, some of

71. *See supra* Part II.A.4.

72. SENATE STAFF REPORT, *supra* note 3, at 29; *see* FCIC REPORT, *supra* note 4, at xxiv. Multiple referencing of RMBSs substantially contributed to the financial crisis. According to the Financial Crisis Inquiry Commission Report, "synthetic CDOs created by Goldman [Sachs] referenced 3,408 mortgage securities, some of them multiple times. For example, 610 securities were referenced twice. Indeed, one single mortgage-backed security was referenced in nine different synthetic CDOs created by Goldman Sachs. Because of such deals, when the housing [market] bubble burst, billions of dollars changed hands." *Id*. at 145–46 (internal footnote omitted).

73. MICHAEL LEWIS, THE BIG SHORT 77 (2010).

74. George Soros, *America Must Face Up to the Dangers of Derivatives*, FIN. TIMES, Apr. 23, 2010, at 9, *available at* http://www.ft.com/intl/cms/s/O/c1237094-4e6e-11df-b48d-00144 feab49a.html?siteedition=intl#axzz2gy5HRNUv.

75. *Id*.

76. Frank Partnoy, *Do C.D.O.'s Have Social Value?, Room for Debate*, N.Y. TIMES, BLOGS (Apr. 27, 2010, at 9, 7:58 PM), http://roomfordebate.blogs.nytimes.com/2010/04/27/do-c-d-o-s-have-social-value/?_r=O.

77. Andrew Ross Sorkin, *When Wall Street Deals Resemble Casino Wagers*, N.Y.

whom have called for a ban on synthetic CDOs.[78]

III. SYNTHETIC CDOS AND THE FINANCIAL CRISIS.

A. *The Role of Synthetic CDOs in the Financial Crisis*

Immediately before the onset of the financial crisis, the synthetic CDO market had grown to an enormous size.[79] There were several reasons for this. First, there was great demand for synthetic CDOs on each side of the transaction.[80] Synthetic CDOs offered higher returns to long investors and opportunities to hedge or speculate on a downturn in the housing market to short investors.[81] Investment banks were happy to sell synthetic CDOs because they could be created much more quickly and easily than cash CDOs.[82] Moreover, toward the end of the housing bubble, investment banks encountered a new obstacle that made it more difficult for them to create new cash CDOs: the supply of subprime mortgages was drying up.[83] Without new subprime mortgages, new RMBSs could not be created. And without new RMBSs, new cash CDOs could not be created. The lack of new subprime mortgages, however, would not be an obstacle to creating new synthetic CDOs, instead, the investment banks could simply reference already-existing RMBSs. The investment bank could sell synthetic CDOs to investors clamoring for cash CDOs

TIMES, Apr. 20, 2010, at B1 ("What purpose does a synthetic C.D.O. . . . serve for the capital markets, and for society?").

78. *See, e.g.*, John Authers, *Why Bets on Synthetic CDOs Must Be Banned*, FIN. TIMES, Apr. 24, 2010, at 16; Jim Cramer, *Beware the Return of Synthetic CDOs,* THE STREET.COM (June 5, 2013, 2:15 PM), http://realmoney.thestreet.com/articles/06/05/2013/beware-return-synthetic-cdos).

79. According to a report by the Securities Industry and Financial Markets Association ("SIFMA"), $66.5 million of synthetic CDOs were issued in 2006. *Global CDO Table 1.1 Global CDO Issuance-Type*, SEC. INDUS. AND FIN. MKT. ASS'N, (Oct. 1, 2013), http://www.sifma.org/research/statistics.aspx (scroll to section titled "Structured Finance" and open "Global CDO Issuance and Outstanding" in Excel document).

80. *See supra* Part II.B.

81. *See supra* note 67.

82. As previously discussed, to create a nonsynthetic (cash) CDO, an investment bank would have to find purchasers for the lower-rated tranches of the RMBS, which was not necessarily easy to do. The investment bank would also have to expend cash to purchase the RMBSs. With a synthetic CDO, each of these problems vanished. *See supra* Part II.A.4.

83. *See* FCIC REPORT, *supra* note 4, at 142–43, 155; *see also* Katalina M. Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown*, CCH FEDERAL BANKING REPORTER, Apr. 2008, at 15, *available at* http://business.cch.com/bankingfinance/focus/news/subprime_wp_rev.pdf.

without having to buy any RMBSs, and could charge high fees at each stage of the creation of the synthetic CDO.[84]

When the housing bubble burst, losses spread rapidly throughout the economy. Homeowners defaulted on their mortgages, which led to defaults on RMBSs, which in turn led to losses on the synthetic CDOs referencing those RMBSs.[85] While the short investors made enormous profits, many long investors in synthetic CDOs, typically insurance companies, commercial banks, and pension funds, were completely wiped out.[86] For example, AIG had to be bailed out by the U.S. government.[87] Several large non-U.S. banks were bailed out by their governments[88] and all but one of the monoline insurance companies went out of business.[89]

Commentators targeted synthetic CDOs as a significant cause of the financial crisis.[90] For example, the report of the Financial Crisis Inquiry Commission,[91] a congressionally mandated, bipartisan task force, concluded that synthetic CDOs spread the risk through the financial system, contributing significantly to the financial crisis.[92] The report states in part that "[s]ynthetic CDOs . . . enabled securitization to continue and expand even as the mortgage market dried up and provided speculators with a means of betting on the housing market. By layering on correlated risk, they spread and amplified exposure to losses when the housing market collapsed."[93] The U.S. Senate Permanent Sub-

84. FCIC REPORT, *supra* note 4, at 142–43.

85. *See id.*

86. *See id*. at 143, 145.

87. *See generally* Matthew Karnitschnig et al., *U.S. To Take Over AIG in $85 Billion Bailout Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1.

88. *See, e.g.*, Neil Irwin & David S. Hilzenrath, *Fed's Crisis Aid Benefited Firms Beyond Wall St.*, WASH. POST, Dec. 2, 2010, at A01.

89. *See Ambac's Fall: And Then There Was One*, THE ECONOMIST, Nov. 4, 2010, *available at* www.economist.com/node/1442088.

90. *See, e.g.,* Morgenson & Story, *supra* note 1.

91. The Financial Crisis Inquiry Commission was established by the Fraud Enforcement and Recovery Act of 2009 to "examine the causes, domestic and global, of the current financial and economic crisis in the United States." Pub. L. No. 111-21, § 5(a), 123 Stat. 1617, 1625 (2009). The FCIC consisted of ten members, appointed by both Republicans and Democrats. § 5(b)(1), 123 Stat. at 1625–26. After months of hearings, in January 2011, the FCIC submitted its 633 page report to Congress. FCIC REPORT, *supra* note 4, at vi. Four members of the FCIC dissented from the report. *Id*. at vii.

92. FCIC REPORT, *supra* note 4, at xxiv (concluding that synthetic CDOs "amplified the losses from the collapse of the housing bubble by allowing multiple bets on the same securities and helped spread them throughout the financial system").

93. *Id*. at 155.

committee on Investigations reached the same conclusion after its two-year examination of the financial crisis.[94] The Permanent Subcommittee on Investigations concluded in its 639 page report[95] that synthetic CDOs "amplified market risk by allowing investors with no ownership interest in the reference obligations to place unlimited side bets on their performance."[96]

B. *Conflicts of Interest and Synthetic CDOs*

Not surprisingly, investment banks came under attack for their role in creating and selling synthetic CDOs, as well as other derivatives.[97] But the focus of the attack was not on the sale of the synthetic CDO itself. Rather, the criticism targeted the perceived greed and unethical behavior of investment banks in putting together the synthetic CDOs.[98] Specifically, at the same time investment banks were encouraging their clients to purchase the bonds issued in synthetic CDOs, the investment banks were often betting against their clients by taking short positions in the very same transaction.[99] Some disappointed investors claimed that the synthetic CDOs were actually "designed to fail" so that short investors would reap great profits at the expense of the long investors.[100] Investment banks were seen as greedy companies, who were more than happy to structure transactions that ruined the global economy in return for high fees and speculative profits.[101] The public's outrage over investment banks was magnified when the government bailed them out.[102]

To provide a better understanding of these arguments, this section summarizes two high profile synthetic CDO transactions that were sold just before the housing bubble burst: the Hudson Mezzanine Funding 2006-1 synthetic CDO and the ABACUS 2007-AC1 synthetic CDO.

94. *See* SENATE STAFF REPORT, *supra* note 3, at 327–28.
95. *Id*. at 639.
96. *See id.* at 11.
97. Morgenson & Story, *supra* note 1.
98. *See, e.g.*, *id*.
99. *Id*.; *see also* FCIC REPORT, *supra* note 4, at 236.
100. *E.g*., Morgenson & Story, *supra* note 1; FCIC REPORT, *supra* note 4, at 40.
101. *See* Morgenson & Story, *supra* note 1.
102. Moira Herbst, Bailout Outrage Races Across the Web, BLOOMBERG BUSINESSWEEK (Sept. 25, 2008), http://www.businessweek.com/printer/articles/309580-bailout-outrage-races-across-the-web?type=old_article.

1. Hudson Mezzanine Funding 2006-1 Synthetic CDO

In late 2006, Goldman Sachs marketed a $2 billion synthetic CDO, Hudson Mezzanine Funding 2006-1, to its clients.[103] In 2008, the securities in the reference portfolio had been downgraded to junk status, and the largest investor in the synthetic CDO, Morgan Stanley, had lost approximately $960 million.[104]

One of the more interesting aspects of this transaction was that Goldman was the sole short investor in the synthetic CDO.[105] In other words, while Goldman was encouraging its clients to bet that the housing market would stay strong, Goldman itself was making a $2 billion bet that that the housing market would fail. Thus, Goldman was betting against its own clients.

Betting against clients is not a particularly effective long-term business model, so why did Goldman do it? As discussed previously,[106] the answer is that a synthetic CDO is one way for an investor to reduce its exposure to mortgage related securities. Apparently, at the time of the Hudson deal, Goldman had a $6 billion long position in mortgage-related securities and was becoming increasingly concerned about the housing market and mortgage defaults.[107] By mid-2006, Goldman management had determined that it needed to reduce its exposure to mortgage-related securities.[108] By creating synthetic CDOs, and then simultaneously taking the short position, Goldman could quickly move to a short position, as long as it structured the transaction appropriately. The key would be to include in the reference portfolio mortgage-related securities that Goldman already owned.

The Hudson synthetic CDO did not use a third party collateral agent or portfolio selection agent to select the reference portfolio.[109] Instead, Goldman itself selected the reference portfolio.[110] Goldman included $1.2 billion in mortgage-related securities from

103. SENATE STAFF REPORT, *supra* note 3, at 390–91. The Hudson synthetic CDO was one of four CDO transactions that the U.S. Permanent Subcommittee on Investigations examined in its investigation of Goldman Sachs and its conflicts of interest. *Id.*, at 390.

104. *Id.* at 392.

105. *Id.* at 390.

106. *See supra* Part II.B.

107. *See* SENATE STAFF REPORT, *supra* note 3, at 398.

108. *See id.* at 401–02.

109. *See id.* at 390–91.

110. *See id.*

Goldman's own proprietary holdings, enabling Goldman to transfer $1.2 billion of its risk away from Goldman to its clients, the purchasers of the Hudson notes. [111] Thus, the Hudson synthetic CDO could be seen as part of a plan to move Goldman from a $6 billion long position in mortgage related securities to a net short position. To make up the remainder of the $2 billion bet, Goldman selected $800 million of risky RMBSs—mostly rated BBB+ or below—to be in the reference portfolio, which presumably increased its chances of recovering on its bet at the expense of its clients.[112]

Was any of this disclosed to the Hudson investors before they purchased the notes? Potential purchasers in the Hudson synthetic CDO, like most synthetic CDOs, received several different disclosure documents as part of their offering materials.[113] Offering materials for synthetic CDOs typically consisted of three documents: (1) the termsheet, a short (approximately five page) summary of the transaction; (2) the "flipbook" or "pitchbook," a longer summary of the transaction that also contains disclaimers, risk factors, and a complete portfolio asset list; and (3) the offering circular, a lengthy document (approximately 200 pages) with disclosures resembling those found in a Registration Statement under the Securities Act of 1933.[114]

The offering materials *did* disclose that Goldman would be on the short side of the transaction.[115] In fact, the offering circular states several times that Goldman was the protection buyer in the Hudson synthetic CDO.[116] For example, the flipbook stated: "On the closing date, the Issuer will enter into pay-as-you-go

111. *See id*. at 391, 399.

112. *See id*. at 390.

113. *See* Offering Circular, Goldman Sachs & Co, Hudson Mezzanine Funding 2006-1, Corp. (Dec. 3, 2006) [hereinafter Hudson Offering Circular], http://fcic-static.law.Stanford.edu/cdn_media/fcic-docs/2006-10-00_Hudson%20Mezzanine%20Funding%202006-1_CDO%20Offering%20Circular.pdf; Pitchbook, Goldman Sachs & Co, Hudson Funding 2006-1, Corp. (Oct. 2006) [hereinafter Hudson Mezzanine Flipbook], http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-10-00_Hudson%20Mezzanine%20Funding%202006-1_CDO%20Pitchbook.pdf; Preliminary Termsheet, Goldman Sachs & Co, Hudson Mezzanine Funding 2006-1, Corp. (Oct. 20, 2006) [hereinafter Hudson Preliminary Termsheet], http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-10-00_Hudson%20Mezzanine%20Funding%202006-1_CDO%20Term%20Sheet.pdf.

114. *Id.*; *see* 15 U.S.C. § 77g(2012).

115. *See* Hudson Preliminary Termsheet, *supra* note 113, at 1; Hudson Flipbook, *supra* note 113, at 13; Hudson Offering Circular, *supra* note 113, at 25.

116. Hudson Offering Circular, *supra* note 113, at 25, 34, 56, 100.

credit default swaps (the "Synthetic Securities") with Goldman Sachs International, ("GSI" and in such capacity, the "Counterparty"), pursuant to which the Issuer will sell credit default protection with respect to a portfolio of Reference Obligations."[117] In addition, the offering materials disclosed that Goldman selected the reference portfolio.[118]

The offering materials also included several warnings that the transaction involved a conflict of interest, such as "[i]t is expected that Goldman Sachs International, an affiliate of Goldman, Sachs & Co., will act as the sole Credit Protection Buyer with respect to the Credit Default Swap, which creates concentration risk and may create certain conflicts of interest."[119] However, the offering materials also tried to paint Goldman's interests as being comparable to the long investors and not a conflict of interest.[120] For example, the flipbook prominently stated that "Goldman Sachs has aligned incentives with the Hudson program by investing in a portion of equity"[121] and "Goldman Sachs will invest in a portion of the . . . [notes]."[122]

Furthermore, the offering materials did not disclose that the purpose of the synthetic CDO was to help Goldman reduce its exposure to mortgage related securities.[123] Rather, the flipbook stated that Goldman's objective was "to develop a long term association with selected partners that can adapt to and take advantage of market opportunities."[124] Nor did the offering materials disclose that $1.2 billion of the reference portfolio consisted of mortgage related securities owned by Goldman.[125] Instead, the flipbook inaccurately stated that the reference portfolio was "sourced from the Street" and was "[not] a Balance Sheet CDO."[126]

117. Hudson Flipbook, *supra* note 113, at 13.

118. *See id.* at 16; Hudson Preliminary Termsheet, *supra* note 113, at 1.

119. Hudson Offering Circular, *supra* note 113, at 50. A similar disclosure can be found in the flipbook. Hudson Flipbook, *supra* note 113, at 13.

120. Hudson Flipbook, *supra* note 113, at 4, 15.

121. *Id.* at 4.

122. *Id.* at 15.

123. *See id.* at 15.

124. *Id.*

125. *See id.* at 16.

126. *Id.*

2. ABACUS 2007-AC1 Synthetic CDO

Another Goldman transaction, ABACUS 2007-ACI ("ABACUS"), has become the poster child for investment bank misconduct in the sale of synthetic CDOs.[127] The $2 billion synthetic CDO closed in late April 2007, just before the housing market crashed.[128] Approximately six months later, 83% of the RMBSs in the ABACUS portfolio had been downgraded, while the remaining 17% were placed on "negative watch."[129] Three months after that, 99% of the portfolio had been downgraded, leading to approximately $1 billion of losses for the long investors and $1 billion of profits for the short investor. [130]

Unlike the Hudson synthetic CDO, in the ABACUS transaction, Goldman did not take a short position itself.[131] Instead, it structured the transaction at the request of an important Goldman client who wanted to take the entire short position in the synthetic CDO.[132] The client was Paulson & Co., a hedge fund known at the time to be very pessimistic about the housing market.[133] Goldman then solicited other clients to take the long positions on the synthetic CDO.[134]

As has been widely reported, Goldman permitted John A. Paulson to choose the RMBSs that would become part of the reference portfolio.[135] As the short investor, Paulson naturally had an in-

127. The ABACUS synthetic CDO was one of four CDO transactions that the U.S. Permanent Subcommittee on Investigations examined in its investigation of Goldman Sachs and its conflicts of interest. SENATE STAFF REPORT, *supra* note 3, at 9.

128. *See id.*, at 560, 572.

129. Complaint at 3, Sec. & Exch. Comm'n v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. Apr. 16, 2011) (No. 10 Civ. 3229). A credit rating issues a "negative watch" when it is considering whether to downgrade the rating.

130. *See id*. at 3.

131. SENATE STAFF REPORT, *supra* note 3, at 9–10. The ABACUS offering materials stated that Goldman would be taking the short position in the transaction. However, Goldman and Paulson & Co. had agreed to enter into a separate credit default swap, meaning that Paulson, not Goldman, would have the sole short position in the ABACUS deal. *Id*. at 396 n.1603.

132. *Id*. at 396.

133. *Id*. For additional discussion of Paulson's participation as a short investor in synthetic CDOs, see generally GREGORY ZUCKERMAN, THE GREATEST TRADE EVER (2009).

134. *See* SENATE STAFF REPORT, *supra* note 3, at 10.

135. *See, e.g.*, Louise Story & Gretchen Morgenson, *S.E.C. Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, at A1 (Apr. 17, 2010) *available at* www.nytimes.com/2010/04/17/business/17goldman.html?pagewanted_all&_r=1& (reporting that the ABACUS transaction was initiated by Paulson).

centive to pick RMBSs that would be likely to default, ensuring that he would win his bet at the expense of long investors who had purchased the ABACUS notes.[136]

The ABACUS synthetic CDO did have a third party portfolio selection agent, ACA Management, LLC.[137] According to published reports, ACA Management was aware of Paulson and, indeed, worked with him to select the reference portfolio.[138] However, ACA Management apparently was under the mistaken impression that Paulson would be purchasing the equity tranche of the synthetic CDO.[139] If Paulson had invested in equity—which is the riskiest long investment in a synthetic CDO—he would have had incentive to select the best RMBSs for the portfolio, not the worst RMBSs.

Was any of this disclosed to the purchasers of the ABACUS notes? The offering materials stated that Goldman, not Paulson, would be taking the short position in the transaction, and did not disclose that Goldman had agreed to transfer the entire short position to Paulson after the transaction closed.[140] The offering materials did not disclose that Paulson was involved in the selection of the reference portfolio.[141] Instead, the marketing materials stated that the reference portfolio was to be "selected by" ACA

136. Complaint, *supra* note 129, at 2.

137. *See* SENATE STAFF REPORT, *supra* note 3, at 396 ("Goldman employed a third party to serve as the portfolio selection agent, essentially using that agent to promote sales and mask the role of its client in the asset selection process.").

138. The SEC complaint filed against Goldman Sachs describes the reference portfolio selection process. Initially, Paulson proposed 123 RMBSs for the portfolio. ACA Management responded by sending Goldman a list of eighty-six RMBSs, fifty-five of which had been included on Paulson's original list. Paulson and Goldman agreed on eighty-two of ACA Management's suggested RMBSs. ACA Management then sent a revised list of eighty-two RMBSs, plus twenty-one additional RMBS. Paulson rejected eight of them. Ultimately, after a month of negotiations, Paulson and ACA Management agreed on the ABACUS reference portfolio of ninety RMBSs. Complaint, *supra* note 129, at 9–11.

139. *See id.* at 13. ACA sued Goldman and Paulson & Co., contending, *inter alia*, that they purposely misled ACA into believing that Paulson was investing in ABACUS equity. *Id.* For additional discussion of this case, see *infra* Part IV.B.3.

140. *See* Offering Circular ABACUS 2007-AC1, Ltd., at 1, 10, 70 (Apr. 26, 2007) [hereinafter ABACUS Offering Circular], http://av.r.ftdata.co.uk/files/2010/04/30414220-ABACUS-Offer-Document.pdf; Flipbook, ABACUS 2007-AC1, Ltd., at 8, 19, 50 (Feb. 26, 2007) [hereinafter ABACUS Flipbook], http://www.math.nyu.edu/faculty/avellane/ ABACUS.pdf; Final Term Sheet, ABACUS 2007-AC1, Ltd., at 2 (July 2, 2007) [hereinafter ABACUS Termsheet], fcic=static.law.stanford.edu/edn_media/fcic-docs/2007-03-00_ABACUS%202007-AC1_CD0%20Term%20Sheet.pdf.

141. SEC v. Goldman Sachs & Co., SEC Litigation Release No. 21,489, 1142 (Apr. 16, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr2148 9.htm.

Management.[142] Paulson was not named at all in the offering materials, not even as the purchaser of the equity tranche; in fact, the offering materials indicated that there were no investors in the ABACUS equity tranche.[143]

The ABACUS offering materials did include specific disclosures relating to conflicts of interest.[144] The offering materials also included several disclaimers.[145] For example, in the Risk Factors section, the Flipbook stated that Goldman "shall not have a fiduciary relationship with any investor" and that Goldman was not making any representations about the suitability of buying ABACUS notes.[146] Goldman also warned investors that it might "possess or have access to non-publicly available information relating to the Reference Obligations" and "does not intend to disclose" the non-public information to investors.[147] Finally, Goldman disclosed that it "is currently and may be from time to time in the future an active participant on both sides of the market and have long or short positions in, or buy and sell, securities . . . or other derivatives identical or related to [the ABACUS notes]."[148]

IV. SYNTHETIC CDOS POST-FINANCIAL CRISIS: FRAUD LITIGATION

Following the housing crash, some investors, as well as the SEC, sued Goldman Sachs and other investment banks, contending that the sales of synthetic CDOs violated the antifraud provisions of the securities laws. After a brief introduction to the antifraud provisions of the federal securities laws, this section discusses the private actions brought by investors and the enforcement actions brought by the SEC against investment banks.

---

142. ABACUS Offering Circular, *supra* note 140, at 2, 23, 84; ABACUS Flipbook, *supra* note 140, at 2, 12; ABACUS Termsheet, *supra* note 140, at 1, 3.

143. *See* SEC Litigation Release, *supra* note 141;

144. *See* ABACUS Offering Circular, *supra* note 140, at 32–33; ABACUS Flipbook, *supra* note 140, at 8.

145. *See* ABACUS Offering Circular, *supra* note 140, at cover page, iv; ABACUS Flipbook, *supra* note 140, at 8.

146. ABACUS Flipbook, *supra* note 129, at 8.

147. *Id*. at 8.

148. *Id*.

A. *The Anti-Fraud Provisions of the Securities Laws*

1. Private Actions

The general antifraud provision of the federal securities laws is Rule 10b-5.[149] To prevail in a Rule 10b-5 action, a plaintiff is required to show (1) fraud; (2) in connection with the purchase or sale of a security; (3) scienter; (4) reliance; (5) loss causation; and (6) damages.[150] Each of these elements is briefly discussed below.

a. Fraud: False or Misleading Statement of Material Fact

To recover, the plaintiff must show that the defendant committed fraud.[151] In other words, the plaintiff must show that the defendant made a false or misleading statement of material fact.[152] Affirmative misrepresentations—outright lies—are unlawful.[153] Misleading statements—half-truths—are also unlawful.[154] In other words, if a person speaks, the disclosure must be completely accurate; the person cannot "omit to state a material fact necessary in order to make the statements made . . . not misleading."[155] However, a pure omission—complete silence—is not fraudulent unless there is an independent duty to disclose, such as the existence of a fiduciary relationship between the plaintiff

149. Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under with they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2013). In general, state anti-fraud provisions have identical requirements. *See, e.g.*, VA. CODE ANN. § 13.1-502 (Repl. Vol. 2011).

150. *See* DuraPharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

151. *Id*. at 341 (citing Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988)).

152. 17 C.F.R. § 240.10b-5(b).

153. *See id*.

154. *See id*.

155. *See id*.

and defendant.[156]

For the plaintiff to recover, the false or misleading statement must be material.[157] Information is material if there is a "substantial likelihood that a reasonable shareholder would consider the information important in deciding how to [act]."[158] The materiality of a particular piece of information will not be judged in isolation. As the Supreme Court of the United States has stated, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[159] Thus, the materiality determination is highly contextual in nature.

b. In Connection With the Purchase or Sale of a Security

The "in connection with" requirement ensures that the fraud is securities fraud. The "in connection with" requirement is met when the fraud "coincides" with the purchase or sale of security.[160] In a case when false or misleading statements are made in disclosure documents for a sale of securities, there is no question that the fraud coincides with the purchase or sale of a security.

c. Scienter

To recover under Rule 10b-5, the plaintiff must show that the defendant acted with scienter, which is defined as a "mental state embracing intent to deceive, manipulate, or defraud."[161] Negligence is not enough.[162] For scienter to be established, the defendant must recklessly or deliberately make a false or misleading statement of fact.[163]

156. Chiarella v. United States, 445 U.S. 222, 230 (1980).
157. Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976)).
158. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
159. *Id*.
160. SEC v. Zandford, 535 U.S. 813, 822 (2002).
161. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–94 n.12 (1976).
162. *See id*. at 216 (Blackmun, J., dissenting).
163. *See id*. at 193–94 n.12.

d. Reliance

Reliance is sometimes called "transaction causation."[164] It is analogous to "but for" causation found in tort actions.[165] In other words, the defendant's fraud, and not something else, must have caused the plaintiff to purchase the securities.[166] For a plaintiff to recover, the reliance must be reasonable, or justifiable.[167] Because reasonable reliance will prove to be a particularly significant issue in fraud claims arising out of the synthetic CDOs, an in-depth discussion of reliance is set forth below.[168]

e. Loss Causation

Loss causation tests whether the plaintiff's losses were due to the defendant's fraud.[169] It is analogous to "proximate causation" found in tort actions.[170] If a plaintiff's losses were caused by something other than the defendant's fraud, such as a downturn in the economy, then the plaintiff will not be able to recover.[171]

f. Damages

Courts have adopted different approaches to calculating damages, but the most popular approach is an out-of-pocket measure

164. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 840 n.174 (2009) (citing Berckeley Inv. Grp., Ltd. v. Colkitt, 455 F.3d 195, 222 (3d Cir. 2006)).

165. *Id*. at 819–20 (citing Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981)).

166. The Supreme Court has recognized two rebuttable presumptions of reliance. Under the *Affiliated Ute* presumption, the court will presume reliance in certain non-disclosure cases if the information that was not disclosed is material. Although some synthetic CDO fraud claims may involve non-disclosures, the presumption will generally not be available to the purchasers of notes because the investment banks cannot be seen as being in a fiduciary relationship with the purchasers. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–54 (1972). In the fraud-on-the-market presumption, the court will presume reliance in cases involving publicly traded securities if the information is material. *See* Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988). Because synthetic CDOs are not publicly traded, the fraud-on-the-market presumption cannot be used by purchasers of notes who claim they have been defrauded by investment banks.

167. *See* 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 35–53 (5th ed. 2005) ("[A]ny reliance by the plaintiff must be reasonable.").

168. *See infra* Part IV.A.2.

169. HAZEN, *supra* note 167, at 507.

170. *Id*. at 505–06.

171. *Id*. at 507.

of damages.[172]

2. Reasonable or Justifiable Reliance

As previously stated, an element of private actions under Rule 10b-5, as well as state fraud cases, is reasonable reliance. In determining whether reliance is reasonable, most courts cite the following factors: (1) "the sophistication and expertise of the plaintiff in financial and securities matters;" (2) "the existence of long standing business or personal relationships;" (3) "access to the relevant information;" (4) "the existence of a fiduciary relationship;" (5) "concealment of the fraud;" (6) "the opportunity to detect the fraud;" (7) "whether the plaintiff initiated the stock transaction or sought to expedite the transaction;" and (8) "the generality or specificity of the misrepresentations."[173]

Two issues that often arise in cases involving the purchase of securities in private transactions are the effect of the plaintiff's sophistication and the impact of contractual provisions, such as non-reliance disclaimers, on the reasonable reliance inquiry.[174]

a. Sophistication and the Due Diligence Requirement

In assessing reasonable reliance, courts generally impose a higher burden on sophisticated plaintiffs.[175] While the federal securities laws do not define sophistication, courts generally look to factors such as wealth and investment experience to determine the sophistication of a purchaser.[176] Institutional investors such as banks, pension funds, hedge funds, and insurance companies would certainly be considered "sophisticated" for purposes of the

---

172. *See* Randall v. Loftsgaarden, 478 U.S. 647, 661-62 (1986); Harris v. Am. Inv. Co., 523 F.2d. 220, 224–25 (8th Cir. 1975).

173. *See* Davidson v. Wilson, 973 F.2d 1391, 1400 (8th Cir. 1992); Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991); Foremost Guaranty Corp. v. Meritor Sav. Bank, 910 F.2d 118, 123–24 (4th Cir. 1990); Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989); Grubb v. Fed. Deposit Ins. Corp., 868 F.2d 1151, 1164 (10th Cir. 1989); Kennedy v. Josephthal & Co., 814 F.2d 798, 804 (1st Cir. 1987); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983).

174. C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1083 (1988); Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 880–81 (1994).

175. Fletcher, *supra* note 174, at 1090 ("[S]ophistication . . . often reduces an investor's ability to show reasonable reliance.").

176. *See id*. at 1151–52.

federal securities laws because they are market professionals investing other people's money.

Moreover, most courts have imposed a due diligence requirement on sophisticated plaintiffs.[177] As the Second Circuit has stated, "[a]n investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth."[178] Thus, to establish justifiable reliance, purchasers of securities would have to show that they investigated publicly available information about the securities and they asked questions about the securities.

b. Non-Reliance Clauses and Big Boy Letters

Another factor that may impact whether a plaintiff will be able to establish reasonable reliance is the existence of contractual disclaimers—especially a non-reliance disclaimer or "big boy" letter. [179] A non-reliance disclaimer is a contractual provision stating that the purchaser of securities has not relied on any representations other than those set forth in the final agreement.[180] Thus, if a court enforces the non-reliance clause, false or misleading statements made by an investment bank's employee during negotiations, for example, would not be actionable because it would not be reasonable for the purchaser to have relied on the false statements, given the express disclaimer of reliance.

A big boy letter is an amped-up non-reliance clause often found in private securities transactions between sophisticated parties, such as the sale of synthetic CDOs.[181] A big boy letter typically

177. *See id.* at 1090 ("[I]n analyzing Rule 10b-5 causation issues, courts often state that investors may not simply close their eyes to obvious risks, but must exercise due diligence in protecting themselves.").

178. Brown v. E.F. Hutton Grp., Inc., 991 F.2d 1020, 1032 (2d Cir. 1993).

179. For a discussion about the propriety of using contract law and certain contractual disclaimers in Rule 10b-5 actions, see Sachs, *supra* note 174.

180. *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 BUS. LAW. 999, 1037 (2009) (setting forth a model non-reliance provision). A non-reliance clause is similar to an integration clause, a common contractual provision that states that the final contract represents the entire agreement of the parties. The integration clause, however, does not expressly disclaim reliance. *See* David K. Lutz, Note, *The Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause*, 79 CHI.-KENT L. REV. 803, 804 n.4 (2004).

181. *See* Joseph M. McLaughlin, *Corporate Litigation: Big Boy Letters and Non-Reliance Provisions*, N.Y. L.J., Dec. 13, 2012 at 5; Extra Equipamentos e Exportaçào Ltda. v. Case Corp., 541 F.3d 719, 724 (7th Cir. 2008) (explaining "in the trade, no reliance

includes representations such as the following:

(a) that the purchaser is a sophisticated institutional investor with such knowledge and experience in financial and business matters that it is capable of evaluating the merits, risks, and suitability of investing in the securities;

(b) that the purchaser has conducted its own due diligence investigation of the company, that it is relying exclusively on its own due diligence investigation and its own sources of information and credit analysis with respect to the securities;

(c) that the purchaser has consulted with its own legal, tax, business, investment, financial, and other advisors to the extent it has deemed necessary, and has made its own investment decision based upon its own judgment and not upon any view expressed by the investment bank;

(d) that the purchaser is not relying for the purposes of making its investment decision on any advice, opinion, or representation of the investment bank;

(e) that the purchaser understands that the investment bank may have non-public information with respect to the issuer or the securities, and agrees that that the information need not be disclosed to it;

(f) that purchaser recognizes that the investment bank may have conflicts of interest with the purchaser; and

(g) that the purchaser agrees that the investment bank has not acted as a financial advisor and does not owe any fiduciary duties to the purchaser in connection with the purchase of securities.[182]

In other words, the purchaser of the securities is saying that it is a "big boy," able to make its own decisions on whether to purchase the securities without the help of the investment bank.

The clear purpose of non-reliance provisions and big boy letters is to preclude a plaintiff's claim that it reasonably relied on de-

clauses are called 'big boy' clauses (as in 'we're big boys and can look after ourselves')").

182. *See, e.g.*, Pharos Capital Partners, LP v. Deloitte & Touche, LLP, 905 F. Supp. 2d 814, 820–21 (S.D. Ohio 2012) (setting forth an example of a big boy letter). Inside information disclaimers that the purchaser understands the investment bank may have non-public information with respect to the issuer or the securities have been controversial. *See generally* Edwin D. Eshmoil, Note, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133 (2008).

fendant's extra-contractual misrepresentations. Two important circuit courts for securities regulation—the Second and Seventh Circuits—have agreed that these disclaimers, at least in heavily negotiated transactions by well-counseled, sophisticated investors, act as a complete bar to claims of reasonable reliance. For example, in *Harsco Corp. v. Segui*, the Second Circuit noted that a sophisticated purchaser who negotiated for fourteen pages of representations and a two-week period to conduct due diligence could not claim that it reasonably relied on extra-contractual representations when the contract expressly stated that the purchaser was relying only on the representations made in the contract. [183]

Similarly, in *Rissman v. Rissman*, the Seventh Circuit affirmed the grant of summary judgment in favor of the defendant based on the existence of a non-reliance clause.[184] The Seventh Circuit further supported its decision by noting that:

> [s]ecurities law does not permit a party to a stock transaction to disavow such representations—to say, in effect, "I lied when I told you I wasn't relying on your prior statements" and then to seek damages for their contents. Stock transactions would be impossibly uncertain if federal law precluded parties from agreeing to rely on the written word alone.[185]

Other courts, including the First, Third, and Sixth Circuits, agree that non-reliance clauses might undercut a claim of reasonable reliance, but have held that the disclaimers are not a dispositive bar to Rule 10b-5 claims.[186] The First and Third Circuits have emphasized that non-reliance clauses could run afoul of the anti-waiver provision contained in Section 29(a) of the Securities Exchange Act.[187] Section 29(a) bars contractual waivers of, *inter alia*, fraud actions under Rule 10b-5.[188] Thus, in *Rogen v. Ilikon*

183. 91 F.3d 337, 344 (2d Cir. 1996) (holding that the presence of a non-reliance clause in a contract negotiated by sophisticated parties barred the plaintiffs from demonstrating reasonable reliance for Rule 10b-5 claims and for common law fraud claims under New York state law).

184. 213 F.3d 381, 387 (7th Cir. 2000).

185. *Id*. at 383.

186. *See* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 921 (6th Cir. 2007); AES Corp. v. Dow Chem. Co., 325 F.3d 174, 181 (3d Cir. 2003); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966)).

187. *AES Corp.*, 325 F.3d at 180; *Rogen*, 361 F.2d at 268. Section 29(a) states that: "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the federal securities laws] shall be void." 15 U.S.C. § 78cc (2012).

188. 15 U.S.C. § 78cc; 17 C.F.R. § 240.106-5 (2013).

Corp.,[189] the First Circuit agreed that a contractual provision stating that the plaintiffs were "fully familiar with the business and prospects of the corporation, are not relying on any representations or obligations to make full disclosure with respect thereto, and have made such investigation thereof as they deem necessary" might undercut a finding of justifiable reliance.[190] However, the court held that the non-reliance clause could not be dispositive, reasoning that:

> This is not, in its terms, a "condition, stipulation, or provision binding [plaintiff] to waive compliance" with the Securities Act of 1934, as set forth in Section 29(a) of the Act. . . . But, on analysis, we see no fundamental difference between saying, for example, "I waive any rights I might have because of your representations or obligations to make full disclosure" and "I am not relying on your representations or obligations to make full disclosure." Were we to hold that the existence of this provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, we would have gone far toward eviscerating Section 29(a).[191]

The Third Circuit reached a similar conclusion. In *AES Corp. v. Dow Chemical Co.*, the court followed the First Circuit's approach in *Rogen*, reversing the district court's dismissal on the grounds that the non-reliance clause established as a matter of law that the plaintiff did not reasonably rely on misleading statements.[192] The court concluded the non-reliance clause could be evidence that the plaintiff acted without reasonable reliance.[193] In *Brown v. Earthboard Sports USA, Inc*. the Sixth Circuit, while not mentioning Section 29(a)'s anti-waiver provision, followed *Rogen* and *AES Corp*. to conclude that a non-reliance clause could not by itself bar a fraud action, but a court could consider it with other factors to determine the reasonableness of reliance.[194]

189. 361 F.2d at 268 (holding that a non-reliance clause could not bar Rule 10b-5 actions, but could be used as evidence that the plaintiff did not reasonably rely on misleading statements); *see also* Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 416–17 (1st Cir. 1989) (holding that a plaintiff could not show reasonable reliance because, *inter alia*, the plaintiff disclaimed reliance on statements other than those set forth in the final transaction document).

190. *Rogen*, 361 F.2d at 265.

191. *Id*. at 268 (alteration in original).

192. *See AES Corp*., 325 F.3d at 180 (2003) (holding that a non-reliance clause could not bar Rule 10b-5 actions, but could be used as evidence that the plaintiff did not reasonably rely on misleading statements).

193. *Id*. at 180–81.

194. *See* 481 F.3d 901, 921 (6th Cir. 2007) (holding that a non-reliance clause could not bar Rule 10b-5 actions, but could be used as evidence that the plaintiff did not reasonably

3. SEC Enforcement Actions

Compared to private plaintiffs, it is easier for the SEC to successfully sue under the antifraud provisions of the federal securities laws. First, the SEC can bring suit under Section 17(a)(2) of the Securities Act of 1933,[195] which does not require the SEC to show scienter.[196] Thus, the SEC can bring enforcement actions for negligent misrepresentations under Section 17(a)(2), which are much easier to establish than reckless or intentional misrepresentations under Rule 10b-5. Second, if the SEC chooses to sue under Rule 10b-5, it need not show reliance, loss causation, or damages.

However, the SEC faces unique challenges in bringing enforcement actions. First, the SEC faces serious resource issues. The SEC cannot bring enforcement actions whenever the federal securities laws have been violated. Rather, the SEC has discretion over what cases it will bring. The SEC must weigh the cost of bringing the action against the potential benefits of the action. In addition, these resource issues mean that very few SEC enforcement actions are fully litigated; most often, its enforcement actions are filed and settled simultaneously.

B. *Private Actions Brought Against Investment Banks*

Somewhat surprisingly, there have been only a handful of cases brought by long investors against investment banks alleging fraud in the sale of synthetic CDOs, and the outcomes of the cases have varied. These private actions have proved to be somewhat difficult to win. Two of the four cases have been dismissed out-

rely on misleading statements).

195. Rule 17(a)(2) states that:

> It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> . . .
>
> (2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, no misleading[.]

Securities Act of 1933, 15 U.S.C. § 77q(a) (2012).

196. While the language of Section 17(a)(2) and Rule 10b-5 is quite similar, the Supreme Court has ruled that scienter is not an element of Section 17(a)(2). *See* Aaron v. SEC, 446 U.S. 680, 697 (1980).

right, while several fraud claims have been dismissed in the actions that have been allowed to continue. [197]

1. *Dodona I, LLC v. Goldman Sachs* (Hudson Synthetic CDO)

In *Dodona I, LLC v. Goldman Sachs*, purchasers of notes issued in the Hudson synthetic CDO discussed previously[198] brought a class action in the Southern District of New York against Goldman, alleging, *inter alia*, violations of Rule 10b-5 and common law fraud.[199] The plaintiff argued that Goldman sold the notes without disclosing that (1) the notes were sold as part of Goldman's strategy to reduce its long exposure to subprime mortgage-related assets and (2) Goldman did not believe that the notes had a "realistic chance of being profitable for investors."[200] Goldman moved to dismiss and the district court, although clearly not happy with Goldman's conduct in structuring and selling the Hudson synthetic CDO,[201] dismissed some, but not all, of the plaintiff's claims.[202]

The court dismissed the plaintiff's claim that Goldman committed fraud by failing to disclose that the Hudson synthetic CDO was part of Goldman's strategy to reduce its long position.[203] According to the court, Goldman did not have a duty to disclose this information.[204] The court noted that the offering materials did not mention Goldman's investment and risk-management strategy,

197. The case brought in New York state court against Goldman relating to the ABACUS synthetic CDO has been dismissed. *See* ACA Fin. Guar. Corp. v. Goldman Sachs & Co., 967 N.Y.S.2d 1, 4 (N.Y. App. Div. 2013). Similarly, the case brought in New York state court against UBS has also been dismissed. *See* HSH Nordbank, AG v. UBS AG, 941 N.Y.S.2d 59, 76 (N.Y. App. Div. 2012).

198. *See supra* Part III.B.1.

199. Dodona I, LLC. v. Goldman Sachs & Co., 847 F. Supp. 2d 624, 630 (S.D.N.Y. 2012). The United States District Court for the Southern District of New York denied Goldman's motion to dismiss the securities fraud claim, and the plaintiff is currently seeking class certification. *See id*. at 653; Amended Class Action Complaint for Violation of the Federal Securities Laws and New York Common Law, *Dodona I, LLC*, 847 F. Supp. 2d 624 (No. 10 Civ. 7497 (VM)).

200. *Id*. at 646.

201. The court rejected Goldman's argument that its conduct was "perfectly normal and unassailable under prevailing law and industry standards." *Id*. at 641. The court stated "[o]n a fair reading of Dodona's Complaint, if the facts alleged were borne out at a trial, Goldman's conduct, viewed charitably, could be found not only reckless, but bordering on cynical." *Id.*

202. *See id*. at 630.

203. *Id.* at 646.

204. *Id.*

so there was no trigger that would require Goldman to disclose its strategy to reduce its long position.[205] In other words, disclosure was not necessary to prevent any existing disclosures from becoming misleading. In addition, the court noted that the federal securities laws do not have an independent disclosure requirement that would require Goldman to disclose its strategy.[206] Because "silence, absent a duty to disclose," does not constitute fraud, the court dismissed this claim.[207]

The court allowed the plaintiff's second fraud claim to go forward, but characterized it as a "closer question."[208] Goldman argued that it would be improper to impose liability for an undisclosed belief or opinion about the future profitability of the notes.[209] However, the court interpreted the plaintiff's claim differently, concluding that "[c]ontrary to Defendants' contentions, the alleged omission is . . . more substantial than a failure to disclose 'mere disbelief' or 'opinions.'"[210] The court interpreted the plaintiff's claim as "an allegation that Defendants inaccurately represented the risk, of which they were actually aware, associated with investing in the Hudson [notes]."[211] The court pointed out that the offering materials included disclosures about the risks of investing in the synthetic CDO.[212] Therefore, Goldman was under a duty to be entirely accurate in its discussion of the risks.[213] As the court reasoned, "[g]iven Dodona's allegations that [Goldman] [was] aware of singularly prohibitive risks associated with the Hudson CDOs in particular, it follows that such boilerplate disclosures do not accurately represent [Goldman's] assessment of the risks."[214] Thus, the court ruled that the plaintiff had ade-

205. *Id.*
206. *Id.*
207. *Id.*
208. *Id.*
209. Citing the Supreme Court of the United States, Goldman argued that "to recognize liability on mere disbelief or undisclosed motive without any demonstration that the [offering documents] w[ere] false or misleading about [their] subject would authorize [securities] litigation confined solely to . . . the 'impurities' of a director's 'unclean heart.'" *See* Memorandum of Law in Support of Defendants Goldman Sachs & Co., The Goldman Sachs Group, Inc., Peter L. Ostrem and Darryl K. Herrick's Motion to Dismiss the Amended Complaint, at 18, *Dodona I, LLC,* 847 F. Supp. 2d 624 (No. 10 Civ. 7497 (VM)) (citing Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1096 (1991)).
210. *Dodona I, LLC*, 847 F. Supp.2d at 646.
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.* at 647. In addition, the court found that the plaintiff adequately pleaded loss

quately alleged a misleading statement in the offering materials.[215]

The court easily found the plaintiff adequately pleaded materiality.[216] It had more difficulty finding the plaintiff's complaint alleged reasonable reliance. Goldman pointed out that the plaintiff was a sophisticated speculator, whose hedge fund was "founded for the purpose of investing in high-risk mortgage related securities" and should not be allowed to claim it blindly relied on Goldman's disclosures.[217] Goldman argued that the offering materials contained extensive disclosures about the reference portfolio, which would allow a sophisticated investor such as the plaintiff to reach his own conclusion about the riskiness of the referenced securities.[218] Moreover, the plaintiff had access to publicly available information about the RMBSs named in the reference portfolio that would have enabled the plaintiff to understand the riskiness of the notes.[219] The court conceded that the sophistication of the plaintiff is a factor in determining reasonable reliance, however, "whether Dodona was sophisticated and whether it should have uncovered the alleged fraud at the time of the investment using public information are questions of fact."[220] The court decided that discovery was necessary to determine whether the plaintiff could show reasonable reliance, and therefore, allowed this claim to go forward.[221]

causation, rejecting Goldman's argument that the plaintiff's losses were due to the market downturn and not to any misleading statement. *Id.* at 649–50. The court also concluded that the plaintiff adequately pleaded scienter. *Id.* at 641–45.

215. *See id*. at 646.

216. *Id.* at 648.

217. *See* Memorandum of Law, *supra* note 209, at 1. Moreover, to invest in the Hudson synthetic CDO, the plaintiff had to represent that he was a "qualified institutional buyer" within the meaning of Rule 144A. *Dodona I, LLC*, 847 F. Supp. 2d at 646 n.12, 648–49. For more information on Rule 144A, see *supra* notes 47–49 and accompanying text.

218. *Dodona I, LLC*, 847 F. Supp. 2d at 648–49.

219. *Id.*

220. *Id.* at 649.

221. *Id*. at 649–50. While the court let the plaintiff's claim that Goldman made a misleading statement of material fact go forward, the court dismissed the claim that Goldman engaged in manipulative and deceptive conduct in violation of Rule 10b-5(a) and (c). *See id*. at 650–51. The plaintiff argued that the structuring and sale of the Hudson synthetic CDO—when Goldman knew that the synthetic CDO would likely fail—constituted manipulative conduct. *See id.* at 650. However, to prevail on a market manipulation claim, the plaintiff was required to allege an efficient market. *Id*. at 650–51. Because there was no efficient market for the notes, the court dismissed this claim. *See id*. at 651.

2. *HSH Nordbank v. UBS AG* (North Street Referenced Linked Notes, 2002-4 Limited Synthetic CDO)

In *HSH Nordbank v. UBS*, a German commercial bank that allegedly lost $500 million in a synthetic CDO sued UBS AG, alleging, *inter alia*, that UBS committed fraud under New York state law by misleading the plaintiff as to the riskiness of the notes.[222] The North Street Referenced Linked Notes, 2002-4 Limited Synthetic CDO was structured by UBS, which also selected the reference portfolio and took the entire short position in the transaction.[223] By agreement, UBS was required to select securities for the reference portfolio that had minimum credit ratings of BBB.[224] UBS complied with this requirement, but according to the plaintiff, UBS knew that the credit ratings assigned to the securities in the reference portfolio did not accurately reflect the risks of the securities.[225] Furthermore, the plaintiff alleged that UBS purposefully selected BBB rated securities for the portfolio that were actually more risky than their BBB ratings.[226] In other words, the plaintiff accused UBS of using "ratings arbitrage" to select the securities for the reference portfolio.[227] According to the plaintiff, UBS selected securities that "had the requisite credit rating, *but traded at wide spreads* (i.e., were higher risk) for that rating."[228] The plaintiff also noted that the spread "reflects the market's understanding, evidenced by the lower value of the security, of a deterioration in credit quality in advance of ratings agency downgrades."[229]

UBS moved to dismiss the fraud claim, arguing that the plaintiff could not show reasonable reliance.[230] UBS pointed out that,

222. HSH Nordbank AG v. UBS AG, 941 N.Y.S.2d 59, 61 (N.Y. App. Div. 2012). Although UBS's motion to dismiss the fraud claim was initially denied, the motion to dismiss was granted on appeal. HSH Nordbank, AG v. UBS AG, No. 600562/08, 2008 N.Y. Misc. LEXIS 10416, at *2, *4–5, *23 (N.Y. Sup. Ct. Oct. 29, 2008), *rev'd* by *HSH Nordbank*, 941 N.Y.S.2d at 61. The remaining contract claims were settled for an undisclosed amount. *See* Chris Dolmetsch, *HSH Nordbank Settles 2008 CDO Suit in N.Y. Against UBS*, BLOOMBERG (Mar. 11, 2013, 2:26 PM), *available at* http://www.bloomberg.com/news/2013-03-11/hsh-nordbank-settles-2008-cdo-suit-in-n-y-against-ubs.html.

223. *See HSH Nordbank*, 941 N.Y.S.2d at 62–63.

224. *See id*. at 62.

225. *See id*. at 64.

226. *Id*.

227. *Id*.

228. *Id*.

229. *See id*.

230. *Id*. at 64–65.

prior to investing in the synthetic CDO, the plaintiff had agreed that: (1) it was not relying on any advice of UBS to make its investment decision; (2) it had received advice from its own advisors; and (3) it made its investment decision based on its own judgment and advice from its own advisors, and not on any statements made by UBS.[231] The appellate court, in a unanimous opinion, affirmed the trial court's dismissal on the grounds that the plaintiff would be unable to show reasonable reliance as a matter of law.[232]

The court began its analysis with a review of New York's law on reasonable reliance. First, the court examined the effect of non-reliance clauses on the reasonable reliance element of fraud.[233] According to the court, because the plaintiff had disclaimed reliance on UBS's advice, it could not show justifiable reliance on UBS's statements about the risk of the reference portfolio.[234] According to the court, these disclaimers were not boilerplate because they covered the subject matter of the misrepresentation: the reliability of the credit ratings as indicators of risk of the notes.[235] Therefore, "[u]nder the disclaimers set forth in the extensively negotiated governing documents, . . . [the plaintiff] had no right to look to UBS for advice concerning the suitability of the deal."[236]

Throughout the opinion, the court stressed the importance of respecting the disclaimers of reliance, which the court noted came about following lengthy negotiations by two highly sophisticated, well-counseled, market participants. For example, according to the court:

> If we were to allow a fraud claim to go forward on this basis, it would render meaningless HSH's agreement that it was not relying on UBS for "any advice, counsel or representations (whether written or oral)" and had "consulted with its own . . . business, investment, financial, accounting and other advisers to the extent it . . . deemed necessary." Sustaining this claim would likewise nullify the offering circular's caution that HSH "must rely on [its] own examination of . . . the merits and risks involved." In effect, the message to the

231. *Id.* at 65 n.5.
232. *Id.* at 76.
233. *See id.* at 65.
234. *See id.*
235. *Id.* at 70–71.
236. *Id.* at 65.

> corporate and financial world would be that "it is impossible for two businessmen dealing at arm's length to agree that the buyer is not buying in reliance on any representations of the seller as to a particular fact." This is a message we decline to send.[237]

Second, the court stated that the plaintiff's claim of justifiable reliance failed because New York law requires sophisticated investors to protect themselves from fraud by conducting a reasonable investigation into the transaction, and the plaintiff had failed to meet its due diligence obligations.[238] The court set forth the law as follows:

> [i]f the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations.[239]

According to the court, the plaintiff's allegations of fraud related to the reliability of the credit ratings, and that information was not "peculiarly within UBS's knowledge."[240] On the contrary, the court noted that given the trading spreads the public market knew that the securities in the reference portfolio were riskier than the BBB credit rating.[241] The court stated that the imposition of a due diligence duty on a sophisticated purchaser "has particular application where, as here, the true nature of the risk being assumed could have been ascertained from reviewing market data or other publicly available information."[242] By failing to conduct its due diligence, the plaintiff could not show reasonable reliance.[243]

The plaintiff also argued that UBS had committed fraud because it told the plaintiff that UBS's interests were aligned with the plaintiff's interests when, in fact, UBS, as the short investor, had incentive to choose risky securities for the reference portfo-

237. *Id*. at 72 (emphasis omitted) (quoting Danaan Realty Corp. v. Harris, 157 N.E.2d 597, 600 (N.Y. 1959)).
238. *See id*. at 61.
239. *Id*. at 65–66 (quoting Centro Empresarial Cempresa S.A. v. Américo Móvil, S.A.B. de C.V., 952 N.E.2d 995, 1002 (N.Y. 2011)).
240. *See id*. at 70.
241. *Id*. at 64.
242. *Id.* at 66.
243. *See id*. at 69.

lio.[244] Once again, the court found that the plaintiff could not show reasonable reliance.[245] The court pointed to extensive disclosures in the offering documents that alerted the plaintiffs to UBS's conflicts of interest.[246] Thus, the court concluded that it was unreasonable as a matter of law for the plaintiff to rely on UBS's statements that its interests were aligned with the plaintiff's.[247] Moreover, according to the court, "[a]ny limitations on UBS's discretion in managing the reference pool or in its other trading activities that HSH expected to be observed should have been incorporated into the heavily negotiated transactional documents."[248]

3. ACA Financial Guaranty Corp. v. Goldman, Sachs & Co. (ABACUS Synthetic CDO)

In *ACA Financial Guaranty Corp. v. Goldman, Sachs & Co.*, ACA Financial Guaranty Corporation, a monoline insurance company that sold credit protection on the unfunded super senior tranche[249] of the ABACUS synthetic CDO previously discussed,[250] sued Goldman for common law fraud for $120 million.[251] According to the plaintiff, it was fraudulently induced to issue the protection by Goldman's statements that Paulson's hedge fund would be taking a long position by investing in equity, when it was actually taking a short position.[252] Goldman moved to dismiss, arguing, *inter alia*, that the plaintiff failed to adequately allege justifiable reliance.[253] The New York trial court denied Goldman's motion to dismiss, but the appellate court, in a 4-2 decision, re-

244. *Id.* at 72–73.

245. *Id.* at 73–74.

246. *Id.* at 73.

247. *Id.* at 73–74.

248. *Id.* at 74.

249. For more information on "super senior" tranches, see *supra* Part II.A.4.

250. *See supra* Part III.B.2. ACA Financial Guaranty Corporation was the parent company of ACA Management, LLC, the portfolio selection agent for the ABACUS synthetic CDO. *See* Complaint at 20, ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., No. 650027/11, 2012 N.Y. Misc. LEXIS 1940 (N.Y. Sup. Ct. Jan. 6, 2011) (No. 650027/11).

251. *ACA Fin. Guar. Corp.*, 2012 N.Y. Misc. LEXIS 1940, at *15. Although Goldman's motion to dismiss was initially denied, the motion to dismiss was granted by a divided appellate court. *Id.* at *42, *rev'd by* ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., 967 N.Y.S.2d 1 (N.Y. App. Div. 2013).

252. *See ACA Fin. Guar. Corp.*, 2012 N.Y. Misc. LEXIS 1940, at *14–15.

253. *Id.* at *22.

versed the trial court's determination.[254] The appellate court dismissed the plaintiff's fraud claim, holding that the plaintiff failed to show justifiable reliance as a matter of law.[255]

The appellate court's opinion emphasized the significance of the non-reliance clause.[256] The plaintiff acknowledged when it entered the transaction that its decision to sell credit protection was based on its own evaluation of the merits of the transaction, and not on any view, opinion, or representation expressed by Goldman, other than the information set forth in the final offering circular.[257] According to the court, the disclaimer barred the plaintiff's fraud claim because the plaintiff would be unable to show reasonable reliance.[258]

Moreover, the appellate court held that the plaintiff had not met its due diligence responsibilities.[259] According to the court, the plaintiff could have discovered Paulson's true role in the synthetic CDO, but "apparently chose not to."[260] The court stated that the offering circular revealed that there was no investor for the equity portion of the synthetic CDO.[261] That should have put the plaintiff on notice that Paulson was not a long investor, which in turn imposed a duty on the plaintiff to ask Goldman and Paulson about Paulson's involvement.[262] By failing to ask questions, the plaintiff could not be said to have reasonably relied on Goldman's statements. [263]

According to the appellate court, this outcome was especially

254. *Id*. at *42, *rev'd ACA Fin. Guar. Corp*. v. Goldman, Sachs & Co., 967 N.Y.S.2d 1 (N.Y. App. Div. 2013).

255. *ACA Fin. Guar. Corp*., 967 N.Y.S.2d at 4.

256. *See id*. For additional discussion of disclaimers and reasonable reliance, *see supra* Part IV.A.2.

257. *See id*.

258. *Id*. In addition, the appellate court concluded that New York's "special knowledge" exception to non-reliance clauses—which holds that disclaimers are not effective if the misleading statement relates to facts "peculiarly within the seller's knowledge"—did not apply because Goldman did not have special knowledge of Paulson's role in the structuring of the synthetic CDO. Goldman pointed out that the plaintiff interacted with Paulson throughout the structuring of ABACUS and had the opportunity to ask Paulson questions about its investment in the transaction, but chose not to do so. *Id*.

259. *See* id. at *3. For additional discussion of due diligence and reasonable reliance, *see supra* Part IV.A.2.

260. *Id*.

261. *Id*.

262. *Id*.

263. *See id*. at 4.

appropriate because the plaintiff, a sophisticated well-counseled entity, could have protected itself by including a "prophylactic provision" in the agreement to ensure against fraud. [264] In other words, according to the court, the sophisticated plaintiff should have done more to protect itself from possible fraud by the investment bank.

4. *China Development Industrial Bank v. Morgan Stanley & Co.* (Stack 2006-1 Synthetic CDO)

In *China Development Industrial Bank v. Morgan Stanley & Co.,* a Taiwanese commercial bank sued Morgan Stanley in New York state court, alleging that Morgan Stanley had fraudulently induced it to provide the credit protection on the super senior tranche of the $500 million Stack 2006-1 synthetic CDO.[265] The synthetic CDO had been structured and sold in 2006, with Morgan Stanley initially providing the super senior swap. [266] However, in early 2007, Morgan Stanley initiated discussions with the plaintiff to transfer its swap to the plaintiff, and, in April 2007, the plaintiff agreed to provide the credit protection on the super senior tranche. [267] According to the plaintiff, Morgan Stanley misled it into believing that the super senior tranche was almost risk-free and that the credit quality of the reference portfolio was good, when in fact, Morgan Stanley knew that the super senior tranche was a risky investment and the credit quality of the reference portfolio was deteriorating. [268] In particular, the plaintiff alleged that Morgan Stanley "corrupted" the ratings process by paying the credit rating agency much higher fees than are typical. [269]

Morgan Stanley moved to dismiss, arguing, *inter alia*, that the

264. *Id*. at 2–3.

265. China Dev. Indus. Bank v. Morgan Stanley & Co., No. 650957/2010, 2011 N.Y. Mis. LEXIS 1808, at *1–4 (N.Y. Sup. Ct. Feb. 25, 2011). The Supreme Court of New York denied Morgan Stanley's motion to dismiss, and this ruling was affirmed on appeal. *Id*. at *20, *aff'd by* China Dev. Indus. Bank v. Morgan Sanley & Co., 927 N.Y.S.2d 52 (2011). For additional discussion of this synthetic CDO, see Jesse Eisinger, *Explosive Charge: Morgan Stanley Peddled Security Its Own Employee Called "Nuclear Holocaust*," PROPUBLICA (Jan. 23, 2013, 1:00 PM) *available at* http://www.propublica.org/thetrade/item/explosive-charge-morgan-stanley-peddled-security-its-own-employee-called-nu.

266. *China Dev. Indus. Bank*, 2011 N.Y. Misc. LEXIS 1808, at *3–4.

267. *Id*.

268. *Id*. at *4.

269. *Id*. at *7.

plaintiff could not establish reasonable reliance because (1) the plaintiff had agreed to a non-reliance provision;[270] and (2) the plaintiff failed to meet its due diligence obligations.[271] However, the New York trial court denied the motion to dismiss, concluding that the special knowledge exception to the effectiveness of non-reliance clauses was applicable.[272] According to the court, the information about Morgan Stanley's corruption of the credit ratings process was peculiarly within Morgan Stanley's control.[273] This also meant that it could not have been discovered by the plaintiff through any due diligence investigation. Thus, the plaintiff would not be barred from establishing reasonable reliance. The appellate court affirmed.[274]

C. *SEC Enforcement Actions Brought Against Investment Banks*

The SEC has brought enforcement actions against three investment banks in connection with the sale of synthetic CDOs. All three have settled.

1. *SEC v. Goldman, Sachs & Co.* (ABACUS Synthetic CDO)

On April 16, 2010, the SEC brought an enforcement action against Goldman Sachs and one of its employees, Fabrice Tourre,

---

270. As part of the transfer of the super senior swap, the plaintiff agreed that:

> Non-Reliance. It is acting for its own account, and it has made its own independent decisions to enter into [the] Transaction and as to whether [the] Transaction is appropriate or proper for it is based upon its own judgment and upon advice from such advisers as it has deemed necessary. It is not relying on any communication (written or oral) of the other party as investment advice or as a recommendation to enter into [the] Transaction; it being understood that information and explanations related to the terms and conditions of a Transaction shall not be considered investment advice or a recommendation to enter into [the] Transaction. No communication (written or oral) received from the other party shall be deemed to be an assurance or guarantee as to the expected results of [the] Transaction; and
>
> Assessment and Understanding. It is capable of assessing the merits of and understanding (on its own behalf or through independent professional advice), and understands and accepts, the terms, conditions and risks of [the] Transaction. It is also capable of assuming, and assumes, the risks of [the] Transaction.

China Dev. Indus. Bank, 2011 N.Y. Misc. LEXIS 1808, at *11–12.

271. *Id.* at *13.

272. *Id.* at *14, *16.

273. *See id.* at *16.

274. China Dev. Indus. Bank v. Morgan Stanley & Co., 927 N.Y.S.2d 52, 53 (N.Y. App. Div. 2011).

relating to the ABACUS synthetic CDO.[275] According to the SEC, the defendants violated Section 17(a) of the Securities Act of 1933 as well as Rule 10b-5.[276]

The filing received substantial news coverage, in part because it was the first high profile enforcement action brought by the SEC following the financial crisis.[277] In addition, the circumstances surrounding the filing were controversial in several respects. First, the complaint was authorized by the SEC commissioners by a split vote, which is highly unusual.[278] Moreover, the split was along party lines.[279] Second, the filing apparently came as a complete surprise to Goldman.[280] Ordinarily, the SEC engages in settlement negotiations with potential defendants before filing complaints, so the SEC's departure from its standard practice in such a high profile case was curious.[281] And, finally, the timing of the filing was seen by some as suspicious, coming several hours before the release of a report from the SEC's Inspector General that was extremely critical of the SEC's response to a well-known Ponzi scheme.[282] Similarly, the SEC was criticized for timing the filing of the suit to influence the then-ongoing Senate debate on legislation that would eventually become the Dodd-Frank Act.[283]

Although Goldman initially stated that it would fight the enforcement action, on July 15, 2010, Goldman entered into a $550 million settlement with the SEC,[284] the result of another 3-2 split

275. Complaint at 1, SEC v. Goldman Sachs & Co., No. 10-CV-3229, 2010 U.S. Dist. LEXIS 119802 (S.D.N.Y. Apr. 16, 2010). For additional discussion of the ABACUS synthetic CDO, *see supra* Part III.B.2.

276. Complaint, *supra* note 275, at 3.

277. *See, e.g.*, Kara Scannell, *SEC Split on Goldman Case—3-2 Vote to Sue Could Politicize Landmark Action; Key Panel at Firm Gave OK to Deal*, WALL ST. J., Apr. 20, 2010, at A1.

278. *Id.*

279. The two Republican commissioners voted against the action, the two Democratic commissioners voted in favor of the action, and the SEC Chair, a registered Independent, cast the deciding vote in favor of filing the enforcement action. *Id.*

280. *Id.*; *see also* Monica Langley, et al., *SEC Chief's Big Bet on Goldman*, WALL ST. J., May 14, 2010, at A1.

281. *See* Brooke Masters, *SEC Engages In High Risk Game*, FIN. TIMES (Apr. 19, 2010, 10:37 PM), http://www.ft.com/intl/cms/s/0/b594015e-4bd4-11df-a217-00144feab49a.html.

282. *See id.*

283. *See* Cyrus Sanati, *Schapiro Hits Back at G.O.P. Critics of Goldman Case*, N.Y. TIMES DEALBOOK (Apr. 21, 2010, 6:14 PM) http://dealbook.nytimes.com/2010/04/21/schapiro-hits-back-at-g-o-p-critics-of-goldman-case/?_r=0.

284. Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO, SEC Litigation Release No. 21,592 (July 15, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21592.htm).

vote by the SEC commissioners.[285] The settlement was approved by Judge Barbara Jones of the Southern District of New York on July 20, 2010.[286]

The settlement is a mixed bag, and each side could conceivably claim victory. However, most commentators see the settlement as a win for Goldman.[287] First, in the settlement, the SEC abandoned its initial claim that Goldman violated Rule 10b-5, the general anti-fraud provision of the federal securities laws.[288] Instead, the SEC pursued a Section 17(a) claim, which—because it does not require proof of intentional misconduct—is seen as a lesser charge to Rule 10b-5.[289] The SEC's decision to give up the Rule 10b-5 claim could be viewed as a concession by the SEC that the fraud case against Goldman was not as strong as it initially believed.

The terms of the settlement did not require Goldman to admit guilt.[290] This is not unusual; until recently, allowing a defendant to state that it was neither admitting nor denying the allegations in the complaint was standard practice for the SEC. However, in this case, it is very clear that there were misleading statements of material fact in the offering materials. Rather than admitting that, Goldman was permitted to concede that the ABACUS offering materials contained "incomplete information."[291] Moreover, in its consent, Goldman stated that:

> it was a mistake for the Goldman marketing materials to state that the reference portfolio was "selected by" ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors. Goldman regrets that the marketing materials did

285. Kara Scannell & Susanne Craig, *SEC Split Over Goldman Deal*, WALL ST. J., July 17, 2010, at A1.

286. SEC v. Goldman, Sachs & Co., 2010 U.S. Dist. LEXIS 119802, at *13 (S.D.N.Y. July 20, 2010).

287. As two commentators noted, "[l]ike any settlement, each side appears to have given a little bit, although the Street consensus is that Goldman got off too easily." *See* Peter J. Henning & Steven M. Davidoff, *Weighing the Trade-Offs in the Goldman Settlement*, N.Y. TIMES DEALBOOK (July 16, 2010, 11:25 AM), http://dealbook.nytimes.com/2010/07/16/weighing-the-trade-offs-in-the-goldman-settlement/?pagewanted=print&_r=0.

288. *See* Consent of Defendant Goldman Sachs & Co., SEC v. Goldman, Sachs & Co. (S.D.N.Y. July 14, 2010).

289. *Id*. at 1. *Compare* 15 U.S.C. § 77q(2) (2012) (codifying section 17(2) claims) *with* 17 C.F.R. § 240.10b-5 (2013) (codifying Rule 100-5).

290. Consent of Defendant Goldman Sachs, & Co., *supra* note 288, at 1.

291. *Id*. at 2.

not contain that disclosure.[292]

This kind of concession and apology is unusual, and could be considered a win for the SEC. However, Goldman's acknowledgment of a "mistake" is much less harmful that an acknowledgment of fraud.

The SEC could also boast that the settlement included the largest penalty the SEC has ever obtained.[293] However, prior to the announcement of the settlement, many commentators had believed that Goldman would have to pay at least $1 billion in any settlement, so the $550 million payment was seen by many as a "steal."[294] Similarly, the SEC obtained only minor ancillary remedies from Goldman,[295] and did not obtain more serious undertakings from Goldman that would have impacted the management or governance of the investment bank. The lower-than-expected settlement amount, coupled with the minor ancillary remedies, was interpreted by some as additional evidence of the weakness of the SEC's case against Goldman.[296]

The SEC's case against Fabrice Tourre, the Goldman employee who was responsible for overseeing the ABACUS transaction, did not settle.[297] Following a trial, the jury found Mr. Tourre liable for six counts of fraud, leading some commentators to conclude that the SEC was too easy on Goldman.[298]

2. *SEC v. JP Morgan* (Squared CDO 2007-1 Synthetic CDO)

On June 21, 2011, the SEC filed a complaint against JP Morgan, and simultaneously entered into a $153.6 million settlement

292. *Id.*

293. *See* Susanne Craig & Kara Scannell, *Goldman Settles Its Battle with SEC*, WALL ST. J., July 16, 2010, at A1.

294. *Id.*

295. For example, the settlement required Goldman, for a period of three years, to (1) modify the process of how mortgage-related products were approved; (2) have all marketing materials for mortgage-related securities reviewed by Goldman's legal or compliance department; (3) have certain marketing materials reviewed by Goldman's outside counsel; and (4) train new employees working with mortgage-related securities in the appropriate parts of the federal securities laws. Consent of Defendant Goldman Sachs & Co., *supra* note 288, at 4–6.

296. *See, e.g.*, Scannell & Craig, *supra* note 285.

297. *See* Justin Baer, Chad Bray & Jean Eaglesham, *'Fab' Trader Liable in Fraud*, WALL ST. J., Aug. 2, 2013, at A1.

298. *Id.*

with JP Morgan,[299] relating to allegations of misconduct very similar to those found in the ABACUS synthetic CDO.[300] Specifically, the SEC alleged that JP Morgan structured and sold the $1.1 billion Squared CDO 2007-1 to investors without disclosing that a large hedge fund, Magnetar Capital LLC,[301] with interests adverse to the long investors, was involved in selecting the reference portfolio for the synthetic CDO.[302] The Squared offering materials stated that the reference portfolio would be selected by an independent entity, GSCP L.P., an investment advisor experienced in assessing credit risk, and did not reveal the significant participation of Magnetar.[303] Approximately $150 million of notes were sold to approximately fifteen institutional investors, who eventually lost their entire investment.[304] According to the SEC, JP Morgan violated Section 17(a)(2) and (3) of the Securities Act because it "negligently misrepresent[ed] a key deal term, namely, who selected the collateral."[305]

In the settlement, JP Morgan (1) stated that it was neither admitting nor denying the allegations of the complaint; (2) agreed

299. Complaint at 1, SEC v. JP Morgan Sec., LLC, (S.D.N.Y. June 21, 2011) (No. 11-Civ. 4206); *see* JP Morgan Securities to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market, SEC Litigation Release No. 22,008 (June 21, 2011), *available at* http://www.sec.gov/litigation/litreleases/2011/lr22008.html. At the same time, the SEC filed a complaint against an employee of the collateral agent, Edward S. Steffelin, alleging that he also committed fraud. *Id.*; James B. Stewart, *Another Fumble by the SEC on Fraud*, N.Y. TIMES, Nov. 17, 2012, at B1. Even after the SEC settled charges against JP Morgan, it continued the enforcement action against Mr. Steffelin. In 2012, the SEC dismissed all charges against Mr. Steffelin with prejudice. Stewart, *supra*.

300. *See supra* Part III.B.2. There are several differences between the ABACUS and Squared synthetic CDOs at issue in this case. For example, Magnetar, unlike Paulson in ABACUS, did take an equity position in the synthetic CDO. *See* Complaint, *supra* note 299, at 2. However, the $10 million in equity was much less than Magnetar's $600 million short position in Squared. *See id*. Therefore, even though it owned the equity, Magnetar had greater incentive to select risky mortgage-related securities for the reference portfolio. In addition, JP Morgan, unlike Goldman in ABACUS, retained the super senior tranche portion of the synthetic CDO. *See id*. at 1–3. Therefore, when the synthetic CDO crashed, JP Morgan reportedly lost approximately $900 million. *See id*. at 3.

301. Magnetar Capital has been the focus of a series of articles on the financial crisis published by ProPublica, the investigative journalism website. To learn more about Magnetar, see Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010, 12:00 PM), http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going.

302. *See* Complaint, *supra* note 299, at 2.

303. *Id*.

304. *Id*.

305. *Id*. at 3.

to a permanent injunction against violating Section 17(a)(2) and (3); (3) agreed to make a payment of $153.6 million, most of which was paid over to the fifteen investors who lost their investments in the Squared synthetic CDO; and (4) agreed to certain prophylactic actions intended to improve disclosure and compliance with the federal securities laws.[306] The settlement was approved by Judge Richard M. Berman of the Southern District of New York on June 29, 2011.[307]

Once again, the settlement could be seen as a win for the defendant, especially when compared to the Goldman settlement.[308] First, unlike the ABACUS transaction, the SEC never alleged that JP Morgan violated Rule 10b-5 or engaged in intentionally fraudulent conduct. Instead, the SEC limited its charge to Section 17(a). Moreover, JP Morgan did not have to make a statement of regret as Goldman was required to do in the ABACUS settlement. JP Morgan did have to agree to some undertakings similar to those made by Goldman, but, like the ABACUS settlement, these ancillary remedies are not burdensome.[309] Finally, the dollar amount of the settlement—far less than the $550 million paid by Goldman—does not seem to be particularly large for a global financial institution.[310]

3. *SEC v. Citigroup Global Markets, Inc.* (Class V Funding III Synthetic CDO)

On October 19, 2011, the SEC filed a complaint against Citigroup Global Markets ("Citigroup"), and simultaneously entered into a $285 million settlement with Citigroup,[311] that involved allegations of misconduct similar to those found in the

306. *See* Consent of Defendant JP Morgan Sec., LLC, SEC v. JP Morgan Sec., LLC, at 1–6 (S.D.N.Y June 21, 2011).

307. *See* Final Judgment as to Defendant JP Morgan Sec., LLC, SEC v. JP Morgan Sec. LLC (S.D.N.Y. June 29, 2011).

308. *See supra* Part IV.C.1.

309. *See supra* Part IV.C.1.

310. *See supra* note 284 and accompanying text.

311. Complaint, SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11 Civ. 7387); Memorandum by Plaintiff SEC in Support of Proposed Settlement, SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328 (No. 11 Civ. 7388) [hereinafter Proposed Settlement]. Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Company Profited From Proprietary Short Position Citigroup Employee Sued for His Role in Transaction, SEC Litigation Release 22,134, (Oct. 19, 2011) *available at* http://www.sec.gov/litigation/litreleases/2011/lr22134.htm.

Hudson synthetic CDO previously discussed.[312] Specifically, the SEC alleged that Citigroup failed to disclose to purchasers of notes in the Class V Funding III synthetic CDO that Citigroup played a significant role in selecting the mortgage-related securities for the reference portfolio and that they had a short position on the transaction.[313] The offering materials stated that the reference portfolio would be selected by Credit Suisse Alternative Capital, Inc., an investor advisor experienced in analyzing credit risk, and did not disclose Citigroup's role in the selection process.[314] When the synthetic CDO failed several months later, long investors lost several hundred million dollars, but Citigroup realized profits of approximately $160 million due to its short position on the synthetic CDO.[315]

The terms of the Citigroup settlement appear very similar to the terms of the JP Morgan settlement.[316] According to the proposed settlement, Citigroup would (1) neither admit nor deny the allegations of the complaint; (2) agree to a permanent injunction against future violations of Sections 17(a)(2) and (3) of the Securities Act of 1933; (3) agree to make a payment of $285 million, some of which could be paid over to the investors who lost their investments in the Class V Funding III synthetic CDO; and (4) agree to certain prophylactic actions intended to improve disclosure and compliance with the federal securities laws.[317]

In an extremely unusual move, the settlement was rejected by Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York.[318] According to the court, the settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest."[319] The court ordered the case to go to trial.[320] The SEC

312. *See supra* Part III.B.1.

313. Complaint, *supra* note 311, at 2. The SEC also sued a Citigroup employee for his role in structuring and marketing the Class V Funding III Synthetic CDO. *Id*. at 1. Following a jury trial, the Citigroup employee was found not liable on all claims. Brian Stoker Found Not Liable, SEC Litigation Release No. 22,541, (Nov. 21, 2012), *available at* http://www.sec.gov/liltigation/litreleases/2012/lr22541.htm.

314. Complaint, *supra* note 311, at 2.

315. *Id*. at 3.

316. *See supra* note 306 and accompanying text.

317. Proposed Settlement, *supra* note 311, at 3–4.

318. SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011).

319. *Id*. at 332. Following the order rejecting the settlement, the SEC and Citigroup moved for a stay of proceedings pending resolution of its appeal. The Second Circuit granted the stay. *See* SEC v. Citigroup Global Mkts. Inc., 673 F.3d 158, 169 (2d Cir. 2012).

320. *Citigroup Global Mkts. Inc*., 827 F. Supp. 2d at 335.

and Citigroup appealed the decision,[321] and in February 2013, the Second Circuit heard arguments on whether Judge Rakoff exceeded his authority by rejecting the settlement.[322] Until the Second Circuit issues its opinion, the trial will be stayed.[323]

V. SYNTHETIC CDOS POST-FINANCIAL CRISIS: CONFLICT OF INTEREST RULES

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") includes a provision that prohibits certain conflicts of interests in the creation of derivatives, including synthetic CDOs. [324]

A. *The Dodd-Frank Act's Conflict of Interest Prohibition*

The Dodd-Frank Act includes a provision regulating the creation of synthetic CDOs. According to Section 621(a):

> [a]n underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.[325]

By focusing on "material conflicts of interest," this provision is a direct response to claims that investment banks sold synthetic CDOs that were designed to fail, as well as claims that investment banks engaged in bad behavior that was unfair to their clients, such as shorting the synthetic CDO while at the same time promoting a long investment to their clients. In other words, the

321. *See* SEC's (1) Unopposed Emergency Motion to Stay the Proceedings Below Pending Appeal, or, in the Alternative, for a Temporary Stay, and (2) Unopposed Motion to Expedite the Appeal at 1, SEC v. Citigroup Global Mkts. Inc., 673 F.3d 158 (2d Cir. 2012) (No. 11-5227).

322. *See* Peter Lattman, *Judge's Rejection of Citigroup Deal Is Heard on Appeal*, N.Y. TIMES, Feb. 9, 2013, at B2.

323. *Citigroup Global Mkts., Inc.*, 673 F.3d at 169.

324. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 621, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 77z-2a(a) (2012).

325. *Id*. § 621(a).

statute's focus is on protecting long investors, the investors who purchased the synthetic CDO's notes.

The Dodd-Frank Act also creates three exceptions to this prohibition against conflicts of interest: (1) certain "risk-mitigating hedging activities;"[326] (2) certain liquidity commitments;[327] and (3) "bona fide market-making" in the security.[328]

While it set forth the broad contours of the prohibition, Congress did not provide much detail in Section 621. For example, Section 621 does not define "material conflict of interest," the most important term in the statute.[329] Nor does Section 621 set forth the limits of the statutory exceptions.[330] Rather, Congress delegated the specifics to the SEC, directing the SEC to issue rules enacting Section 621[331] and delaying the effectiveness of Section 621 until the SEC adopted those final rules.[332]

The SEC proposed the rules in September 2011.[333] However, even after extending the comment period twice, the SEC has yet to issue final rules under Section 621. Therefore, the prohibition on conflicts of interest is not yet effective. Although not final, the

---

326. The statute permits conflicts of interest if they are:

> risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement initial purchaser, or sponsorship.

Id. § 621(c)(1).

327. The statute permits conflicts of interest if they are "purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate of subsidiary of any such entity, to provide liquidity for the asset-backed security." *See id.* at § 621(c)(2)(A) (codified at Securities Act of 1933, 15 U.S.C. § 77z-2a(c)(2)(A) (2012)).

328. The statute permits conflicts of interest if they are "purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security." *Id.* § 621(c)(2)(B).

329. *See id.* § 621.

330. *See id.*

331. Congress directed the SEC to issue the rules within 270 days of the passage of the Dodd-Frank Act. *Id.* § 621(b). However, the SEC did not meet this deadline and the rules were proposed on September 28, 2011, more than a year after the passage of the Dodd-Frank Act on July 21, 2010. Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 34-65,355, 78 Fed. Reg. 60,320 (Sept. 2011) [hereinafter Proposing Release].

332. According to Section 621, the section "shall take effect on the effective date of final rules issued by the Commission under subsection(b)." § 621(b).

333. *See* Proposing Release, *supra* note 331.

proposed rules offer the best evidence of the SEC's likely approach, and so the following section provides a quick summary of the proposed rules and related Proposing Release.

B. *The SEC's Proposed Conflict of Interest Rules*

Proposed Rule 127B is the SEC's attempt to implement Section 621.[334] Somewhat surprisingly, the proposed rule does not provide any meaningful detail. Proposed Rule 127B essentially restates Section 621.[335] The details are provided in the thirty-one-page proposing release ("Proposing Release").[336] While the Proposing Release includes guidance and numerous examples of how the proposed rule would operate, it also includes 120 separate requests for comments or additional information, indicating, perhaps, SEC uncertainty in regulating conflicts of interests.[337]

---

334. *See id.* at 60,350.

335. Proposed Rule 127B states in its entirety:

> Rule 127B Conflicts of interest relating to certain securitizations.
>
> > (a) Unlawful activity. An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 . . . , which for the purposes of this rule shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security [or synthetic CDO], engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
> >
> > (b) Excepted activity. The following activities shall not be prohibited by paragraph (a) of this section:
> >
> > > (1) Risk-mitigating hedging activities. Risk-mitigating hedging activities in connection with positions or holdings arising out the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsorship associated with such positions or holdings; or
> > >
> > > (2) Liquidity commitment. Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security; or
> > >
> > > (3) Bona fide market-making. Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

Id.

336. *Id.*

337. *See, e.g.*, *id.*

a. Scope of Proposed Rule

According to the Proposing Release, in order for the proposed rule to apply, the transaction "must involve (1) [c]overed persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts and (5) a 'material conflict of interest.'"[338] The following is a short description of the scope of the proposed rule.

"Covered persons" are entities that "typically have substantial roles in the assembly, packaging and sale" of asset-backed securities and synthetic CDOs; that is, underwriters, placement agents, initial purchasers, and sponsors.[339] It is not clear whether collateral managers or portfolio selection agents would constitute "covered persons" under the proposed rule, and the SEC asked for guidance on whether they should be included.[340] In addition, it does not appear that hedge funds meet the definition of covered persons.

"Covered products" include asset-backed securities, defined under the federal securities laws, and synthetic CDOs.[341] Proposed Rule 127B does not define synthetic CDOs; according to the Proposing Release, it was unnecessary to do so because the "term is commonly used and understood by market participants."[342]

The "covered timeframe" of Proposed Rule 127B ends one year following the first sale of the synthetic CDO.[343] In other words, assuming the transaction is covered by the rule, the investment bank would not be able to engage in prohibited conduct for one year following the first sale of the notes.[344]

"Covered conflicts" mean conflicts that arise between a covered person and an investor in the synthetic CDO.[345] The Proposing Release expressly states that a covered conflict does not include any conflicts that are exclusively between covered persons or ex-

338. *Id.* at 60,325.
339. *See id.* at 60,325–26
340. *See id.*
341. An "asset-backed security" is a "fixed-income or other security collateralized by any type of self-liquidating financial asset . . . that allows the holder of the security to receive payments that depend primarily on cash flows from the asset. . . ." *Id.* at 60326 (quoting 15 U.S.C. § 79c(a)(70)(A) (2012)).
342. *Id.*
343. *See id.* at 60,327
344. *See id.*
345. *Id.* at 60,328.

clusively between investors.[346] This approach is consistent with congressional intent to protect the purchasers of the notes in the synthetic CDOs. The Proposing Release also provides two other carve-outs from the definition of "covered conflict."[347]

Finally, there must be a "material conflict of interest."[348] The SEC chose not to define the term "material conflict of interest" in its proposed rules.[349] According to the Proposing Release,

> any attempt to precisely define this term . . . might be both over— and under—inclusive in terms of identifying those types of material conflicts of interest . . . that Section 127B was intended to prohibit, especially given the complex and evolving nature of the securitization markets, the range of participants involved, and the various activities performed by those participants.[350]

Instead, the SEC provided interpretive guidance, setting forth a two-pronged test for material conflict of interest:

> Either:
>
> > (A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (1) Adverse performance of the asset pool supporting or referenced by the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS, or (3) decline in the market value of the relevant ABS (where these are discussed below, any such transaction will be referred to as a "short transaction"); or
> >
> > (B) a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underling the ABS, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above; and
>
> (2) there is a "substantial likelihood" that a "reasonable" investor would consider the conflict important to his or her investment deci-

346. *Id*.

347. The two other carve-outs are if the conflict (1) did not arise as a result of or in connection with the related ABS transaction; or (2) did not arise as a result of or in connection with "engaging in a transaction," such as taking the short side on a transaction or choosing the reference portfolio in a synthetic CDO. *Id*.

348. *Id*. at 60,325.

349. *Id*. at 60,329.

350. *Id*.

sion (including a decision to retain the security or not).[351]

Note that the first part of the two part test does not require that the synthetic CDO be designed to fail for the conduct to be a material conflict of interest.[352] Instead, the guidance focuses on whether the securitization participant would benefit from the transaction, not the intent of the securitization participant.[353]

For the second part of the test, the guidance indicates that the SEC is drawing from the definition of materiality found in the federal securities laws.[354] That definition is based in part on an understanding that materiality is contextual in nature.[355] That would mean, for example, that the materiality determination of a conflict of interest would not be made in isolation, but would be made after reviewing the marketing materials and all other information known to reasonable investors. However, the guidance states that the use of the materiality definition "is not intended to suggest that a transaction otherwise prohibited under the proposed rule would be permitted if there were adequate disclosure by the securitization participant."[356] This language could be interpreted to mean that investors would be unable to waive conflicts of interests under Proposed Rule 127B. The Proposing Release seeks comment regarding the effect of conflict of interest disclosures on the definition of materiality.[357]

b. Statutory Exceptions

The Proposed Rule includes the same three exceptions set forth

351. *Id.*

352. *Id.* at 60,330 (stating that "[i]t would not be necessary for a securitization participant to *intentionally* design an ABS to fail or default in order to trigger the rule's prohibition.").

353. *Id.*

354. *Id.* at 60,332. The test for materiality is whether there is a substantial likelihood that a reasonable investor would consider [the information] important in deciding how to act. *Compare id.* (stating that, generally the proposed interpretation of materiality is "whether there is a substantial liklihood that a reasonable investor would consider the issue important to his or her investment decision"), *with* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 499 (1976) (stating that "an omitted fact is material if there is a substantial liklihood that a reasonable shareholder would consider it important in deciding how to vote").

355. *See* Proposing Release, *supra* note 331, at 60,331–32.

356. *Id.* at 60,332.

357. For example, the Proposing Release requests "comment as to whether and to what extent adequate disclosure of a material conflict of interest should affect the treatment under the proposed rule of an otherwise prohibited transaction." *Id.*

in the Dodd-Frank Act.[358] One of them—the risk-mitigating hedging activities exception—is of particular importance to synthetic CDOs. The "risk-mitigating hedging activities" exception[359] is intended to permit securitization participants to engage in hedging activities to reduce risk from a position arising out of the creation of the synthetic CDO. Hedging will be permitted to avoid a loss, but not to earn a profit.[360] According to the Proposing Release, the exception is "not intended to permit speculative trading masked as risk-mitigating hedging activities."[361] Of course, it will often be difficult to ascertain whether an investment bank's activities constitute permitted hedging or prohibited speculation.

C. *Assessment of the Proposed Conflict of Interest Rules and Synthetic CDOs*

The proposed conflict of interest rules, if adopted, would seem to prohibit the most notorious examples of bad behavior by investment banks in selling synthetic CDOs.[362]

For example, the conflict of interest rules would prohibit an investment bank from betting against its client in a synthetic CDO, at least when it does not have any exposure to the synthetic CDO or the assets in the reference portfolio.[363] According to the Proposing Release, by entering into the credit default swap, the investment bank would be engaging in a material conflict of interest to the detriment of the long investors.[364] However, if the investment bank contemporaneously entered into an off-setting credit default swap transaction with a third party, this transaction would fall

358. *Id*. at 60,333.

359. Proposed Rule 127B(b)(1) permits:

> Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings.

Id. at 60,350.

360. *See id*. at 60,334.

361. *Id*.

362. The general conflict of interest rules appear to bar the kinds of misconduct seen in the ABACUS and Hudson synthetic CDOs. However, the general rules are subject to several exceptions that might permit the conflict of interest. Thus, whether or not the investment bank could engage in the conduct depends upon the actual facts of the transaction.

363. *See* Proposing Release, *supra* note 331, at 60,338.

364. *See id*.

within the "risk-mitigating hedging activity" exception to the conflict of interest rules.[365] The Proposing Release makes clear that the exception would not be available if the investment bank or the third party selected the securities for the reference portfolio.[366] In other words, the conflicts of interest rules would have prevented Goldman from taking the short position in the ABACUS synthetic CDO discussed above.[367]

The conflict of interest rules would also prohibit an investment bank from going short in a synthetic CDO to reduce its long exposure to the reference portfolio. According to the Proposing Release, this balance sheet synthetic CDO would also violate the rules.[368] Because the investment bank would benefit from a decline in the value of the assets in the reference portfolio, by entering into the credit default swap, the investment bank would be engaging in a material conflict of interest.[369] Moreover, according to the SEC, this kind of transaction would not fall under the "risk-mitigating hedging activity" exception because the hedge was for an existing long position, rather than for a long position created by its underwriting activities.[370] Thus, the conflict of interest rules would have prevented Goldman's short in the Hudson synthetic CDO discussed above.[371]

In addition, the conflict of interest rules would prohibit an investment bank from permitting a short investor to select the reference portfolio.[372] Thus, the conflict of interest rules would have prevented Paulson's participation in the selection of the portfolio in the ABACUS synthetic CDO previously discussed.[373]

VI. ADDITIONAL REGULATION OF SYNTHETIC CDOS IS NECESSARY

Following the financial crisis, synthetic CDOs became famous because of the highly publicized bad behavior of investment

365. *See id.*
366. *See id.*
367. *See supra* Part III.B.2.
368. Proposing Release, *supra* note 331, at 60,347.
369. *See id.* at 60,329.
370. *Id.* at 60,338.
371. *See supra* Part III.B.1.
372. *See* Proposing Release, *supra* note 331, at 60,338.
373. *See supra* Part III.B.2.

banks.[374] This attention has led to fraud actions against several investment banks and proposed conflict of interest rules governing the sale of synthetic CDOs.[375] The emphasis on penalizing and preventing investment bank misconduct is unfortunate because it has taken attention away from the real problem: the synthetic CDO itself. This section argues for increased regulation of synthetic CDOs to address the inherent dangers of spreading risk throughout the financial system. First, focusing on fraud in the sale of synthetic CDOs is the wrong approach. Second, the proposed conflict of interest rules do not go far enough to address the dangers of synthetic CDOs. Finally, this section concludes by urging regulators to give serious consideration to banning the sale of all synthetic CDOs.

A. *Relying on Antifraud Provisions to Adequately Regulate the Sale of Synthetic CDOs Is the Wrong Approach*

1. In General, Investors in Synthetic CDOs Were Not Defrauded

Following the financial crisis, the conventional wisdom has been that investment banks defrauded their clients when they structured and sold synthetic CDOs.[376] There is no doubt that several investment banks engaged in bad behavior and treated long investors unfairly. But can it really be said that these long investors of synthetic CDOs were defrauded within the meaning of the securities laws? In general, the answer is no.

As the previous discussion of synthetic CDO litigation has shown, plaintiffs have generally not been successful in fraud actions against the investment banks.[377] A review of these cases shows that there are two particular obstacles. First, the long investor may not be able to show that the investment bank made a false or misleading statement of material fact. Second, even if the long investor is able to show that the investment bank made a false or misleading statement of material fact, the long investor

374. *See, e.g.*, Stephanie Tsao, *Developments in Banking and Financial Law: 2007–2008: VII. Managing Investment Banks During the Mortgage Crisis*, 27 REV. BANKING & FIN. L. 323, 325 (2008) ("Despite the mounting warning signs, investment banks continued to underwrite risky mortgage-based securities backed by subprime loans.").

375. *See supra* Part IV.

376. Tsao, *supra* note 374, at 325.

377. *See supra* Part IV.B.

will often not be able to show that it reasonably relied on the false or misleading statement.

Certainly, in some synthetic CDOs, the investment banks made false or misleading statements of material fact. For example, the ABACUS marketing materials falsely stated that the reference portfolio was selected by a portfolio manager, when it was in fact selected, at least in part, by Paulson, the short investor.[378] However, in other cases, it might be difficult for the plaintiff to show fraud because (1) the investment bank actually disclosed the information; (2) the investment bank did not have a duty to disclose the information; or (3) the investment bank's undisclosed belief in the quality (or lack of quality) of the security is non-actionable.[379]

It is a widely accepted belief that investment banks lied about the synthetic CDOs to their clients.[380] However, at least in some of the synthetic CDOs discussed, the investment banks actually disclosed their bad behavior in the marketing materials.[381] For example, in the Hudson synthetic CDO, Goldman disclosed that it was taking the entire short position, that Goldman was selecting the reference portfolio, and that the reference portfolio consisted almost entirely of poorly rated RMBSs.[382] Goldman's behavior in pushing a deal to long investors while at the same time betting against the transaction can be seen as unfair to its clients, but so long as Goldman made full disclosure, there is no fraud.[383]

On the other hand, the plaintiff may argue that the investment bank committed fraud because it did not fully disclose certain material information. For the plaintiff to recover, it will have to show that there was a duty to disclose, which may not always be easy to do. For example, in the *Dodona I, LLC v. Goldman Sachs*

378. *See supra* Part III.B.2.

379. *See supra*

380. *See* Tsao, *supra* note 374, *see, e.g.*, Robert Schmidt, Clea Benson & Phil Mattingly, *Goldman Sachs Mislead Congress After Duping clients Over CDOs, Levin Says*, BLOOMBERG (Apr. 14, 2011), http://www.bloomberg.com/news/print/2011-04-14/goldman-sachs-misled-congress-after-duping-clients-over-cdos-levin-says.html.

381. *See supra* Part IV.B.1.

382. *See supra* Part IV.B.1.

383. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977) ("[T]he Court repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.").

case, the court found that Goldman did not have a duty to disclose its strategy to reduce its long exposure in mortgage-related securities.[384] To many, this may be seen as a surprising result because this is certainly information that long investors would want to know before investing in the synthetic CDO. However, just because information is material does not mean it must be disclosed. There must be an independent duty to disclose, which the court did not find in this case. More broadly, while a fiduciary duty owed to the long investors would be sufficient to establish a duty to disclose, the investment banks did not owe a fiduciary duty to their clients. And, in any case, the long investors in synthetic CDOs disclaimed the existence of fiduciary duties.

Some long investors have also argued that investment banks committed fraud when they sold synthetic CDO notes that the investment banks "knew" were very likely to default. Can an investment bank be liable for its undisclosed opinion about the quality of the securities it is marketing? *Dodona I, LLC* appears to say yes, but a closer reading of the case indicates that the court actually sidestepped the question.[385]

The *Dodona I, LLC* court's hesitancy to judicially impose a general duty on investment banks to disclose their beliefs about the quality of the securities they are marketing is understandable. Courts have been confronted with a similar argument in a different context, but refused to impose a duty. In the past, plaintiffs have argued that Rule 10b-5 requires companies to disclose forward-looking statements or issue projections.[386] These claims are based on the rule that a corporation, once it makes disclosure, must be completely accurate in its disclosure.[387] So it could be argued, for example, that a company that discloses its operating results, knowing that its results are likely to be worse in the future, must disclose its projections at the same time—in order to avoid making a misleading statement of material fact in violation of Rule 10b-5.[388] The courts, however, have not embraced this argument. The courts have not wanted to turn Rule 10b-5, a fraud

384. 847 F. Supp. 2d 624, 646.
385. *See supra* Part IV.B.1.
386. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 287, 291–92 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1982).
387. *See id.* at 292.
388. *See id.* at 289, 291–92.

provision, into a disclosure provision.[389] According to the courts, if Congress (or the SEC) wants to expand the line item disclosure requirements of the federal securities laws to include the issuance of projections, it knows how to do so.[390] For the same reasons, courts would be hesitant to impose a duty on investment banks to issue statements of opinion when marketing synthetic CDOs.

Moreover, if courts were to impose such a duty on investment banks, it would be difficult to limit its application to the facts of synthetic CDOs. Would a company selling securities in a public offering have to disclose its opinion on the quality of the common stock? Such a result seems especially wrong, given that the philosophy underlying the Securities Act of 1933 is one of disclosure, and not one of merit review. So long as the investor has sufficient information to form an opinion about the quality of the securities, the goals of the federal securities laws has been met.

Finally, permitting plaintiffs to make arguments that an investment bank committed fraud by failing to disclose its opinion about the quality of the investment would seem to run afoul of the Supreme Court's reasoning in *Virginia Bankshares, Inc. v. Sandberg*.[391] In *Virginia Bankshares*, bank shareholders were asked to approve a merger.[392] The bank's board of directors stated in the proxy materials that it approved the merger "because it provides an opportunity for the Bank's public shareholder to achieve a high value for their shares."[393] According to the plaintiff, the real reason the board members approved the merger was to retain their seats on the board.[394] The plaintiff sued for fraud, arguing that the statement of opinion was actionable because the board did not actually believe what it said.[395] The court held that statements of opinion or belief could be actionable under the federal securities laws, but only if the plaintiff could show that both (1) the speaker did not actually believe the expressed opinion; and (2) the subject matter underlying the opinion is false.[396] In

389. *See id.*
390. Walker v. Action Indus., Inc., 802 F.2d 703, 709 (4th Cir. 1986).
391. 501 U.S. 1083 (1991).
392. *Id.* at 1088.
393. *Id.* at 1090.
394. *Id.* at 1088–89.
395. *Id.*
396. *Id.* at 1096.

other words, if the merger consideration really was "high," but the board did not believe it, the plaintiff would not be able to recover.

The holding was primarily based on the United States Supreme Court's concern for the dangers of "vexatious litigation," as expressed in its earlier case of *Blue Chip Stamps v. Manor Drug Stores*, that could arise if plaintiffs were permitted to sue for the mere subjective disbelief of a stated belief or opinion, standing alone.[397] The Court reasoned that "to recognize liability on mere disbelief or undisclosed motive without any demonstration that the proxy statement was false or misleading about its subject would authorize . . . litigation confined solely to what one skeptical court spoke of as the 'impurities' of a director's 'unclean heart.'"[398] The court concluded that "the temptation to rest an otherwise nonexistent [fraud] action on psychological enquiry alone would threaten just the sort of strike suits and attrition by discovery that *Blue Chip Stamps* sought to discourage."[399] Allowing plaintiffs to sue investment banks for selling synthetic CDOs that they allegedly "knew" would fail raises the very same concerns expressed in *Virginia Bankshares*.

Even if long investors are successful in showing a false or misleading statement of material fact, it will often be difficult for the plaintiffs to show that they reasonably relied on the fraud. In the above discussion of synthetic CDO cases, several courts—especially New York state courts—did not seem readily disposed to accept arguments that the sophisticated long investors had been defrauded.[400] The long investors of synthetic CDOs were large institutional investors, such as banks, pension funds, hedge funds, and insurance companies, all of whom were sophisticated market participants. The sales of the notes were heavily negotiated with the purchasers typically represented by pre-eminent corporate law firms. As part of these private transactions, the purchasers typically disclaimed reliance on statements not appearing in the final offering circular or provided "big boy" letters, indicating that they were able to make investment decisions on

397. *Id*. at 1092 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 743 (1975)).

398. *Id*. at 1096 (quoting Stedman v. Storer, 306 F. Supp. 881, 887 (S.D.N.Y. 1969)).

399. *Id*.

400. *See supra* Part V.B.

their own, without the advice of the investment banks. As previously shown, the combination of these factors substantially undercuts most claims that long investors were defrauded by the investment banks.

2. SEC Enforcement Actions Will Not Deter Misconduct by Investment Banks.

The SEC may be more successful in its enforcement actions than private plaintiffs because the SEC is not required to show reasonable reliance.[401] However, it can legitimately be asked why the SEC should expend scarce enforcement resources to bring actions to recover losses[402] for the benefit of sophisticated institutional investors who chose to invest in complicated derivatives in the hopes of receiving high returns. The SEC prides itself on being the "investor's advocate," but it is hard to understand why the banks, pension funds, and insurance companies who invested in synthetic CDOs need the SEC to be their advocate.

The SEC may argue that the reason for bringing the enforcement actions against investment banks was to deter fraud, not to compensate the long investors in the synthetic CDOs. However, that argument is a weak one.[403] The fines paid by investment banks could not possibly be seen by any of the investment banks as significant deterrents. After all, although $550 million—the

401. Nor does the SEC need to show scienter, loss caution, or damages. *See supra* Part IV.A.3.

402. Under the "Fair Funds" provision of the Dodd-Frank Act, the SEC is authorized to distribute any civil penalties it obtained from defendants to the victims of the fraud. *See* 15 U.S.C. § 7246(a) (2006 & Supp. 2011). The SEC distributed the civil penalties it received in the settlements with Goldman Sachs, JP Morgan, and Citigroup to the investors in the synthetic CDOs. *See* David S. Hilzenrath, *Citigroup Has Agreed to Pay $285M to Investors In Negligence Suit, SEC Says*, WASH. POST (Oct. 19, 2011) http://articles.washingtonpost.com/2011-10-19/business/35280755_1_Citigroup-employee-citigroup-unit-fraser-hunter; Jonathan Stempel, *UBS to Pay $49.8 Million to Settle SEC Fraud Charges over CDO*, REUTERS, Aug. 6, 2013, http://www.reuters.com/article/2013/08/06/us-ubs-sec-settlement-itusSRE9750TS20130806.

403. Similarly, private fraud actions would seem to have limited deterrence value because investment banks will often be able to use the element of reasonable or justifiable reliance to defeat private anti-fraud claims. *See* Amgen, Inc. v. Conn. Ret. Plans and Trust Funds, 568 U.S. ___, 133 S. Ct. 1184, 1191–93 (2013) (citing Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. ___, ___, 131 S. Ct. 1309, 1317 (2011)); Basic, Inc. v. Levinson, 485 U.S. 224, 245 (1988) (explaining that reliance is an essential element of a private securities fraud action but also noting that it is possible for Rule 106-5 plaintiffs to establish a rebuttable presumption of reliance based on material misrepresentations made to the general public).

settlement paid by Goldman in connection with the ABACUS synthetic CDO—is certainly an enormous amount of money on an absolute basis, Goldman had revenues of $39.16 billion in 2010 (the year it entered into the settlement) and earnings of $8.35 billion in 2010.[404] To large investment banks, these SEC fines would be a drop in the bucket. Similarly, the ancillary remedies imposed by the SEC are not so burdensome as to be avoided by investment banks. The fines and any prophylactic remedies will be viewed as just another cost of doing business by investment banks.

Similarly, SEC enforcement actions against individuals would not be likely to deter fraud by investment bank employees. In the two of the three enforcement actions brought against investment banks for the sale of synthetic CDOs, the SEC also sued a mid-level investment bank employee. In the *Citigroup* case, following a trial, the Citigroup employee was found not liable on all claims.[405] In the *Goldman* case, following a trial, the Goldman employee was found liable on six claims.[406] However, because Goldman paid for Mr. Tourre's legal representation and will presumably pay any fines assessed against Mr. Tourre, it is difficult to see the deterrence value.[407] Moreover, if the SEC truly wanted to send a message that would deter fraud, it would bring enforcement actions against high-level management of the investment banks, not mid-level employees.

404. *Compare* Press Release, The Goldman Sachs Group, Inc., Goldman Sachs Reports Earnings Per Common Share of $13.18 for 2010 (Jan. 19, 2011), *available at* http://www.goldmansachs.com/media-relations/press-releases/current/pdfs/2010/q4-earnings.pdf, *with* Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* www.sec.gov/news/press/2010/-123.html.

405. Judgment, S.E.C. v. Stoker, 11 Civ. 7388(JSR), (S.D.N.Y. Aug. 3, 2012); Brian Stoker Found Not Liable, SEC Litigation Release No. 22,541 (Nov. 2, 2012), *available at* www.sec.gov/litigation/;itreleases/2012/lr22541.htm; *see also* Chat Bray, Jury Finds Ex-Citigroup Employee Not Liable of Negligence, FIN. NEWS (Aug. 1, 2012), http://www.efinancialnews.com/story/2012-08-01/citigroup-brian-stoker-not-guilty?ea9c8a2deoee11104560l abo426736 22.

406. Verdict, S.E.C. v. Tourre, 10 Civ. 3229, (S.D.N.Y. Aug. 1, 2013); Andrew Ross Sorkin, *Wall St. Debates Who Should Pay Legal Bills*, N.Y. TIMES DEALBOOK (Aug. 12, 2013), http://dealbook.nytimes.com/2013/08/12/wall-st-debates-who-should-pay-legal-bills/?_r=0.

407. *Id.*

3. Even Fraud-Free Sales of Synthetic CDOs Could Harm the Economy

Relying on the antifraud provisions to regulate the sales of synthetic CDOs is misplaced for an even more important reason. The real danger of a synthetic CDO is the possibility that risk can be spread without limitation through the global economy. Therefore, the sale of a synthetic CDO in a completely fraud-free transaction—one where a large, sophisticated, and well-counseled institutional investor receives all the information it needs to make an informed investment decision—is just as dangerous to the economy as a sale in a fraudulent transaction.

B. *The Proposed Conflict of Interest Rules Do Not Go Far Enough to Address the Dangers of Synthetic CDOs*

The proposed conflict of interest rules were a direct response to concerns that the purchasers of notes in synthetic CDOs had been harmed as a result of bad conduct by investment banks.[408] When adopted, the proposed rules will do what they were supposed to do: reduce the conflicts of interest that harmed those long investors.[409] However, by focusing on conflicts of interest, Congress missed the opportunity to address the real threat of synthetic CDOs: that the sale of synthetic CDOs spreads risk in dangerous ways, possibly leading to another financial crisis.

If the proposed rules could stop synthetic CDOs from spreading risks throughout the financial system, there would be no need for further regulation. But the proposed rules do not prohibit investment banks from selling synthetic CDOs; they merely prohibit investment banks from selling synthetic CDOs if the investment bank would benefit from an adverse performance of the securities in the reference portfolio.[410]

It is true that the proposed rules will curtail the sale of some synthetic CDOs. Specifically, as previously discussed,[411] balance sheet synthetic CDOs will essentially be prohibited if the pro-

408. *See infra* Part III.A.

409. *See supra* Part III.B.; *see also*, *e.g.*, 156 CONG. REC. S4110 (daily ed. May 24, 2010) (statement of Sen. Levin).

410. *See supra* Part V.B.

411. *See supra* Part V.C.

posed rules become effective. However, under the proposed rules, an investment bank can structure, sell, and take a long position in the same synthetic CDO.[412] An investment bank can even take a short position in a synthetic CDO, as long as the investment bank is not also one of the securitization participants. And an investment bank can structure and sell a synthetic CDO without taking either a long or short position in the transaction. And it is likely that the SEC will eventually permit long investors to waive certain conflicts of interests.[413] Thus, the proposed conflict of interest rules, when they become effective, will still permit the sales of many types of synthetic CDOs that could harm the financial system.

C. *Regulation of Synthetic CDOs Should Focus on the Harm to the Economy, Not Harm to Investors*

Synthetic CDOs present a unique danger to the economy. Regulating synthetic CDOs by focusing on investment bank misconduct or harm to investors does not sufficiently protect the economy. Therefore, regulators need to revisit the regulation of synthetic CDOs and focus on what really matters: the potential harm to the economy.

A good start would be for Congress to initiate a study of synthetic CDOs or demand the prompt completion of the long-overdue[414] report required by Section 620 of the Dodd-Frank Act,

412. The SEC states that "[n]othing in the proposed interpretation would prevent a securitization participant from taking positions in which its economic interests would be aligned with the investors in the [notes] it has created and sold—such as by purchasing the [notes]." *See* Proposing Release, *supra* note 331, at 60,330.

413. The Proposing Release expressly asks for guidance as to "whether certain types of conflicts relating to an investor could be managed through disclosure." *See id.* at 60,343. Although the senators who were the driving force behind Section 621 of the Dodd-Frank Act have stated that disclosures should not be able to cure conflicts of interest, it seems probable that the SEC will allow waivers in certain circumstances. *See* Letter from Jeff Merkley & Carl Levin, U.S. Senators to Elizabeth M. Murphy, SEC (Jan. 12, 2012) *available at* www.knowledgementac.com/gateway/DoddfrankComments/SEC_S73811-15.pdf. As the SEC recognized, the federal securities laws already permit conflicts of interest to be managed through disclosure in some circumstances. *See* Proposing Release, *supra* note 331, at 60,343. Moreover, full disclosure, followed by the approval of the beneficiaries of the duty, has been accepted in other areas of law as a way to cleanse conflicts of interest. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (Repl. Vol. 2011 & Cum. Supp. 2012) (managing self-dealing transactions by a member of a corporation's board of directors through disclosure and approval); UNIF. P'SHIP CODE § 103(b)(3) (1997) (permitting certain aspects of the duty of loyalty to be varied by partners by agreement).

414. The Section 620 study was due January 21, 2012 (not later than 18 months after

which requires a study of bank investment activities.[415] As part of the study, the appropriate federal banking agency will be assessing

> (1) [W]hether each activity or investment has or could have a negative effect on the safety and soundness of the banking entity or the United States financial system; (2) the appropriateness of the conduct of each activity or type of investment by banking entities; and (3) additional restrictions as may be necessary to address risks to safety and soundness arising from the activities or types of investments described in subsection (a).[416]

Presumably, this report will study the sale of synthetic CDOs. In its report on the financial crisis, the U.S. Senate Permanent Subcommittee on Investigations recommended that the Section 620 study "consider the role of federally insured banks in designing, marketing, and investing in . . . synthetic financial instruments."[417]

Once the report has been submitted, regulators will be able to weigh the dangers of synthetic CDOs against the benefits. As previously discussed,[418] the benefits of synthetic CDOs appear to be slim. The primary benefit offered by synthetic CDOs is risk management. However, the same risk management could be achieved through non-synthetic transactions. For example, if a bank wanted to transfer the risk of certain assets, a cash CDO, rather than a synthetic CDO, could be used. The cash CDO is much safer to the financial system because it does not allow the unlimited spread of risk. Because the potential dangers of synthetic CDOs are so extraordinary, unless the benefits of synthetic CDOs can be shown to be equally extraordinary, regulators should give serious consideration to banning the sale of all synthetic CDOs.

---

the enactment of the Dodd-Frank Act). Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 620(a)(1), 124 Stat. 1376 (2010).

415. According to Section 620, the appropriate banking agencies are required to review and consider:

"(A) the type of activities or investments;

(B) any financial, operational, managerial, or reputation risks associated with or presented as a result of the banking entity engaged in the activity or making the investment; and

(C) risk mitigation activities undertaken by the banking entity with regard to the risks." *Id.*

416. *Id*. § 620(a)(2).

417. *See* SENATE STAFF REPORT, *supra* note 3, at 639.

418. *See supra* Part II.B.

VII. CONCLUSION

Investment banks exhibited extraordinary greed and sometimes outrageous misconduct in the sale of synthetic CDOs. It is understandable that regulators focused on this bad behavior. However, it was not the bad behavior that furthered the financial crisis; it was the use of the synthetic CDO itself. Because the regulators focused on wrong problem, the dangers caused by synthetic CDOs still exist. Synthetic CDOs are dangerous to the economy whether or not an investment bank defrauds its clients. The danger is present regardless of whether an investment bank engages in a material conflict of interest or not. The danger exists even if sales are made in heavily-negotiated transactions with sophisticated investors who have access to all the information they need to make an informed investment decision. Given the obvious dangers inherent in the sale of synthetic CDOs, unless a compelling argument can be made that synthetic CDOs somehow provide extraordinary benefits that exceed those dangers, regulators should consider banning the use of synthetic CDOs.