March 8, 2012

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

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FITTING AN OLD TIGER WITH NEW TEETH:

PROTECTING PUBLIC EMPLOYEE FUNDS INVESTING IN

COMPLEX FINANCIAL INSTRUMENTS

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Introduction

The financial panic that began almost invisibly late in 2006 spread, like a growing epidemic, from largely unregulated organizations such as hedge funds to supposedly regulated institutions such as securities dealers and banks. It has now spread beyond that circle to strike at sovereign nations and, within the United States, at institutions deeply embedded in the fabric of society such as employee benefit funds. An important threat to benefit funds is similar in nature to that suffered by other financial institutions: during the years preceding the crisis, they invested heavily in complex financial instruments that they did not understand, and which, when the crisis hit, proved to be worth far less than their cost, or which became impossible to value and therefore impossible to sell.

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

2 See Louise Story, In Bear Stearns Case, Question of an Asset’s Value, THE NEW YORK TIMES, June 20, 2008 (one of most vexing problems facing Wall Street, even before the crash of 2008, was how to value securities backed by subprime mortgages); see also, Gretchen Morgenson, Wall Street’s Tax on Main Street, THE NEW YORK TIMES, August 6, 2011 (municipalities and benefit funds face financial ruin not only because of benefit obligations and weak revenues, but because of investment in financial instruments they do not understand and whose downside is not adequately disclosed to them).
Public benefit funds are also threatened because the states and municipal entities that sponsor them have failed to make adequate contributions to support their future obligations. This is a largely a political problem, although it is linked to the securities law issues which are the primary subject of this Article, because the funds, in order to make up for underfunding, have made improvident investments to obtain above-market yields on their assets. Given the broad distinction between problems of funding and those arising from investments in instruments sold as offering above-market yields, this Article will focus primarily on the latter, dealing with issues arising under the securities laws.

The problems faced by public benefit funds differ in important respects from those faced by their private counterparts. One important distinction is that qualifying private benefit funds are regulated by and, if they nonetheless turn out to be insolvent, their beneficiaries will ultimately be compensated for at least part of their losses by the federal Pension Benefit Guaranty Corporation ("PBGC"). The federal Employee Retirement Income Security Act ("ERISA") and the regulations adopted thereunder have given these funds substantial protection from abuses by financial intermediaries peddling risky financial instruments, although this protection has not been perfect.

Ironically, benefit funds operated by states and their subdivisions are at greater risk. They are largely exempt from investment standards mandated by ERISA and PBGC insurance, and

3 The PBGC was established by ERISA in 1974. See 29 U.S.C. §§1001 ff.

4 Pub. L. 93-406, 88 Stat. 829 (1974), codified in various sections of 29 U.S.C. ERISA covers both qualifying private benefit plans and health benefit plans, and mandates supervision of funding and investments for such plans, inter alia, by the federal Department of Labor, the Internal Revenue Service, and the PBGC.

received little protection from federal statutes and regulations until the enactment, after the financial crisis had already taken its toll, of the Dodd-Frank Act. It is not surprising, therefore, that problems are coming to light concerning the value of securities held by this large class of benefit funds, which present state governments with the risk of a wave of failures on top of the burdens already confronting them based on loss of revenues due to the continuing national financial crisis. Because major insolvencies at the state level could adversely impact the credit of the country as a whole, large-scale insolvency of state and local benefit funds could cause a financial crisis comparable to the threatened failure of private financial institutions that brought on the 2008 crisis, and hence could require federal intervention despite the lack of formal coverage by the ERISA and PBGC insurance as presently codified.

During the decade leading to present financial crisis, benefit funds tremendously increased their exposure to risky investments, particularly in the form of complex asset-backed securities. The funds that proved vulnerable to the peddling of these financial instruments—often deceptively marketed as offering safety in addition to high yield—include not only smaller


7 U.S. Census data show that there were about 2,550 state and local benefit funds holding about $2.2 trillion in total assets—about 1/3 of all assets held in U.S. benefit funds—as of June 30, 2008, just before financial crisis reached its peak. See U.S. Census Bureau, State and Local Government Retirement Systems, http://www.census.gov/govs/retire.

8 See infra, TAN [105] ff.

9 See infra, TAN [111] ff.

and less sophisticated funds, but large and supposedly sophisticated funds such as CALPERS\textsuperscript{11} and the Texas Teachers Fund.\textsuperscript{12} These funds were subject to pressures from their beneficiaries and political officials to obtain higher rates of return on their investments, at a time when prevailing low interest rates depressed yields on conventional investments to levels that made it more difficult to fund potential claims for pension and other benefits.\textsuperscript{13}

The turkeys are now coming home to roost for benefit funds that bought risky instruments which have defaulted or have sharply diminished in value. Faced with steep losses, some have commenced lawsuits against the financial advisers who sold the risky investments to them.\textsuperscript{14} Both the transactions leading to these cases and the process of resolving them lead back to major holes in the federal statutes and regulations that supposedly protect investors against misrepresentations and manipulative conduct in the sale of securities. One of these deficiencies, the exclusion of public funds from ERISA coverage, would require significant new federal


\textsuperscript{13} \textit{See} David Evans, \textit{The Poison in Your Pension} at 68 (“the county was earning 8 percent in what was a 3 percent world”), Bloomberg Markets, July 2007; \textit{Yes, They can go down too}, THE ECONOMIST, May 13, 2007 (Dallas Police and Fire Pension Funds bought high-risk CDOs to boost rates of return).

legislation to overcome. Given the issues of federalism that this would raise, and the present highly partisan political climate—which seems likely to persist into the indefinite future—the burden of overcoming resistance to such legislation appears insuperable as of this writing.

This Article therefore suggests that new rules dealing with investment vehicles sold to public benefit funds—both those created in the period leading up to the financial crisis, and for protection against new abuses in the post-crisis world—should focus upon the peddlers of complex financial instruments rather than on their targets. To provide a unified federal structure of protection, this approach necessarily will be based on financial regulation by means of the securities laws. Congress took certain limited steps toward dealing with the problem in the Dodd-Frank Act, and the SEC, beyond drafting regulations to give effect to the new statute, has set up a task force within its Enforcement Division to deal with it.15

There are several reasons why these measures are inadequate. First, Dodd-Frank is so large, complex, and riddled with legislative compromises that the agencies charged with enforcing it, which have been deliberately and systematically underfunded by Congress, have had to delay their drafting of interpretive regulations well beyond the deadlines set by the statute.16 Moreover, Dodd-Frank continues to face legislative hostility that is likely to make agencies tread carefully in drafting regulations to implement it.17 In addition, it virtually


excludes enforcement actions by parties other than regulatory agencies such as the SEC. This is a major weakness because, as is true for other actions by the SEC and other regulatory agencies, the number of professionals available for federal agency enforcement falls far short of the number required to deal with the securities law violations involved in the crisis. Although Dodd-Frank provides for creation of an annual $100 million reserve fund for the SEC, financed by registration fees paid to the Commission, the House Appropriations Committee, under the curious belief that the English language cannot employ the noun “regulation” unmodified by the adjective “burdensome,” sought to nullify the statute by barring the creation of such a fund in its current bill making appropriations for the SEC, and freezes other appropriations for the SEC at 2011 levels. Congressional failure to allow funding of the SEC at levels required by law has impaired the ability of agencies to draft regulations to enforce Dodd-Frank).

18 See infra, TAN [155] et seq.

19 See Stephen J. Crimmins, “New SEC Enforcement Unit Focuses on Funds and Advisers,” BNA SECURITIES LAW DAILY 12/6/2010 (SEC Enforcement Division has “limited resources,” and new unit to enforce Investment Advisers Act will comprise only 65 professionals, including both lawyers and accountants).

http://www.bna.com/sdlh/SDLNWB/split_display.adp?fedfid=1868792&vname=slbdulallissues&fn-1867982&jd=a0c5m9t0w8&split=0. As early as 1964, the SEC advised the Supreme Court in an amicus brief that it lacked sufficient personnel to carefully examine the 2,000 proxy statements submitted to it annually, a number that has multiplied many times since then. See J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). The lack of sufficient personnel not only prevents the agency (and other agencies involved in enforcement such as the CFTC) from bringing enforcement actions in many cases, but has forced the SEC to accept settlements which not only fail to bring about full disgorgement payments made in transactions violating the securities laws, but in which accused wrongdoers, even if subject to injunctions for prior violations, are not required to admit wrongdoing. See, e.g., Edward Wyatt, Judge Blocks Citigroup Settlement With S.E.C., THE NEW YORK TIMES, November 28, 2011.


21 See James Hamilton, House Financial Services Appropriations Bill Would Eliminate SEC Reserve Fund, CCH FINANCIAL REFORM NEWS CENTER, June 16, 2011,
crippled the agency not only in its ability to recruit badly needed new personnel, to conduct enforcement activities, but even to engage in routine examinations, both at the national and at the local levels.\textsuperscript{22} Other federal regulatory agencies, such as the Commodities Futures Trading Commission (“CFTC”), have also suffered Congressional cutbacks, but attacks on the SEC have special impact because it has been the spearhead of federal enforcement of antifraud statutes and regulations.\textsuperscript{23}

That means that recovery of losses will require measures to amplify the effectiveness of the SEC as presently staffed, and to aid the states in acting on their own behalf. While some statutory changes of recent years, such as the Private Securities Litigation Reform Act

\textsuperscript{22} See Stephen Joyce, \textit{Budget Deficiencies Leading to Change in SEC Examination Process, Canellos Says}, BNA \textsc{Securities Law Daily}, November 22, 2011, \url{http://www.news.bna.com/sdln/display/batch_print_display.adp} (short funding by Congress pushing the SEC to change its examination process to focus on alleged wrongdoing at expense of more prudential examinations); Stephen Joyce, \textit{Lack of Self-Funding Presents SEC With Big Challenge, Regional Chief Says}, BNA \textsc{Securities Regulation and Law Report}, 43 SRLR 2197, October 31, 2011, \url{http://news.bna.com/slrn/display/batch_print_display.adp}.

\textsuperscript{23} SEC understaffing has long forced the agency to accept settlements with financial institutions accused of securities violations in which, even in cases of repeat violations, the targets of its actions have been able to avoid any admissions of specific acts of wrongdoing. \textit{See, e.g.}, Edward Wyatt, \textit{Judge Blocks Citigroup Settlement With S.E.C.}, \textsc{The New York Times}, November 28, 2011 (study by \textsc{The New York Times} showed 51 instances in which the SEC accepted settlements with companies that had previously agreed to injunctions not to commit similar infractions). Settlements of this kind not only result in inadequate compensation of the victims of securities violations through agency action, but leave such victims with no court record on which to base their own actions against the offenders.
(hereinafter “PSLRA”), have created impediments to actions by parties other than the SEC, they have had a penumbral effect beyond their actual language in dissuading benefit funds from undertaking actions in the federal courts not actually blocked by the restrictive legislation, even though the funds are exempt from the obstacles posed by the PSLRA, and its parallel statute, the Securities Litigation Uniform Standards Act (the “SLUSA”), which enables defendants in securities fraud class actions brought under state law to remove them to federal court, where they can be dismissed without discovery under the PSLRA.

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


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

26 Part of this effect is probably due not only to the standards imposed for bringing actions, but to sanctions that the PSLRA imposes for allegedly abusive actions under the Exchange Act. See Exchange Act § 21D(c), 15 U.S.C. § 78u-4(c). In fact, however, recent decisions indicate that the PSLRA is having adverse effects on actions by benefit funds—not intended targets of the statute—under the federal securities laws—and increasingly pushing them into state court. See, e.g., Mississippi Public Employees’ Retirement System v. Boston Scientific Corp., 523 F.3d 75 (1st Cir. 2008)(reversing district court dismissal under PSLRA). Even a large private entity such as AIG, in a securities-based action against two private investment firms, chose to bring the action under state law in New York even though it could have had its case heard in federal court based on facts pleaded in a parallel action by the SEC. See also AIG Financial Products v. ICP Investment Management LLC, N.Y. Sup. Ct., No. 651117/2011 (complaint filed April 28, 2011); SEC v. ICP Asset Management LLC, S.D. N.Y., No. 10-cv-04791 (complaint filed June 21, 2010).


besets Congress and is likely to continue into the foreseeable future, it seems unrealistic to propose new legislation at this writing. Instead, the SEC and agencies coordinating with it, especially the CFTC, at the federal level, plus corresponding state attorneys general and securities officials, should draft regulations based on existing statutes, focusing in particular on an increased level of interagency and federal-state cooperation.

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

See, e.g., Andrew J. Entwistle & Jonathan H. Beemer, Approaches to Asset Recovery for Pension Fund Subprime Exposure, Entwistle & Capucci, New York, NY, http://www.entwistle-law.com/news/publications/000041. The chief state law remedies are those for common law fraud, breach of contract and breach of fiduciary duty, and state securities legislation, increasingly including the Uniform Securities Act, whose § 101 has antifraud provisions that track Exchange Act Rule 10b-5 (although case law has yet to establish whether they will be interpreted in the same way as federal courts apply Rule 10b-5).

15 U.S.C. §§ 77a et seq.

To redress past abuses, the suggested changes will draw upon statutes previously enforceable only by the SEC, including the Advisers Act and certain provisions of the 1933 Act and the Securities Exchange Act of 1934 (hereinafter the “Exchange Act”).\textsuperscript{32} For the future, this Article proposes new regulations to be promulgated by the SEC under the new Dodd-Frank Act, the Investment Advisers Act, and significant modifications of Rule 506 (promulgated pursuant to the 1933 Act).\textsuperscript{33} These will require more adequate disclosure of risk factors in the issuance of financial instruments other than traditional fixed-income, blue-chip equity, and government securities to public benefit funds; reduce dependence on dubious ratings by credit rating agencies that, even after Dodd-Frank, remain lightly regulated;\textsuperscript{34} and give state regulators clearer targets for establishing sound investment practices for the funds under their supervision.\textsuperscript{35}

As noted, regulatory changes should focus on improving present coordination between the SEC and state regulators, by means such as expanding the SEC’s present role in providing training for lawyers in state attorney generals’ offices in bringing enforcement actions, and by employing state lawyers to assist thinly staffed SEC enforcement teams in maintaining actions that only the SEC itself has standing to bring. The SEC can also amend current regulations to protect benefit funds going forward by limiting the ability of smaller funds to buy privately

\footnotesize\textsuperscript{32} 15 U.S.C. §§ 78a et seq.

\footnotesize\textsuperscript{33} 17 C.F.R. § 230.506.

\footnotesize\textsuperscript{34} See infra, TAN [108] ff.

\footnotesize\textsuperscript{35} See infra, TAN [121] ff.
placed securities and by applying the SEC’s “Plain English” disclosure rules to all securities
disclosure, including that in private placement memos.36

I. Exotic Securities in the New Gilded Age

The last thirty years have been marked by a proliferation of new types of securities,
which steadily increased in complexity, risk, and difficulties in understanding the nature of the
risk presented. The problem has been aggravated by the deregulation of the financial system,
which created a climate of financial recklessness bringing to mind the “Gilded Age” of the late
nineteenth century.37

At the same time that the nature of the securities made them less comprehensible to
potential purchasers and even the financial intermediaries peddling them, the low interest rates
on conventional debt securities based on Federal Reserve policy since the shortly after the turn of
the century38 created an appetite for higher yields, particularly by underfunded benefit funds.

36 Since 1998, the SEC has required disclosure in any prospectus accompanying registered
securities to be written in “Plain English,” making it clear to investors exactly what risks they
and Assistance, A PLAIN ENGLISH HANDBOOK: How to create clear SEC disclosure documents,

37 See generally MARK TWAIN & CHARLES DUDLEY WARNER, THE GILDED AGE (1873). See also,
GEORG WILHELM FRIEDRICH HEGEL, 12 VORLESUNGEN ÜBER DIE PHILOSOPHIE DER
WELTGESCHICHTE 8 (1831)(“Was die Erfahren und die Geschichte lehren, ist dieses, daß Völker
und die Regierungen niemals etwas aus der Geschichte gelernt…haben,” roughly translated,
“The only thing we learn from history is that we never learn anything from history.”).

38 See infra, n. [86]; see also, E. Scott Reckard, Bank deposits soar despite rock-bottom interest
rates, LOS ANGELES TIMES, September 17, 2011,
Even a benefit fund receiving contributions at levels that had previously sufficed to meet eventual beneficiary demand would face eventual underfunding if it followed old patterns of investing in well-understood and traditionally safe instruments such as government securities and corporate bonds. For many benefit funds, whose contribution rates fell well below the amount needed to fund beneficiary demand even if invested in traditional instruments, the potential deficits ran much higher.

**A. The Onset of Complexity: Asset-backed securities**

Low yields on traditional securities helped fuel the growth of new types of securities, which offered higher yields at the cost of rapidly increasing complexity, volatility, and concealed risk. These can be described generically as asset-backed securities, since all of them, from plain-vanilla mortgage-backed Fannie Mae securities to the most complex derivatives based on them, rest on streams of payments from pools of debt instruments, chiefly residential home mortgages.

The forerunner of all of these securities was the residential mortgage-backed security (“RMBS”). Securities backed by pools of mortgages were sold in the U.S. at least as early as

39 See, e.g., Yes, They can go down too, THE ECONOMIST, May 13, 2007 (Dallas Police and Fire Pension Funds bought high-risk CDOs to boost rates of return).

40 “Fannie Mae” is the nickname generally used for the Federal National Mortgage Association, founded as a government agency in 1934 and privatized—but with a remaining link to the federal government that has proven costly to taxpayers—in 1968. See Richard E. Mendales, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 ILL. L. REV. 1359, 1365-66 (2009).

41 The SEC, in its proposed rulemaking concerning the Dodd-Frank provisions affecting rating agencies, has divided asset-backed securities into the RMBS, commercial mortgage-backed securities (“CMBS”), commercial loan obligations (“CLOs”), asset-backed commercial paper conduits (“ABCP”), and collateralized debt obligations (“CDOs”—covering asset-backed securities including miscellaneous collateral, including other asset-backed securities). See SEC, Release No. 34-64514, Nationally Recognized Statistical Rating Organizations, File No. S7-18-
the 1880s, but were first issued in their modern form by the Federal National Mortgage Association (“Fannie Mae”), while it was still a government agency, in 1966.\textsuperscript{42} Fannie Mae was split into two entities—the Government National Mortgage Association, which remained a government agency—and the present Fannie Mae, which was largely privatized but continued to buy mortgages for securitization, in 1968.\textsuperscript{43} The Federal National Mortgage Association (“Freddie Mac”) was created in 1970 as a publicly held corporation, also for the primary purpose

\textsuperscript{42} See Mendales, \textit{Collateralized Explosive Devices, supra} n. [40], at 1365. Actually, what may have been the earliest form of mortgage-backed security, the Pfandbrief [plural “Pfandbriefe”—German nouns are always capitalized], was introduced by Frederick the Great of Prussia as early as 1769 to help pay the ruinous costs of the Seven Years’ War, and has received a new lease on life in the form of “covered bonds” being issued not only in other civil law countries but in the U.S. as well during the past few years. \textit{See} Stefan Kofner, \textit{The German Pfandbrief System Facing the Financial Crisis}, For the European Network of Housing Research, International Housing Conference, Prague, Czech Republic, 28 June – 1 July, 2009, \url{http://www.soc.cas.cz/download/808/paper_Kofner_01.pdf}; Steven L. Schwarcz, \textit{The Conundrum of Covered Bonds}, 66 \textit{THE BUSINESS LAWYER} 561, 563-564 (2011). Pfandbriefe continue to flourish in Germany, regulated by the Pfandbriefgesetz, a statute that has been continually modernized (most recently in 2009), and their analogues have become popular in other civil law countries. Because they are regulated by law that ensures their backing by high-quality collateral, they are safer than their CMO cousins and have weathered the present economic storm far better. Despite the new vogue for “covered bonds,” which employ structural elements borrowed from the Pfandbriefgesetz, American law does not provide the kind of regulation that gives Pfandbriefe their reliability. In fact, fairly drastic changes in U.S. law such as statutorily mandated certification and monitoring of issuers and their collateral would be required to establish a similar level of safety. \textit{See generally}, Bundesministerium der Justiz, PFANDBRIEFGESETZ; Pfandbrief Verband Deutscher Pfandbriefbanken, DER PFANDBRIEF, \textit{Advantages of Pfandbriefe}, \url{http://www.pfandbrief.de/cms/_internet.nsf/tindex/en_14.htm}.

of enhancing the market for buying, selling, and securitizing mortgages.\textsuperscript{44} Although Fannie Mae and Freddie Mac, throughout the period of the housing boom following the turn of the century, were publicly held corporations, the facts that their securities were exempt from SEC registration, and that they held emergency lines of credit from the federal government, led participants in the secondary mortgage markets to believe that they enjoyed implicit guaranties from the federal government throughout the period before the financial crisis. They have therefore been referred to as “government-sponsored entities” (“GSEs”).\textsuperscript{45}

Beginning about 1977, investment banks began to assemble pools of mortgages and issue “private label” CMOs that passed through proportionate shares of principle and income from the underlying pools to purchasers.\textsuperscript{46} In a basic CMO, a mortgage originator (originally a bank or thrift institution, but, as the 1990s wore on, increasingly a nontraditional and largely unregulated lender)\textsuperscript{47} sells mortgage instruments to an investment bank, which pools mortgages thus obtained


\textsuperscript{46} See Mendales, \textit{Collateralized Explosive Devices}, supra n. [40], at 1365.

\textsuperscript{47} Nontraditional mortgage companies were loosely and inconsistently regulated by the states rather than the federal government, which regulated FDIC-insured banks and thrifts. The increasing origination of mortgages by these poorly regulated entities, with the intent to sell them for securitization rather than to keep than on the originators’ balance sheets, was a factor in the deterioration of mortgage collateral that contributed to the financial crisis. \textit{See} Martin N. Baily, Robert E. Litan, & Matthew S. Johnson, \textit{The Origins of the Financial Crisis} 79, 80, \textit{in Lessons From the Financial Crisis: Causes, Consequences, and Our Economic Future} (Robert W. Kolb, ed. 2010).
and transfers them to an entity generally known as a “special purpose vehicle” (SPV), which then sells certificates representing fractional shares of the pool to investors. The buyers of these securities are then entitled to receive proportionate shares of the total payments of interest and principal by mortgagors on the instruments held in the pool. The advantages to an investor in buying a mortgage-backed security include the purported safety of mortgages as collateral, diversification of risk among geographically diversified mortgages included in each pool, and interest rates that, being based on rates paid by individual mortgagors, tend to be higher than those on similarly rated corporate debt obligations.

Safety, at least as measured in ratings issued by the three leading credit rating agencies (S.E.C.-accredited rating agencies are officially known as “nationally recognized statistical rating organizations,” or “NRSROs”), was vital for CMOs. This was not only a practical sales point, but because ratings were the key to special treatment under the securities laws based on

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48 See formal definition in I.R.S. Reg. § 1-901-2T(e)(5)(iv)(B)(1), 26 C.F. R. § 1-901-2T(e)(5)(B)(1). SPVs are also, less formally, referred to in finance as “special purpose entities” (SPEs).

49 See Mendales, Collateralized Explosive Devices, supra n. [40], at 1364-68. SPVs have also been used for shady accounting purposes such as removing questionable items from corporate balance sheets in cases such as Enron. See Enron Aside, Special Purpose Vehicles Are Legal, Innovative and Widely Used, KNOWLEDGE @WHARTON, May 17, 2006, http://www.knowledge.wharton.upenn.edu/printer_friendly.cfm?articleid=1483.

50 In fact, however, even before the financial crisis precipitated by the bursting of the housing bubble in 2008, it became clear that the risk associated with investment-grade corporate debt was significantly less than that associated with mortgage-backed securities given similar ratings. See infra, n. [72].

the 1984 Secondary Mortgage Market Enhancement Act (SMMEA). Under SMMEA, CMO instruments with face amounts above $250,000 and rated in the top two grades of at least one accredited NRSRO did not have to be registered under the 1933 Act, and the pliant SEC of that period established by regulation that SPVs issuing CMO securities did not have to apply to the Commission for letter rulings, but would automatically be considered exempt from having to register under the Investment Company Act of 1940.

Apart from SMMEA’s effect on private label securities, it also authorized the GSEs to deal in subordinate lien mortgages, a factor that weakened their securities—especially in the absence of effective accounting controls. This, along with the deterioration in standards for even first-lien mortgages purchased and securitized by the GSEs, contributed to the unperceived increase in risk in their securities—and, based on their inventories of these securities, to their own insolvency when the crisis of 2008 struck.


54 17 C.F.R. § 270.3a-7. As the financial crisis gathered momentum in July, 2008, the SEC, while admitting that it originated the term “NRSRO” in its rules in 1975, claimed that its use of ratings was “for a narrow purpose,” though admitting that ratings had become widely used in state, federal, and even international regulations, and attempted, far too late, to reduce regulatory dependence on ratings by the major rating agencies. See SEC Release No. 34-58070, File No. S7-17-08, References to Ratings of Nationally Recognized Statistical Rating Organizations, Proposed Rules, 73 Fed. Reg. 40088ff., July 11, 2008. The proposed rule changes to reduce reliance on ratings were abandoned in 2009, and replaced by new regulations, including some mandated by the Dodd-Frank Act in 2010. See SEC Release No. 34-64514, File No. S7-18-11, Proposed Rules for Nationally Recognized Statistical Rating Organizations, 3-5 and n.3.


56 See, e.g., Bloomberg, America’s Fannie Mae & Freddie Mac Tumble on ‘Insolvency’ Fears, THE TELEGRAPH (London), 10 July 2008 (GSEs feared insolvent based on fair value accounting because of large borrowing to purchase mortgage-backed securities for their inventories).
The dependence on ratings was not confined to the U.S. One of the reasons why the financial crisis that followed the discovery that ratings did not accurately predict risk for structured instruments was that they became imbedded in the capital of financial institutions around the world based on ratings.⁵⁷ Even the Basel Committee on Bank Supervision made ratings the basis for its proposals on the quality of bank capital for major international banks.⁵⁸

CMOs only began the story, however, as the first step in the creation of a new sector of the financial world that became known as “structured finance.” During the 1980s, CMOs became a subclass of a broader class of securities generally known as “collateralized debt obligations” (CDOs). The collateral pooled to back these obligations included many kinds of debt that were generally less secure than conventional residential mortgages, originally defined as collateral acceptable for Federal Housing Authority mortgage insurance, which imposed standards for insurability such as minimum down payments and debtor credit history.⁵⁹ This included residential mortgages not meeting the same quality requirements as conventional mortgages, debt secured by non-traditional collateral such as commercial property and car loans,

⁵⁷ See 73 Fed. Reg. at 40088.
and totally unsecured debt, including obligations such as student loans and credit card debt. CDO collateral pools also included other asset-backed securities whose safety was primarily measured by the less than reliable standards set by credit rating agencies—although mortgages remained the most important instruments underlying CDOs in terms of aggregate value.

CDOs were supposed to be safe, since the safety of at least the highest-rated interests in a CDO pool, as with CMOs, was one of their chief selling points. This presumed safety, which both buyers and regulators imprudently inferred from high ratings given to instruments in each pool by the three leading credit rating agencies, was originally based on the presumed security of conventional mortgage lending standards, augmented by what were called “credit enhancements” to provide additional safety for prepayment of standard mortgages, and for less reliable collateral such as home mortgages not meeting FHA standards and other forms of debt-based collateral such as commercial property mortgages, car loans, and even unsecured debt such as credit card balances.

The earliest credit enhancements were relatively straightforward. They included some measures resembling the protective features of German Pfandbriefe, which, as noted above, were

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60 See infra at n. [59] ff. andaccompanying text concerning rating standards.

61 See Arthur E. Wilmarth, Jr., Reforming Financial Regulation to Address the Too-Big-to-Fail Problem, 35 BROOK. J. INT’L L. 707, 724 (investors relied heavily on ratings for complex instruments because their complexity made it difficult for outsiders to determine the level of risk).

fairly effective in withstanding the financial crisis of 2009.63 These features included overcollateralization (including assets in a pool with nominal values greater than the value of securities sold based on interests in the pool); recourse—the requirement that sellers of mortgages into a pool retain at least part of their risk of default;64 and backing by insurance-type arrangements including standby letters of credit issued by banks to make good on defaulted collateral and insurance issued by monoline insurance carriers65 such as AMBAC.66 Each of these protective features carried with it expenses that raised the cost to issuers and underwriters, who sought to cut their costs by devising less expensive but unproven protective measures inherent in the structure of the asset-backed securities themselves.

63 See n. [42], supra.

64 Overcollateralization and retention of risk by mortgage originators are among the features that give Pfandbriefe their safety. Pfandbriefe, however, have additional safety factors such as statutory supervision that have never had a place in Wall Street CMOs. See n. [42], supra.

65 Monoline insurers engage solely in insuring financial instruments. They emerged in the 1970s, originally insuring municipal securities but soon extending their coverage to asset-backed securities. See Investopedia, Monoline Insurance Companies, http://www.investopedia.com/terms/m/monolineinsurance.asp#axzz1ht1AiPzj. Their specialization is a result of state regulation forbidding traditional insurers from issuing such policies. Paradoxically, this absence of diversity in their risk portfolios makes them and their insurance products riskier than traditional insurers and their products.

66 See, e.g., Michael Lea, Securitization: A Primer on Structures and Credit Enhancement, http://www.ihfp.wharton.upenn.edu/2009Readings/lea-SecuritizationPrimer.pdf; Partnoy, Siskel & Ebert, supra n. [51] at 671. In the experience of the author of this Article at Skadden, Arps, Slate, Meagher & Flom in New York during the early days of private label securitization in the 1980s, the first widely-used forms of credit enhancement were recourse, overcollateralization, insurance from monoline insurers, and standby letters of credit from banks. Recourse posed a particular problem because the transfers of mortgages from originators to SPVs were intended to be true sales, making the SPVs remote from any hypothetical bankruptcy of the originator, while significant retention of risk by the issuer created the danger that a bankruptcy court would rule that an intended sale was merely a secured loan, so that the SPV would not be remote from a bankruptcy case involving the issuer.
B. Ratcheting up complexity: derivatives based on asset-backed securities

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

The credit rating agencies’ motivation in following this path was based in part on a new business model that created a major conflict of interest for the agencies. Prior to 1970, they were paid by subscribers—and even then their ratings, particularly for lower-rated securities, were criticized for unreliability. During the 1970s, however, the agencies switched their business model to reliance on payments by the issuers of securities that they rated. They made this

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

68 See Wilmarth, Reforming Financial Regulation, supra n. [61] at 724-25.

69 See Partnoy, Siskel & Ebert, supra n. [51], 646-48 (1999).
change just at the time that their ratings became more central to the securities business because
government agencies, beginning, ironically, with the SEC, as a basis for judging the quality of
securities used as reserves by securities dealers and other moneyed businesses. This created a
conflict of interest that made them subject to pressure by issuers and underwriters to issue high
ratings for the issuers’ securities.\textsuperscript{70}

In no context did this conflict manifest itself more strongly than in the issuance of asset-
backed securities. While the agencies used the same letter ratings for these securities as for
conventional corporate debt, the new securities had different default characteristics. The
agencies did not test their methodologies to assure that a CDO rated AAA possessed the same
degree of safety that such a rating would indicate for a conventional corporate bond,\textsuperscript{71} and
studies done well before the 2008 crash showed that in fact CDOs given investment-grade
ratings failed at a much higher rate than conventional corporate debt.\textsuperscript{72}

The first technique used to offer high-rated asset-backed securities based on structure
rather than external credit enhancement was to slice and dice the streams of payments from pools
of debt instruments. Investment bankers, rather than including an excess of collateral in a pool or
obtaining external support for the obligations issued based on a pool, divided securities deriving
payments of principal and interest from a given pool into “tranches”—often five or more based
on a single pool of debt instruments. A first and sometimes a second tranche would have priority

\textsuperscript{70} See Partnoy, Siskel & Ebert, supra n. [51], at 652.

\textsuperscript{71} See Roger Lowenstein, Triple-A Failure, \textsc{The New York Times}, April 27, 2008 (prior to the
failure of the CDO market in 2007, Moody’s rated CDOs based on models relying on the
securities’ structure, using untested assumptions and without conducting due diligence
concerning the quality of the underlying collateral).

\textsuperscript{72} See \textit{infra}, TAN [76].
over subsequent tranches, and hence would benefit from what was called the “waterfall” effect to receive the backing of greater assets than the nominal value of the tranche. This generally sufficed to persuade pliable credit rating agencies to give first (and sometimes second) tranches their top ratings for ability to pay interest and principal—ratings that should have been questionable not only because the agencies’ models were untested but because the agencies suffered from conflicts of interest in being paid by the issuers of the CDOs they were rating.

Unfortunately, despite the dubious character of the ratings, they became increasingly important to the buyers of asset-backed securities as the securities became more complex, since the ratings were the only generally accepted way to assess the ability of a new type of security to pay principal and interest. Even before the quality of collateral providing cash flows for CDOs began to decline in the late 1990s, however, it became clear that ratings for structured finance securities did not mean the same thing as the same ratings given to conventional corporate debt:

73 Priority gave senior tranches the right to receive payments of principal and interest from a pool of debt instruments to the full amount due the senior tranches on any date payment was due, before any payments could be made to junior tranches. Priority could be sequential—based on earlier payment due senior tranches than for junior tranches (a significant factor, since one of the problems faced by holders of mortgage-backed securities consists of prepayments by mortgagors on their underlying debt)—or by contractual subordination of junior tranches. By analogy to the normal priority of distributions under corporate law, the most junior tranches with rights against any pool were often referred to as the “equity.” See, e.g., SEC v. Steffelin, Complaint at ¶ 20 (the “equity” tranches of a CDO are the most subordinate, generally unrated notes secured by a given pool of assets), 06/21/2011, http://www.sec.gov/litigation/complaints/2011/comp-pr2011-131-steffelin.pdf.

74 The rating agencies were also, unlike other participants in the creation of new securities, largely unregulated by the securities laws until the passage of the totally inadequate Credit Rating Agency Reform Act (“CRARA”), Pub. L. No. 109-291, 120 Stat. 1327 (codified at 15 U.S.C. §78o-7), in 2006. This statute attempted to address agency deficiencies by encouraging the creation of competing agencies, but actually forbade the SEC from attempting to regulate the rating process. See Mendales, Collateralized Explosive Devices, supra n. [40], at 1385-1387.

75 See generally Partnoy, Siskel & Ebert, supra n. [51].
a structured security rated AAA was much more likely to default than a corporate bond with the same rating. During the period 1993-2005, beginning well before subprime mortgages became the chief collateral backing CDOs, CDOs rated Baa by Moody’s (the lowest “investment grade” rating given by Moody’s) had ten times the default risk as conventional debt with the same rating.  

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


78 See, e.g., Aristotle, POLITICS, Book I, Chap. 11, §§ 5-10.
six months hence by making a contract to sell a large part of its production of the grain at something approaching present prices six months in the future.\textsuperscript{79} Commodities futures are relatively well understood, and the garden variety—chiefly consisting of futures contracts traded on the Chicago Board of Trade—is regulated by the federal Commodities Futures Trading Commission (“CFTC”).\textsuperscript{80}

During the 1990s, however, derivative securities were developed based on anticipated changes in the values of CDOs, which functioned more to multiply the level of risk than to hedge against rationally anticipated future changes in value. These new derivatives added first one and then more levels of complexity to what had already become complex financial instruments. The most basic of these derivatives was generated in “credit default swap” (“CDS”) transactions, in which one financial institution agreed to pay the other if specified CDOs held by the other defaulted, in return for fees corresponding to insurance premiums.\textsuperscript{81} The contracts creating rights to receive payments on default, and rights to receive fees for protecting holders of debt-based collateral, both derived value from that collateral, and were thus considered “derivative” securities. They were assembled deal by deal and took advantage of exemptions from

\textsuperscript{79} See Futures, \url{http://www.riskglossary.com}.


\textsuperscript{81} Credit default swaps were invented by JPMorgan in 1994. The first major CDS deal, involving about $9.7 billion, was done by Morgan in 1997. See Matthew Philips, \textit{The Monster that Ate Wall Street}, \textit{NEWSWEEK}, September 26, 2008. Their use grew exponentially until the CDS market volume exceeded $45 trillion by mid-2007, more than twice the value of equities traded on U.S. stock markets. See Janet Morrissey, \textit{Credit Default Swaps: The Next Crisis}, \textit{TIMEBUSINESS} March 17, 2008, \url{http://www.time.com/time/business/article/0,8599,1723152,00.html}. 
registration (and thus from the disclosure requirements of the 1933 Act) with the SEC, and were in turn dumped into pools of assets that collateralized CDOs.

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

In part, this was because the instruments used as reference portfolios for CDOs were evaluated for quality largely based on ratings assigned them by agencies such as Moody’s, based on mathematical models that relied on unproven assumptions rather than on due diligence as to the soundness of underlying collateral. Moreover, even had due diligence on underlying collateral been performed, the complexity of the new instruments became so great that even those who traded them in huge volume had no way to rationally evaluate their underlying value. Since most of them were exempt from registration under the 1933 Act because their sale


83 See id. at 1, 18, 21, 23, 25-26 (models used in disclosure of risks in various tranches of CDOs result in systematic failure by CDO sellers to disclose full risks imposed on buyers).

84 See Lowenstein, Triple-A Failure, supra n. [71].

85 See generally Gibson, supra n. [82].

86 In fact, mathematical models used to determine the probability of default are so complex that they require their users to make substantial, possibly counterfactual assumptions. See generally,
was exempt from registration under SEC Rule 506, most were created in private contracts between institutions and traded over the counter rather than on recognized exchanges. Therefore, central banks such as the Federal Reserve and other regulatory institutions were unable to estimate their volume—which ran into trillions of dollars worldwide—or what effect defaults in underlying collateral would have on the entire financial house of cards and thus, given the effects on key financial institutions—on the U.S. and world economies.

C. The downward spiral of quality in collateral: the great debt bubble of 1998-2006

While part of the fragility of the CDO market was a function of the complexity of the instruments traded in that market, an even more significant factor arose with the increasing burdens of debt borne both by individuals and institutions, originating in stagnating individual incomes and fed by easy credit, that led to the housing bubble which took off after the turn of the century. Consumer debt began rising as early as the 1970s, in part to replace actual income—

Gordy, supra n. [58]. The complexity of the computations used by modelers such as Gordy, requiring elaborate numerical integration, suggests that results in terms of the probability of default under any model will be altered with extreme sensitivity based on any deviation from initial data or assumptions—in other words, any change from initial assumptions will cause chaotic, and hence unpredictable, variations from the results predicted by the model used for the initial rating of a security. Chaotic behavior of this kind is what makes long-term weather prediction impossible even with high-quality data. See generally, JAMES GLEICK, CHAOS: MAKING A NEW SCIENCE (1988). The intractability of this problem is further supported by the failure of sophisticated mathematical methods prevent the insolvency of Long-Term Capital Management, a large hedge fund that employed Nobel laureates in economics. See generally, ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001).

87 17 C.F.R. § 230.506.

88 See supra, n. [86]; Jonathan C. Lipson, Enron Rerun: The Credit Crisis in Three Easy Pieces, 43, 44, in LESSONS FROM THE FINANCIAL CRISIS, supra n. [47].
median per capita income in the U.S. leveled off in 1973, and consumers substituted debt for increasing income to maintain expected standards of living. This long-term structural problem was aggravated by events in the financial sector.

A preliminary crisis, which should have warned participants in the market for complex securities of the larger crisis to come, was the failure of a hedge fund called Long-Term Capital Management in 1998. The hedge fund had based its investing strategy on complex mathematical models which failed it both because of the complexity of the instruments in which it invested and because of the weakness in the collateral underlying those instruments. The Federal Reserve, fearing that the failure could trigger a recession, cut interest rates to near-record lows. The Fed’s action was based not only on the failure of Long-Term Capital at home, but on the bursting of financial bubbles overseas that helped to kill Long-Term Capital, including sovereign default crises in Asia, Russia, and Latin America, and the bursting of the “dot-com” stock market bubble in the U.S. which, continuing through 2002, helped motivate the Fed to keep down interest rates. These low rates, which were reflected in loans made throughout the U.S. economy,

89 See Edward Luce, The Crisis of Middle-Class America, FT Magazine, July 30, 2010, [link] (incomes of bottom 90% of U.S. families essentially flat since 1973, with lost increases in wage income made up by increasing debt).


91 See Carmen M. Reinhart & Kenneth S. Rogoff, This Time is Different: Eight Centuries of Financial Folly 162, 171, 206 (2009).
including the markets for government and corporate debt and the home mortgage market, helped lead to the outsized housing bubble of the new century.\textsuperscript{92}

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

The reduction in the general cost of credit, which itself played an important role in inflating the housing bubble that followed the turn of the century, accompanied successive and dramatic lowering of the standards of creditworthiness required of mortgagors. This occurred partially at the instance of the federal government, which steadily lowered the minimum down payments required for FHA insurance, and pressured Fannie Mae and Freddie Mac to lower their standards for the creditworthiness of mortgagors whose mortgages they would purchase. The idea behind this was to make housing more available to Americans of limited means, a goal that, while not without superficial appeal, was fraught with financial peril, as easier lending standards

\textsuperscript{92} See ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 40-41 (2d ed. 2005); Jonathan C. Lipson, Enron Rerun: The Credit Crisis in Three Easy Pieces, 43, 46, in LESSONS FROM THE FINANCIAL CRISIS, supra n. [47] (the “persistent, artificially low rate of interest” was a central cause of the financial crisis). During the bubble, the Case-Shiller housing price index, as compared to increase in GDP and the consumer price index, increased faster and farther than any previous housing bubble since 1891, the starting point for the Case-Shiller index. See REINHART & ROGOFF, THIS TIME IS DIFFERENT, supra n. [91], at 207.
led home prices in the U.S. to rise 52% between 1997 and 2004, a rate significantly higher than 
the increase in median income.93

While standards for conventional mortgages were eased, mortgage underwriting 
standards were further relaxed on the initiative of private lenders, many of whom were now unlicensed, who used a lending model based on originating mortgages to sell them for packaging 
into securities, rather than holding them and the risk attendant upon them. The result was a 
proliferation of “Alt-A” mortgages—mortgages to borrowers who could not quite meet the 
standards imposed on holders of conventional mortgages94—and, worse yet, “subprime” loans— 
loans backed by mortgages extended to borrowers who did not even approach the relaxed federal 
standards for creditworthiness, documentation and other qualifications such as substantial down 
payments that were required for conventional mortgages during the 1990s. “Subprime” 
mortgages, were usually originated by poorly regulated mortgage brokers on an originate-to-sell 
business model, so that their originators lacked the incentive to assure their quality that would 
have existed had they kept the loans on their balance sheets. This in itself set them off from 
traditional mortgages backing loans by institutions such as banks and thrifts, who started with a 
model of loans kept on their balance sheets and therefore had some incentive to assure that they 
had at least some chance of being repaid. “Subprime” mortgages began to proliferate before the 

93 See SHILLER, IRRATIONAL EXUBERANCE, supra n. [92], at 12-13.

94 See FRANK J. FABOZZI, FIXED INCOME SECURITIES 286 (1999); Alt-A Mortgages, 
CityTownInfo.com, http://www.citytowninfo.com/mortgage-articles/specialty-mortgages/alt-
a_mortgages (Alt-A mortgages were traditionally mortgages to borrowers who could meet 
conventional mortgage standards, but lacked certain documentation; but the designation became 
a fuzzy term applying to mortgages just short of conventional mortgage quality but ranking 
above “subprime” mortgages).
turn of the century, and spread like a financial pandemic during the period from 2003 through 2006.95

“Subprime” mortgages included several characteristics that made them and financial instruments for which they served as collateral financial time bombs. Many of them included specific terms that set them ticking, such as low “teaser” interest rates that mortgagors could barely afford at the time they signed on the dotted line, but which would automatically reset to far higher rates—likely to be beyond the mortgagors’ ability to pay—at dates in the near future. Other types of mortgages whose default could readily have been predicted at the time they were made included “liar loans,” where the mortgagors’ creditworthiness was deliberately misrepresented or totally undocumented, or where the value of the mortgaged property was deliberately inflated;96 interest-only loans, where mortgagors would not have to begin repaying principal until a specified time in the future; and home equity loans based on the equity acquired by the out of control spiral of home values based on artificially low credit.

Relaxed standards led to a proliferation of new mortgage lending to borrowers who represented not merely heightened risks which could be estimated with actuarial models based on prior data, but to borrowers who were virtually certain to default. This qualitative transformation could have been recognized from earlier experience if the rating agencies and


96 See, e.g., John Hechinger, Shaky Foundation: Rising Home Prices Cast Appraisers in a Harsh Light, THE WALL STREET JOURNAL, December 13, 2002 (brokers and developers systematically induced real estate appraisers to put unrealistically high values on real estate, with frauds resulting in legal actions well before the actual topping out of real estate prices in 2006).
other participants in the issuance of asset-backed securities had paid attention to it. The net effect was to invalidate the “waterfall” model on which the rating agencies based the high ratings they assigned to senior tranches of asset-backed securities: while higher-risk collateral could still permit repayment of senior tranches if there was enough of it and it paid something, zero-value collateral, regardless of its nominal value, could not yield any payment to a senior tranche regardless of its level of seniority.

II. Things Fall Apart: The Financial Crisis

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

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

**A. The crumbling firewall: deregulation and the financial crisis**

Investments by benefit funds in risky securities are subject to three major federal statutes governing the sale of securities. These are the 1933 Act, the Securities Exchange Act of 1934 (hereinafter the “Exchange Act”), and the Investment Advisers Act. Each is hedged about with regulations promulgated by the Securities and Exchange Commission (“SEC”) and by a framework of judicial interpretation.

Since the 1970s, deregulation embodied both in statutes and regulations, and increasingly restrictive judicial decisions, pulled some of the teeth from the aging tiger of securities regulation. Ironically, the SEC itself began the process, first by accepting securities receiving top ratings from the credit rating agencies as part of the capital of the brokerages that it regulated, and then, even more significantly, by its regulatory expansion of the small business exemptions for registration of securities into exemptions that went well beyond the 1933 Act’s purposes in authorizing such exemptions.

Deregulation went much further with Congressional actions beginning in the 1970s. This began with the lifting of some key regulation on savings and loan institutions (“thrifts”), at that time among the most important originators of mortgages, which were regulated separately from

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99 See Mendales, Collateralized Explosive Devices, supra n. [40], at 1373-74.
banks. The toxic effect of this deregulation was felt in the massive failures of deregulated institutions, which caused a national financial crisis that spanned the 1980s, but this crisis did not slow the deregulatory juggernaut.

The hallowed separation between commercial and investment banking, to name the most conspicuous example of this deregulation, was abolished by the Gramm-Leach-Bliley Act of 1999, exposing commercial banks to the risks involved in underwriting and dealing in

More financial institutions failed during the savings and loan crisis than at any time since the Great Depression. From 1986 through 1995, the Federal Savings & Loan Insurance Corporation (which was itself wound up as a result of its liabilities from the crisis) and the Resolution Trust Corporation (established by Congress to deal with the crisis) closed 1,043 thrift institutions with $519 billion in assets, and the number of federally insured thrifts in the U.S. declined by about 50%. See Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REVIEW 26, December, 2000. The savings and loan crisis was the most famous part of a larger banking crisis in which more than 1,600 FDIC-insured banks were closed or required financial assistance from the FDIC. See FDIC, *The Banking Crises of the 1980s and Early 1990s: Summary and Implications, Chapter 1 of HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE*, http://www.fdic.gov/bank/historical/history/3_85.pdf.

Commercial and investment banking were separated by one of the statutory foundations of New Deal regulation, the Glass-Steagall Act, formally titled the Banking Act of 1933, Pub. L. 73-66, 48 Stat. 162 (1933). Glass-Steagall did far more than accomplish this separation; it included other measures to restore confidence in the financial system, shaken by the Great Depression, such as establishing the Federal Deposit Insurance Corporation (FDIC). Formally titled the Financial Services Modernization Act of 1999, Pub. L. 106-102, 113 Stat. 1338 (1999), which, *inter alia*, repealed §§ 20 and 33 of Glass-Steagall. Gramm-Leach-Bliley’s destruction of the wall between commercial and investment banking has been modified by the incorporation of the “Volcker Rule” in Dodd-Frank § 619, which at first glance appears to bar federally insured banking institutions from engaging in proprietary trading. However, the section, read as a whole, is so permeated with the typical Dodd-Frank foam of compromise that its real effectiveness is uncertain. Of particular concern for purposes of this Article, Dodd-Frank §619(g)(2) states that the section should not be construed to prohibit an affected institution from engaging in securitization of loans. Despite the questionable efficacy of the provision, it has come under strong partisan attack in Congress which (a) makes it unclear whether the drafting of implementing regulations will be funded, and (b) makes its long-term survival uncertain. See, *e.g.*, Josh Boak, *Volcker Rule Shredded by Republicans*, POLITICO, January 8, 2012 (after agencies charged with enforcing rule released 300 pages of proposed regulations, key Republicans attacked the rule itself as a “self-inflicted wound”), http://www.politico.com/news/stories/0112/71602.html.
securities, including the new complex breeds of securities, and adding to risks to the entire financial system by promoting the growth of “too big to fail” financial institutions. The mischief wrought by Gramm-Leach-Bliley, which manifested itself in the financial crisis, went well beyond ending the long-standing Berlin Wall between commercial and investment banking: notably, for example, it forbade the SEC from regulating securities-based swap agreements beyond the general antifraud provisions of the securities laws. The shackles on federal regulation of derivatives were locked tightly by the Commodity Futures Modernization Act of 2000, which barred the Commodity Futures Trading Commission from regulating swaps not based on securities, notably including credit default risk swaps.

Beyond legal limitations placed on its authority by statute during the 30 years preceding the financial crisis, the SEC has been chronically starved for legal and accounting firepower, which has limited its ability to assure compliance with the securities laws in the face of rapidly expanding securities markets. It has therefore generally welcomed the judicial recognition of private rights of action for violations of securities statutes and regulations, particularly Securities


105 Pub. L. 106-554. This limitation has also been repealed, subsequent to the financial crisis, by Dodd-Frank.

Exchange Act §§ 10(b)\textsuperscript{107} and 14(a),\textsuperscript{108} and the SEC’s Rules 10b-5\textsuperscript{109} and 14a-9\textsuperscript{110} (the antifraud provision of the SEC’s Proxy Rules promulgated pursuant to 14(a)).\textsuperscript{111} After initially recognizing these rights of action, however, the courts quickly reversed course, refusing to permit parties other than the SEC to redress violations of other provisions of the securities laws through litigation, unless such rights were expressly conferred by statute.\textsuperscript{112} Judicial decisions have not only refused to imply new rights of action for violation of the securities laws, but have increasingly curbed the ability of parties other than the SEC to maintain actions under the statutes and regulations for which private rights of action have already been recognized.\textsuperscript{113}

\textsuperscript{107} 15 U.S.C. §78j(b).
\textsuperscript{109} 17 C.F.R. § 240.10b-5.
\textsuperscript{110} 17 C.F.R. § 240.14a-9.
\textsuperscript{111} See J. I. Case Co. v. Borak, 377 U.S. 426 (1964)(shareholder had private right of action under the § 14(a) and the Proxy Rules). The private right of action under § 10(b) and Rule 10b-5 was recognized by lower federal courts as early as in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), but not recognized by the Supreme Court until Superintendant of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 9 (1971).

\textsuperscript{112} The Supreme Court expressly refused to recognize a private right of action under the Investment Advisers Act in Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979), and has also refused to recognize private rights of action under other provisions of the securities laws such as §17(a) of the Exchange Act. See Touche Ross & Co. v. Redington, 442 U.S. 560, 567-68 (1979)(the fact that a federal statute has been violated and a person harmed does not automatically give that person a private cause of action under the statute).

\textsuperscript{113} The Supreme Court began to restrict the ability of private plaintiffs to bring actions under Rule 10b-5 almost immediately after recognizing it, with Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972)(requiring plaintiff to show “causation in fact”). More recently, it has drawn not only upon the text of the PSLRA but on Congressional intent in adopting the PSLRA to reduce the ability of plaintiffs other than the SEC to bring actions under Exchange Act 10(b). See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 3--, 127 S. Ct. 2499, 2504-05, 2510-11 (2007).
B. Prelude: The credit bubble reaches its limits

Warnings that the housing bubble was unsustainable appeared at least as early as 2004. The bubble continued to inflate, however. Benefit funds, trying to obtain 8% yields in a world where conventional investments were paying 3%, continued to invest in complex instruments that appeared to promise the yields they sought, peddled with deceptive promises of safety, and the total volume of complex structured instruments being created continued to expand dramatically. As the bubble reached the peak of its expansion, clear signs of an impending financial crisis appeared late in 2006, when U.S. housing prices first leveled off and then began to decline. The implications of this beginning of the long slide toward economic disaster for asset-backed securities were quickly felt. By June, 2007, the investment banking firm Bear, Stearns, which had had been particularly aggressive in generating CDOs despite the deteriorating quality of the underlying collateral, was forced to bail out two of its affiliated hedge funds because of the sharp deterioration of their CDO assets.

114 See SHILLER, IRRATIONAL EXUBERANCE 40-41, supra n. [92]; see also, Yulya Demyanyk, Ten Myths about Subprime Mortgages, 87, 91, in LESSONS FROM THE FINANCIAL CRISIS, supra n. [47] (signs of the brewing crisis were noted as early as 2001-2005, though masked by rising housing prices).

115 See Ashok Bardhan, Of Subprimes and Sundry Symptoms: The Political Economy of the Financial Crisis 17, 18 in LESSONS FROM THE FINANCIAL CRISIS, supra n. [47].

C. The Financial Crisis: The Crash of 2008

Over the next year, the depth of the developing crisis became apparent as Bear, Stearns itself spiraled toward insolvency. On March 14, 2008, the Federal Reserve provided emergency financial assistance to keep Bear, Stearns out of bankruptcy, and two days later, in an exercise of its powers not employed since the crises of the 1930s, provided $30 billion in backing as the venerable Wall Street firm was sold at a fire-sale price to Morgan Stanley.117

Despite signs of impending crisis that had multiplied during 2007, workaround measures by the Federal Reserve and private financial institutions working with it to save troubled institutions such as Bear, Stearns kept the slide toward world financial crisis slow and largely below the radar of the financial markets until the third quarter of 2008. By that time, subprime mortgages began to cascade into default; it became apparent to the financial community that CDO ratings were meaningless, and the solvency of the institutions holding them was therefore itself questionable.

The crisis came to a head with the failure of Lehman Brothers in 2008. Lehman was “too big to fail,” both in the sense that it was so large a component of the international financial condition that its failure entailed severe consequences,118 and that it was too big for the Fed to bail out with the resources it had at hand. The Fed was unable to find a purchaser for the firm, 

117 See Associated Press, In Bear Bailout, Fed Says It Tried to Avoid Contagion, THE NEW YORK TIMES, June 28, 2008 (Federal Reserve assistance in bailing out Bear, Stearns was “unprecedented”).

118 See, e.g., GEORGE SOROS, THE CRASH OF 2008 AND WHAT IT MEANS (2008)(Lehman was a major issuer of and market-maker for commercial paper).
and allowed it to file for bankruptcy—the largest bankruptcy in dollar terms in U.S. history. At this point, financial markets all over the world slid downward at a pace threatening to rival the Great Crash of 1929, as it became clear that many large financial institutions around the world held much of their capital in financial instruments that were either worthless or impossible to value. Interbank lending, the lifeblood of international commerce, froze because institutions worried that their borrowers—even in the “too large to fail” class, might be insolvent. With financial institutions around the world unable to engage in routine short-term lending to each other, the real threat emerged of a worldwide economic collapse comparable to the Great Depression of the 1930s.

As noted below, governments and central banks acted quickly and drastically in attempts to contain the crisis. Their efforts, however, fell short of dealing in full with the exigencies of the crisis, both in terms of expenditures and in terms of regulations to stabilize the financial environment and to prevent further crises from springing up from seeds planted in the years leading up to the initial crisis. It is therefore necessary to discuss what has been accomplished, and what measures are still required to deal with the damage already done and to minimize future harm resulting from the excesses of the bubble years.

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119 Lehman filed its bankruptcy petition with about $613 billion in scheduled debt, nearly six times as much as in the largest previously filed bankruptcy case. See Sam Mamudi, *Lehman folds with record $613 billion debt*, MarketWatch, September 15, 2008, http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid==rss. Almost simultaneously with the Lehman Brothers bankruptcy, another “too large to fail” institution, Merrill Lynch, was pushed by the Treasury Department into acquisition by the Bank of America in order to avert a similar fate. See Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill is Sold*, The NEW YORK TIMES, September 14, 2008.

III. The Securities Laws and Investments by Benefit Funds

A. Ad Hoc Responses: Trying to Contain the Crisis

The bankruptcy of Lehman Brothers was a “firebell in the night”\textsuperscript{121} that precipitated a financial crisis of breadth and depth such as had not been seen since the great Crash of 1929. Every sector of the U.S. economy was affected, beginning with the credit and equity markets. In late 2008, stocks plummeted from the all-time high levels reached in 2007, much as they had done in 1929. The most widely followed stock index, the Dow Jones Industrial Average, dropped almost 2,400 points in eight trading days.\textsuperscript{122} Even more seriously, credit markets all over the world froze. Since financial institutions held large portions of their capital in the form of once highly rated CDOs, which now were either worth substantially less than their nominal value, or whose value could not be computed at all, the institutions making up the system were reluctant to make the short-term loans to each other which the world financial system requires to function effectively. That, in turn, threatened to dry up credit to businesses around the world that depended on the institutions for credit to keep running.\textsuperscript{123}

The result was a quick sequence of major interventions by Congress, the Federal Reserve, the U.S. Treasury, and corresponding institutions of other major financial powers to shore up


\textsuperscript{122} See Kirk Shinkle, \textit{The Crash of 2008: How bad is it, and when will it end?} U.S. NEWS AND WORLD REPORT, October 17, 2008.

endangered private financial institutions that were “too big to fail,” and to restore liquidity to the international financial system. The level of commitment by governments, central banks, and major private institutions to this end was unprecedented in scope, size, and the level of international cooperation involved, continuing across national elections that transferred power from one political party to another.

As the U.S. government struggled to keep the national economy from collapse, one of its first formal measures was to establish the Troubled Asset Relief Program (“TARP”). This was enacted by Congress as a monumental appropriation--$700 billion—to be used to purchase toxic assets from the financial institutions that had embedded them in their capital. The urgency of the crisis, however, made this gradual approach appear too slow to avoid the failure of at least some of the institutions concerned, and so the TARP was transformed into a fund for protecting the solvency of troubled institutions by directly extending credit to them or, in many cases, purchasing equity interests in them. The toxic assets, however, remained embedded in their capital, and continue as a latent threat both to the institutions holding them and counterparties to swap transactions in which the counterparties agreed to assume at least part of the risk of the assets involved. This continues to play a significant role in the difficulties faced by the world economy in recovering from the crisis of 2008.

In the U.S., regulatory agencies also attempted to redraft the regulations which had embedded ratings issued by the conflicted credit rating agencies in the issuance of asset-backed

124 The TARP was created as the central part of the Emergency Economic Stabilization Act, Pub. L. 110-343 (2008).

securities. As the financial crisis moved toward its climax in 2008 and the rating agencies scrambled to lower their high ratings on securities based on defaulting mortgages, the SEC, for example, acknowledged that its prior use of ratings had been ill-advised and proposed amendments to its regulations that would limit their use going forward.\textsuperscript{126} These proposals, however, were limited in scope, and were never implemented because the Dodd-Frank Act, passed in 2010 as an attempt to deal with the problems that had resulted in the crash of 2008, superseded them both with self-executing provisions and with elaborate requirements for new, far more extensive regulations to be drafted by the SEC and other agencies dealing with ratings to limit their use and to make them, so far as they continued to be used, more reliable.\textsuperscript{127}

\begin{center}
\textbf{B. Incomplete answers: The Dodd-Frank Act and preliminary attempts at regulation}
\end{center}

With the Dodd-Frank Act of 2010,\textsuperscript{128} Congress attempted to deal comprehensively with many of the problems that underlying the financial crisis. Dodd-Frank, together with regulations being drafted by the SEC, the CFTC, and other regulatory agencies to interpret it and to give new force to prior regulatory statutes, contain some valuable provisions trapped within a mountain of verbiage. While, as we shall see, Dodd-Frank has severe limitations, it is helpful to begin by


reviewing its more effective provisions (at least, in terms of preventing harm of the type this Article discusses from occurring again). First, Dodd-Frank repeals the Gramm-Leach-Bliley’s bar to the SEC regulation of swap agreements.\(^{129}\) Regulations governing swaps will not only serve to enable regulators to ascertain the value of swaps outstanding, and thereby help to curb the volatility of financial markets generally—though derivatives such as swaps are inherently volatile and hard to value long-term,\(^ {130}\) so that it is unlikely that any regulatory scheme can make instruments that include them as collateral suitable to be offered for sale to vulnerable parties such as benefit funds.

Dodd-Frank also imposes some limits on securitization which, while limited, improve upon prior law. The most important of these is that it requires federal banking and securities regulators to formulate regulations to require the sellers of asset-backed securities to retain part of the risk of the assets such as mortgages that provide cash flow for the securities.\(^ {131}\) There are several important problems with this section, however: it is not self-executing, and requires regulations to be drafted by several different regulatory agencies to take effect. Moreover, it specifies that the amount of risk retained is to be at least 5%, hardly enough to deter investment banking firms who took on enormous levels of risk during the period leading up to the 2008 debacle.\(^ {132}\) Worse yet, the retention requirement does not apply to “qualified residential

\(^{129}\) Dodd-Frank Act §§ 761-763, 766, 768 (2010).


\(^{132}\) See Friedman & Friedman, supra n. [87], at 33 (after SEC agreed to let investment banks monitor their own risks in 2004, they took on enormous new risks, with Bear, Stearns taking on a leverage ratio of 33:1 by the time of its failure).
mortgages,” a term which the statute leaves to the agencies to define by regulation, but which presumably will include conventional mortgages. As we have seen, the failure of mortgage-backed securities that triggered the financial crisis was caused not just by the use of “subprime” mortgages, but by the steady relaxation of standards required for “conventional” mortgages. The SEC, in reliance on Dodd-Frank, has for the first time extended Regulation AB to cover privately placed asset-backed securities as well as those that are publicly registered. This small step forward, however, comes to grief, like so many provisions of Dodd-Frank, in the discretion that it gives to those whom it purports to regulate. New Rule 15Ga-1 requires securitizers—the assemblers of pools of assets used to collateralize asset-backed securities—to report incidents in which they are required to repurchase or replace collateral that proves defective. The SEC itself, however, somewhat ruefully noted that this obligation will be


134 See supra, TAN [88-90]. By contrast, the German PFANDBRIEFGESETZ, see supra, n. [42], requires strict supervision of financial institutions permitted to issue Pfandbriefe and of the collateral that backs the instruments. Inter alia, issuing institutions retain all risk on the Pfandbriefe that they are permitted to issue, and if mortgages collateralizing a Pfandbrief become riskier than at the time the Pfandbrief was issued, independent trustees (“Treuhänder”) must replace them with instruments that adequately cover the obligations evidenced by the Pfandbrief. See, e.g., PFANDBRIEFGESETZ §§ 1-4, 12-16, 27-28. Pfandbriefe survived the 2007-09 crisis far better than their CMO cousins. Ironically, the only significant crisis affecting Pfandbriefe during the world financial crisis occurred late in 2008 not because of failure of mortgages collateralizing Pfandbriefe, but because a leading issuer, the Hypo Real Estate Pfandbrief Bank, became enmeshed in a crisis concerning its corporate parent, the Hypovereinsbank, because of the parent’s failed investment in the Depfa Bank in Ireland, requiring the German government to bail out the corporate parent. See Kofner, supra n. [42], § 3.2.

135 Dodd-Frank § 943.


triggered only if a securitizer subjects itself to a contractual obligation to repurchase or replace assets that prove defective, and that commentators responding to the proposing release had noted the improbability of its having significant effects.\(^\text{138}\)

Dodd-Frank also makes an elaborate but, in the last analysis, limited attempt at protecting buyers of complex financial instruments such as benefit funds by imposing more controls on rating agencies and the use of their output than previous legislation.\(^\text{139}\) Most significantly, it requires the SEC, banking regulators, and other federal agencies to remove the use of ratings previously required by regulations dating back to 1975 for matters as varied as qualifying for short-form registration of securities and quality of required capital for financial organizations ranging from broker-dealers to banks.\(^\text{140}\)

Furthermore, since it accepts that ratings will continue to be widely used in evaluating the quality of securities, it attempts to assure greater objectivity in credit ratings by requiring rating agencies, as a condition for registration, to establish their own systems of internal controls for the

\(^{138}\) See SEC Releases 33-9175 and 34-63741 at 6, 8-10.

\(^{139}\) See Dodd-Frank Act Title IX, Subtitle C, “Improvements to the Regulation of Credit Rating Agencies.” Pub. L. No. 111-203, §§ 939, 939D-939F.

\(^{140}\) Dodd-Frank § 939A requires federal agencies, within a year after enactment of the statute, to review all use of ratings used in their regulations. While this has in fact taken far longer than the time required, the SEC has already adopted extensive amendments to its rules and forms, effective December 12, 2012, which remove virtually all use of ratings in its rules and forms, such as the use of ratings to qualify for use of the simplified forms S-3 and F-3 for registering securities for public distribution. See SEC, Security Ratings, Releases No. 33-9245 and 34-64975, File No. S7-1808. The changes also include the elimination of former 1933 Act Rule 134(a)(17), 17 C.F.R. § 230.134(a)(17), which had provided a “safe harbor” for issuers to use credit ratings in communications not subject to the rules governing prospectuses. As the SEC noted in removing the “safe harbor,” the change will probably have little effect because issuers will still be able to use ratings in free writing prospectuses, and, as we will see, the new rules that are supposed to improve the accuracy of ratings leave almost no room for an investor to sue an issuer or rating agency based on an inaccurate rating. See SEC Release No. 33-9245 at 38-39.
formulation of procedures and methodologies designed to produce consistent and accurate ratings. It requires the agencies to appoint compliance officers to assure that each agency, in formulating its ratings, is in compliance with its own policies, and requires the chief executive officer of each agency to attest to its compliance with these policies.\textsuperscript{141}

Additionally, it requires rating agencies to disclose their methodologies, including mathematical models, data used to formulate the ratings, limitations on the reliability of the ratings, and information concerning the past performance of the ratings. These are to be provided, on standard forms to be developed by the agencies themselves, to users of the ratings.\textsuperscript{142} These forms are supposed to be “easy to use and helpful for users of credit ratings to understand the information contained in the report…”\textsuperscript{143}

All of this sound and fury signifies next to nothing, however, for a number of reasons. First, of course, even if Dodd-Frank provided for rules imposed by a body other than the agencies themselves, and enforceable by users of the ratings as well as the SEC, the reports it prescribes to accompany the ratings would be unlikely to be materially helpful to unsophisticated users, for whom, as the experience of the last decade shows, the ratings themselves are surrogates for due diligence on the quality of complex securities. In the assembly of collateral for CDOs, as previously noted, complexity led even sophisticated investment bankers to rely solely on ratings for evaluating the chances of default on the securities based on that collateral.\textsuperscript{144}

\textsuperscript{142} See Dodd-Frank § 932(r), (s), codified at Exchange Act § 15E(r), (s), 15 U.S.C. § 78o-7(r), (s).
\textsuperscript{144} See supra, TAN [51-55, 86].
Even if users were to actually make use of the new reports required by Dodd-Frank, however, agencies face little deterrence against formulating rules that favor themselves at the expense of their customers, because (a) enforcement of the provisions is left exclusively to the SEC, and (b) even worse, the SEC’s authority is merely to prescribe rules under which the agencies are to regulate themselves, and its power to sanction misbehavior by a rating agency is largely confined to the authority to suspend or disbar agencies that fail to conform to their own rules.

Moreover, Dodd-Frank and the regulations being drafted to implement it do not offer any remedy at all for the problems faced by benefit funds holding complex financial instruments that are now worthless, sharply diminished in value, or currently impossible to value. Moreover, they do not address important issues concerning the prevention of a similar debacle in the future.

The first problem is that Dodd-Frank, whatever its use going forward, cannot be applied to transactions already completed. It therefore cannot be a source of remedies for wrongs committed in the sale of complex securities to benefit funds before the financial crisis, and in any case adds little to the enforcement powers of the SEC, other federal regulators, and self-regulating organizations such as FINRA.


146 See Dodd-Frank § 932(a)(2), codified at Exchange Act § 15E(c), (d), 15 U.S.C. § 78o-7(c), (d).

147 See Landgraf v. USI Film Products, 511 U.S. 244 (1994)(there is a strong presumption against retroactive application of a statute unless retroactivity is expressly stated by Congress). An SEC administrative law judge, addressing an initial attempt by the SEC to apply Dodd-Frank, held that substantive provisions of Dodd-Frank do not apply retroactively. See In re Lawton, SEC, Admin. Proc. File No. 3-14162 (April 29, 2011).
Secondly, Dodd-Frank, as it currently stands, is immensely complex, running over 2,300 pages.\textsuperscript{148} In attempting to deal with the multitude of problems that became manifest with the 2008 financial crisis, it incorporates provisions that deal with matters ranging from consumer protection to the regulation of rating agencies. Because of this attempt at being comprehensive, and the compromises that went into achieving its wide scope, it lacks the conciseness and consistent legislative architecture that have made legislation such as the 1933 Act and the Sarbanes-Oxley Act of 2002\textsuperscript{149} effective tools for securities regulation, and often fails short of real effectiveness in matters of concern to this Article such as regulation of the rating agencies. Dodd-Frank, and particularly the sections of its Title IX that apply to rating agencies, are so prolix, indirect, and lacking in force as to fit the Court of Claims’ characterization of the 1959 Life Insurance Company Income Tax Act as a “conspiracy in restraint of understanding.”\textsuperscript{150}

Moreover, to an even greater degree than earlier securities law, Dodd-Frank depends upon interpretive regulations which are being drafted—with considerable difficulty—by multiple administrative agencies, for its enforcement.\textsuperscript{151} It is also subject to ongoing hostility in Congress that could result in the revision or repeal of some of its provisions, and which could also deter administrative agencies from drafting interpretive regulations as forceful as regulations already

\begin{footnotes}
\item[149] 15 U.S.C. §§ 7201 \textit{et seq.}
\item[151] The CFTC, for example, has voted to delay its rulemaking for key portions of Dodd-Frank (other than those that are self-executing) until at least the end of 2011, more than six months after the deadline in the Act. \textit{See CFTC Proposes Six-Month Delay For Bulk of Dodd-Frank Swaps Rulemaking}, \textsc{Securities Law Daily} 06/15/11, \url{http://news.bna.com/sdln/display/batch_print_display.adp}.
\end{footnotes}
in effect under older federal statutes concerning securities.\textsuperscript{152} All of this is likely to limit its effect even going forward.

Dodd-Frank, more than prior legislation, gives the appearance of attempting to deal with the problems associated with the credit rating agencies.\textsuperscript{153} It requires the SEC to establish within itself an Office of Credit Ratings to administer the rules that it authorizes the SEC to draft concerning credit rating agencies, and to promote accuracy in the ratings.\textsuperscript{154} It also contains some useful provisions for disclosure by rating agencies on their practices in formulating ratings.\textsuperscript{155}

Dodd-Frank provides, somewhat deceptively, for agency input in supervising what is essentially a scheme of self-regulation by the credit rating agencies. To do so, inter alia, it mandates the creation within the SEC of an Office of Credit Ratings.\textsuperscript{156} Nonetheless, its elaborate provisions concerning rating agencies shows that it anticipates that ratings will continue to be used, particularly in privately placed offerings, and it approaches abuses by credit rating agencies obliquely rather than directly.\textsuperscript{157} Its immense complexity is a source of weakness rather than strength: It is partly self-executing, and partly relies on studies to be made and regulations to be promulgated by eight different federal agencies—the Treasury, Federal

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\item\textsuperscript{152} See Levitt, Don’t Gut the S.E.C., supra n. [17] (Congressional Republicans, as part of their general hostility to the securities laws, have deliberately underfunded the S.E.C.’s statutorily required efforts to promulgate regulations for enforcement of Dodd-Frank).
\item\textsuperscript{153} See Pub. L. 111-203, 124 Stat. 1376, Title IX, Subtitle C.
\item\textsuperscript{155} See supra, TAN [142-146].
\item\textsuperscript{157} See supra, TAN [137-43].
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Reserve, SEC, CFTC, FDIC, FHFA,\textsuperscript{158} NCUA,\textsuperscript{159} and the Office of the Comptroller of the Currency, plus a new Bureau of Consumer Protection.\textsuperscript{160}

Substantively, it gives the SEC some authority over the credit rating agencies, an important point for the concerns of this Article,\textsuperscript{161} but, as is all too typical of the Dodd-Frank Styrofoam skyscraper, it leaves in place Exchange Act § 15E(c)(2), inserted by the toothless Credit Rating Agency Reform Act of 2006, which bars not only the SEC but any State from regulating the agencies’ procedures, methodologies, or the substance of credit ratings, except in indirect ways.\textsuperscript{162} While it has elaborate provisions requiring rating agencies to establish procedures for formulating ratings, and requires that these procedures be documented and disclosed,\textsuperscript{163} it does not permit regulatory agencies to play a direct role in formulating the ratings

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\item[158] The Federal Housing Finance Administration, successor agency to the Office of Federal Housing Oversight and conservator for the formerly independent Fannie Mae and Freddie Mac.
\item[159] The National Credit Union Administration.
\item[160] Dodd-Frank requires the SEC alone to establish five new offices, conduct more than 20 studies, and draft more than 100 sets of rules. See Chairman Mary L. Schapiro, SEC, Testimony on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, 2/17/11, \url{http://www.sec.gov/news/testimony/2011/ts021711mls.htm}.
\item[161] See generally, Pub. L. 111-203, Title IX, Subchapter C, §§ 931-39H.
\item[162] Exchange Act § 15E(c)(2), 15 U.S.C. § 78o-7(c). See SEC Release No. 34-64514, Nationally Recognized Statistical Rating Organizations, File No. S7-18-11, 76 Fed. Reg. 33420, 33429 (6/8/2011). See also, Mark Twain, “A lie is like a cat. It never comes at you straight.” In fairness, Twain was intensely fond of cats, something that could not be said of his feelings toward Congress (“Reader, suppose you were a member of Congress. And suppose you were an idiot. But I repeat myself.”).
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that the agencies place upon securities. Moreover, it preserves the exclusive authority given to the SEC by CRARA to enforce provisions of the securities laws dealing with rating agencies, if the agencies materially fail to conform to the procedures for rating securities prescribed by Dodd-Frank and other litigation.

Dodd-Frank does allow a private right of action against rating agencies under extremely limited circumstances: where the complainant is injured by a rating that was prepared by an agency in knowing or reckless disregard of its own procedures for formulating ratings, or of information used in rating a security. It is, however, even more restrictive than the PSLRA in establishing high barriers that pleadings in such actions must overcome to allow them to proceed to discovery, making the right almost meaningless. In the first place, the pleading barrier

164 While Dodd-Frank states that the SEC may prescribe factors that an NRSRO should take into consideration in establishing, maintaining, enforcing, and documenting, an effective internal control system, the SEC role is permissive rather than mandatory, and the primary responsibility is still placed with the rating agency itself. See Dodd-Frank § 932(a)(2)(b), codified at Exchange Act § 15E(c)(3)(A), 15 U.S.C. § 78o-7(c)(3)(A). The SEC, as of August 8, 2011, deferred such prescription indefinitely pending observation of actual formulation by the rating agencies of their own internal control structures, illustrating in part the futility of doing so, given the complexity of the task in proportion to SEC resources, and the ultimate self-regulatory authority allowed the agencies under Dodd-Frank. See SEC Release No. 34-64514, File No. S7-18-11, at 7-8.


166 New SEC Rule 17g-7 requires NRSROs to disclose, as part of the report accompanying their ratings of asset-backed securities, any representations, warranties, and enforcement mechanisms available to investors under the rating agencies’ own internal procedures, and how they differ from the representations, warranties, and enforcement mechanisms under similar securities—but since these are left almost entirely to the discretion of the agencies themselves, the rule is deceptively meaningless. SEC Release No. 33-9175, File No. S7-24-10, 76 Fed. Reg. 4489, 4507, 4510, January 26, 2011.

167 Dodd-Frank § 939(g), at first glance, seems to give non-agency claimants stronger claims against NRSROs for misleading ratings by repealing 1933 Act Rule 436(g). This rule provided that when a rating was referred to in a registration statement for securities, the NRSRO that issued it would not be considered an expert participating in the registration process for purposes
applies not just to class action plaintiffs, but to all plaintiffs, including public benefit funds. Secondly, it bars any action from proceeding as far as discovery unless the plaintiff’s pleadings establish “a strong inference” that the agency, in preparing the rating, failed to comply with its own procedures, or to obtain “reasonable verification” of factual elements of the rating from sources other than the issuer or underwriter “that the credit rating agency considered to be competent” concerning the security being rated.\textsuperscript{168} The near-complete discretion given agencies to choose the methods and facts they use to rate securities makes it difficult to envision circumstances under which a plaintiff could overcome the pleading barrier to state a case.

While Dodd-Frank requires federal agencies to remove formal requirements that ratings be used in evaluating the creditworthiness of securities, it leaves individual federal agencies to provide for substitutes by regulation.\textsuperscript{169} While the SEC and other regulatory agencies have complied with this directive by promulgating new rules to remove references to ratings by the of liability under 1933 Act § 11. Dodd-Frank, in repealing it, established that NRSROs would not be considered experts for purposes of § 11 liability unless they file a written consent to the inclusion of the rating in the registration statement. This is likely to have little impact (1) because most of the securities with which this Article is concerned are exempt from registration, and (2) because the rating agencies have indicated they will not give the requisite consents. \textit{See} Gregory A. Fernicola, Stacy J. Kantor, & Joshua B. Goldstein, \textit{Dodd-Frank Act Rescinds Exemptions Under Rule 436(g)}, SKADDEN, EVENTS & PUBLICATIONS, July 23, 2010, \url{http://www.skadden.com/Index.cfm?contentID=51&itemID=2172}.


\textsuperscript{169} The SEC, \textit{inter alia}, has removed investment grade ratings as requirements for the registration of primary offerings of non-convertible, non-equity securities for cash on short forms S-3 and F-3 (as compared to the much longer forms S-1 and F-1 used for offering non-qualifying securities), and substituted a requirement that the issuer have issued at least $1 billion in non-convertible, non-equity securities registered under the 1933 Act over the prior three years, or meet certain other transaction history requirements. \textit{See} SEC, revised General Instruction 1.B.2 to Forms S-3 and F-3, 17 C.F.R. § 239.13; Releases No. 33-9245 and 34-64975, File No. S7-18-08, pages 14-25, July 27, 2011.

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NRSROs from their regulations,\(^{170}\) they have not come up with adequate substitutes, nor is it clear that it is possible to do what the ratings purported to do—i.e., to predict performance by complex securities over more than a short period of time.\(^{171}\)

Moreover, Dodd-Frank and its regulatory progeny do little to prevent the ratings from continuing to be formulated for investors’ guidance. Its treatment of the conflicts of interest created by the agencies’ business model of being paid by the issuers of securities they are rating is typical of its soft approach to hard problems. Instead of taking as its model the stringent provisions created by the Sarbanes-Oxley Act in dealing with conflicts of interest by auditors,\(^{172}\) it merely provides for a paper-thin separation between the agency employees who sell their agencies’ services and those who actually rate securities.\(^{173}\) It takes little analytic skill to see that


\(^{171}\) Many comments made to the Office of the Comptroller of the Currency on its proposed rules to replace ratings with complex economic models noted that most community and regional banks did not have systems and staff capable of performing analyses at the level of credit rating agencies—and the same is, if anything, more true of all but the most sophisticated benefit funds. See Department of the Treasury, Office of the Comptroller of the Currency, Risk-Based Capital Guidelines, supra n. [161] at 7.

\(^{172}\) See Sarbanes-Oxley Act § 208(b), 15 U.S.C. § 7234 (making it unlawful for a registered public accounting firm or any person associated therewith to prepare or issue an audit report concerning an issuer of securities if subject to a conflict of interest as defined in 1934 Act §10A(g)-(l).

agency employees who formulate ratings are aware that their agencies are paid by the issuers of the securities they are rating and depend for their revenues on good relations with the small circle of financial institutions that underwrite the securities, whether or not they have direct contact with those who sell the agencies’ services. It is this systemic conflict of interest, rather than conflicts of interest by agency employees that Dodd-Frank seeks to control, that were the source of deceptively positive ratings issued for complex financial instruments such as CDOs to benefit agencies during the New Gilded Age.\footnote{See Illinois v. McGraw-Hill Cos., Inc., Ill. Cir. Ct., No. 12 CH 2535, January 25, 2012; Michael Bologna, Illinois AG Accuses S & P of Fraud in Ratings of Structured Finance Securities, January 26, 2012 (Illinois sued S & P in state court under the Illinois Consumer Fraud Act and Uniform Deceptive Practices Act, claiming that, in the ratings it gave structured finance securities sold to state agencies, S & P systematically misrepresented its credit analysis of the securities as objective when it in fact ignored their true risks to secure business from the securities’ underwriters).}

Another Dodd-Frank provision that superficially appears to encourage agency objectivity in formulating ratings similarly falls short of real effectiveness. This is the requirement that an agency, in formulating a rating, shall rely on information from a source other than the security’s issuer or underwriter that it considers reliable.\footnote{Dodd-Frank § 935(v), codified at Exchange Act § 15E(v), 15 U.S.C. § 78o-7(v).} This is deceptively meaningless because the source must be one that the rating agency itself considers credible—and by leaving the decision on credibility to the agency itself, renders virtually unenforceable a claim that the agency failed to rely on truly objective evidence. The vaporous nature of the provision is highlighted by considering what third-party sources a rating agency could rely upon to provide such information—given that the only parties likely to have the resources to perform the kind of “due diligence” to which the statute refers, in the context of examination by agencies of third-party
data,\textsuperscript{176} are the small circle of financial institutions that share a mutual interest in assuring that complex securities receive good ratings.

Even the requirement that the SEC prescribe a short form on which rating agencies are to be required to provide ratings users with the assumptions and methodologies underlying the procedures used in formulating ratings, and the data used in preparing particular ratings,\textsuperscript{177} may ironically prove counterproductive. Given the complexity of the mathematical models used to formulate ratings, one can be sure that they will add little or nothing to the ability of fiduciaries for all but the largest benefit funds to understand what the ratings mean, and smaller fund fiduciaries are more likely to simply look at the rating itself, and erroneously take confidence from the analytical apparatus provided by the forms that the ratings can be relied upon.\textsuperscript{178}

\textbf{IV. Where Do We Go from Here?}

Two problems must be addressed in dealing with losses incurred by public benefit funds before the losses escalate into a new dimension of the financial crisis that could prove comparable to or even more severe than the failure or threatened failure of great private financial institutions. The first is to enable them to recover losses by rescinding transactions or recovering

\textsuperscript{176} Exchange Act § 15E(4)(A). The statute’s use of the term “due diligence” is itself deceptive in that it falsely implies that providers of such information will be subject to the kind of liability to which an underwriter would be subject under Securities Act § 11(a) and (b) for failure to perform due diligence, when Dodd-Frank in fact does not impose such liability.

\textsuperscript{177} Exchange Act § 15E(s), 15 U.S.C. § 78o-7(s).

\textsuperscript{178} See Elisabeth Rosenthal, \textit{I Disclose…Nothing}, \textit{The New York Times}, January 22, 2012 (elaborate required disclosure is rarely read by its intended recipients, and instead tends to be used by its providers to show compliance with disclosure law and thereby avoid legal liability).
damages from financial institutions that led them down the primrose path to improvident investments. The second is to put in place a framework of regulation which will make it more difficult for benefit funds to put themselves in this kind of financial jeopardy in the future.

Recoveries of losses—both those already realized and those that are still latent—will require enforcement of statutes and regulations designed for this purpose. Given the comparatively small size of the SEC’s Enforcement Division, this enforcement will require private as well as public actions under the securities laws. This, in turn will require clarifying regulations designed to encourage meritorious actions being brought by benefit funds under the federal securities laws, dispelling the penumbra of deterrence created by the PSLRA that has driven securities fraud actions into the uncertain and inconsistent forums provided by the state courts. The regulations should also make it possible for benefit funds to maintain actions in the federal courts based on statutory provisions that have heretofore been the exclusive preserve of the SEC.

**A. Enforcement: Regulations in aid of benefit funds for pre-crisis investments**

The first concern in addressing the problems faced by benefit funds with respect to investments in complex instruments which are now non-performing and either worthless or at least unsalable is to recover losses incurred when their purchase of the instruments in question was based on material misrepresentations or omissions by their vendors. There are good arguments for addressing such wrongs through action by the SEC, because of the expertise of the SEC’s Enforcement Division; because the SEC can make use of statutes such as the Advisers
Act which may not be privately enforced,\textsuperscript{179} and because such enforcement would help create more uniform national rules. Unfortunately, as has been noted,\textsuperscript{180} the SEC lacks staffing and financial resources to address all but the most serious cases of securities fraud.

\textbf{B. Enforcement: Giving statutes regulatory teeth}

The SEC has—unfortunately well after much of the damage was done—taken action against abuses by investment advisers who allegedly fattened themselves in violation of the Investment Advisers Act during the period leading up to the financial crisis. It has brought actions against parties accused of violating the Act, and formed a new unit within the Enforcement Division to specialize in violations of the Act. Nonetheless, the unit consists of a total of just 65 professionals—enough to bring some high-profile cases but not nearly enough to deal with abuses during the prelude to the crisis, let alone the future.\textsuperscript{181}

Dodd-Frank, despite the weaknesses described above,\textsuperscript{182} suggests a viable approach, even though the legislation only takes some preliminary steps in that direction: The SEC can multiply the effectiveness of its professionals by working with the states. Dodd-Frank does this, \textit{inter alia}, by amending § 203A of the Investment Advisers Act to provide that investment advisers


\textsuperscript{180} See, \textit{e.g.}, n. [19] \textit{supra}.

\textsuperscript{181} See n. [19], \textit{supra}.

\textsuperscript{182} See TAN [103-114], \textit{supra}.
with less than $100 million under management must be registered with and examined by their home states, and barring advisers in this group from registering with the SEC. Perhaps even more significantly, the Advisers Act authorizes the SEC to provide training and other reasonable assistance to state authorities in connection with the regulation of investment advisers. These provisions, however, are limited by barring the states from bringing enforcement actions against larger advisers that are required to register with the SEC, except for “fraud or deceit,” implying that such actions require state enforcement in these cases requires proof of scienter, a requirement to which the SEC is not subject.\footnote{See SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).}

This suggests that more systematic cooperation between the SEC and the states across the entire spectrum of securities regulation would provide an effective way to allocate scarce resources to protect state instrumentalities such as benefit funds. A first step in establishing a closer working relationship between the SEC and the states would be to split off a new Office of State Coordination from the SEC’s present Office of Legislative and Intergovernmental Affairs, which presently engages in the largely futile exercise of attempting to conduct liaison with Congress.\footnote{See SEC, Office of Legislative and Intergovernmental Affairs, http://www.sec.gov/about/offices/olia.htm.} The new office would amplify the effectiveness of the SEC staff by arranging for it to coordinate both the drafting of regulations for the protection of state instrumentalities such as benefit plans, providing training in securities enforcement for state professionals, and coordinating enforcement actions on behalf of such agencies with state attorneys general and

\footnote{See Dodd-Frank Act § 410 and Advisers Act § 203A, 15 U.S.C. § 80b-3a.}

\footnote{Advisers Act § 203A(d), 15 U.S.C. § 80b-3a(d).}
other legal officers. Moreover, it would help state agencies by providing regular procedures to notify the SEC of the need for enforcement action, thereby helping to place the investigative powers of the SEC at their disposal, and enabling the state agencies to make use of enforcement powers reserved by current law to the SEC, such as those created by the Advisers Act\textsuperscript{187} and other federal statutes such as § 17(a)(2) and (3) of the 1933 Act.\textsuperscript{188}

In addition to multiplying the effectiveness of SEC enforcement, this coordination strategy would also help to ensure uniformity in the creation and enforcement of antifraud regulations affecting state benefit funds, by centering them on common federal standards rather than relying on inconsistent state legislation and state court interpretations of such legislation.\textsuperscript{189}

\textsuperscript{187} See Advisers Act § 206(2), 15 U.S.C. § 80b-6, which imposes a fiduciary duty on investment advisers requiring them to disclose all material information to clients and prospective clients—including public benefit funds. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194-97 (1963). The SEC has made use of the Advisers Act to obtain settlements from dealers who fail to disclose risks in complex financial instruments—including conflicts of interests on the part of dealers who had taken short positions on the instruments they were selling—to clients. See In the Matter of Credit Suisse Alternative Capital, LLC, et al., SEC Administrative Proceeding File No. 3-14595, Investment Advisers Act of 1940, Release No. 3302, October 19, 2011.

\textsuperscript{188} 15 U.S.C. § 77q(a)(2) and (3). The SEC has found § 17(a)(2) and (3) to be effective weapons against misrepresentations in the issuance of securities because, unlike the more famous § 10(b) of the Exchange Act and Rule 10b-5, based on § 10(b), they allow relief without requiring the agency to prove \textit{scienter}—willful or reckless misrepresentations or omissions. See Aaron v. SEC, 446 U.S. 680 (1980).

\textsuperscript{189} State enforcement actions based on securities violations rose by 51% from 2009 to 2010 alone. See State Enforcement of Securities Violations In 2010 Up 51 Percent Over Previous Year, BNA SECURITIES REGULATION & LAW REPORT, 43 SRLR 2228, 10/31/2011. Lack of uniformity in the application of state law to actions based on alleged securities fraud is a problem not only in cases involving public benefit funds but also for private class actions, the primary target of the PSLRA, which have been brought in state courts in increasing numbers—a trend that has accelerated since 2005. See Study: More M & A Class Actions Filed In State Courts Than in Federal Courts, SECURITIES LAW DAILY 6/15/11, http://www.news.bna.com/batch_print_display.adp...
More effective enforcement, based on uniform standards, will not only help benefit funds recover losses from prior investments, but should have a deterrent effect against future abuses.

C. Rethinking exemption from registration for asset-backed securities

One of the basic problems created by deregulation beginning in the 1970s, which helped lead unsophisticated managers of state and local benefit funds down the primrose path to the purchase of asset-backed securities is that they have been exempt from registration with the SEC, and therefore from the stringent disclosure and due diligence obligations imposed on participants in the issuance of securities by the Securities Act of 1933.\textsuperscript{190} The exemptions have been created both by the 1933 Act itself\textsuperscript{191} and pursuant to SEC regulations based on the statute.\textsuperscript{192}

Rule 506 is the final part of the SEC’s Regulation D, which is one of several regulations exempting the sale of certain securities from the general requirement that new securities be registered with the SEC before they can be sold. The Regulation D exemptions, based on the less specific exemptions provided by 1933 Act §§ 3, 4, and 5,\textsuperscript{193} have a dual purpose: to relieve small and startup businesses from the considerable burden of registering their securities under the 1933 Act, and to relieve the already overtaxed SEC staff from the need to review the offering

\textsuperscript{190} See 1933 Act § 11, 15 U.S.C. § 77k.


\textsuperscript{192} See Regulation D, Rules 501(a)(1) and 506, 17 C.F.R. §§ 230.501(a)(1) and 230.506.

materials for securities not intended for general distribution for registration. Like the other exemptions from registration, it was not intended not make serious inroads upon the Act’s primary purpose—to insure full and fair disclosure concerning new securities to protect unsophisticated investors from the kind of securities fraud which was discussed in ample detail by the Congress that enacted the Securities laws in the wake of the great stock market crash of 1929. Rather, it was designed to facilitate the sale of securities by small and start-up businesses without requiring the substantial time and expense required for registration under the 1933 Act.\textsuperscript{194}

Rule 506 differs from the other exemptive provisions of Regulation D (Rules 404 and 405) in that it allows the issuance of unregistered securities without regard to their aggregate offering price if all persons to whom they are sold are “accredited investors,” as defined in Rule 501(a). It is here that the devil gets into the details: First, “accredited investors,” as defined by Regulation D to include public benefit funds with assets of $5 million or more, are not necessarily more sophisticated than the general public in their ability to assess the risk of securities offered to them. Andrew Kolotay, a financial advisor with a Ph.D. in mathematics, testified at an SEC hearing that most municipal decision makers did not have sufficient skills to evaluate even comparatively simple swap transactions, and were therefore, even in the absence of fraud by their vendors, and frequently overcharged by swap advisers and dealers.\textsuperscript{195}


\textsuperscript{195} See Andrew Kolotay, Prepared Remarks at SEC Hearing on the State of Municipal Securities Market, Birmingham, AL, July 29, 2011. On the other hand, large funds, such as CALPERS,
Moreover, the inclusion of smaller benefit funds in the class of persons to whom securities can be offered without meeting the requirements for registration does not serve the chief purpose of the 1933 Act’s intent in providing for exemptions of this kind—allowing investors in small and startup businesses—both the founders of such businesses and sophisticated venture capitalists able to understand the risks of such investments and, unlike benefit funds, able to absorb them—the chance to invest in such businesses without incurring the substantial costs of registration.

Regardless of the exemption employed, smaller benefit funds suffer from several vulnerabilities in being allowed to purchase unregistered securities. First, as noted above,\textsuperscript{196} their managers lack the sophistication to understand the risks of complex securities that are difficult even for experts to evaluate. Generally, the only basis they have had for judging the quality of their investments has been ratings, which have proven unsatisfactory for reasons already explained, and whose deficiencies are not adequately addressed by Dodd-Frank and agency regulations based on it.

The exemption from registration also means that issuers and persons involved in the issuance of complex securities are not bound by the due diligence requirements of Securities Act § 11,\textsuperscript{197} nor are they subject to more than minimal disclosure requirements. Since they are not have substantial expertise concerning complex securities, although even they are subject to pressures by beneficiaries and political officials to seek higher yields at the expense of safety.

\textsuperscript{196} See id.

\textsuperscript{197} See 15 U.S.C. § 77k(b)(3).
subject to the SEC’s Plain English Rules,\textsuperscript{198} the disclosure of risks in any security privately placed with them pursuant to the exemptions, even in the absence of deliberate fraud, can be hidden in obfuscatory language that can be puzzling even to specialists in securities law. Moreover, of particular concern to smaller funds, unregistered securities are less liquid than registered securities, since they may be sold even if registered or pursuant to one of the SEC’s exemptions for the resale of unregistered securities.\textsuperscript{199}

There are three possible ways to remedy this situation.\textsuperscript{200} The first would be to exclude benefit funds entirely from the class of investors to whom securities may be sold without registration under the 1933 Act. This would require two changes: the definition of “Accredited Investor” in Rule 501(a)(1) would be amended by striking the language “any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000…”\textsuperscript{201} To complete this exclusion, Rule 506(b)(2)(ii) would need to be amended to eliminate the accreditation of this category of purchaser, without regard to the value of its assets, from those purchasers to whom an offering could be made subject to the exemption.


\textsuperscript{199} See 1933 Act § 5, 15 U.S.C. § 77e. Even if public funds qualify for a resale exemption such as that in 1933 Act § 4(1), which is less than clear under case law—\textit{see, e.g.,} SEC v. Guild Films, Inc., 279 F.2d 485 (2d Cir. 1960)—they would still be illiquid for lack of a ready market.

\textsuperscript{200} Dodd-Frank gives backhanded support to the problems inherent in exemptions for offerings to “accredited investors” by repealing 1933 Act § 4(5), 15 U.S.C. § 77d(5)—\textit{see} Dodd-Frank §944(a)(1)—but that exemption, applying solely to the offering of securities to accredited investors of securities with aggregate value of less than $5 million—had far less significance than the exemption of securities without limitations on value established by Rule 506.

\textsuperscript{201} 17 C.F.R. § 230.506(a)(1).
An alternative approach would be to permit only the largest, and presumably the best-advised and most sophisticated, funds, to take advantage of the exemption, while barring its use by smaller and less sophisticated funds. This could be done, for example, by raising the lower limit for fund assets to $100 million, a level that would support the retention of bond counsel by the funds. Doing this would further one of the original purposes of Rule 506—to reduce the number of SEC filings. There are two reasons, however, why this approach would be less satisfactory than the first: Experience has shown that even the most sophisticated funds, such as CALPERS and the Texas Teachers Fund, suffered losses from improvident investments in complex financial instruments. This is partly due to the opacity of disclosure private placement memoranda for securities not subject to registration, and perhaps more because even the largest funds are subject to political pressures and pressures from their beneficiaries to raise yields on their investments—possibly to unreasonably high levels—in order to reduce required contributions by state agencies and beneficiaries.

A third and simpler approach would be to design a special exemption for benefit funds, while barring the private placement of securities with them under Rule 506. Under this approach, well-known seasoned issuers would be permitted to make private placements of conventional debt and equity securities with larger benefit funds, but would be required to

202 See supra, TAN [11-12].

203 “Well-known seasoned issuers” are defined by Rule 405 under the 1933 Act, 17 C.F.R. §230.405, as large, experienced issuers with a worldwide market for their securities, which have a history of compliance with the securities laws.

204 While, as we have seen, size alone does not guarantee sophistication on the part of a benefit fund, a fund managing at least $500 million in assets is better able to afford the risks inherent in holding unregistered securities than the present, ludicrously low limit of $5 million in current
make the same kind of “plain English” disclosure of risks now required on registration statements under the 1933 Act. “Plain English” disclosure of risks in order of the degree of danger they pose to investors will provide significantly more information to potential purchasers than simple ratings. This approach would be a substantial improvement over reliance on ratings in aiding potential purchasers to understand the risks posed by complex financial instruments, giving them more of the security provided by purchasing registered securities, while also serving the Regulation D purposes of facilitating capital formation and relieving the SEC of the burden of having to review an augmented number of registration statements.

D. Amplifying disclosure: Borrowing from the FDA

The credit rating agencies have clearly proven themselves inadequate to give benefit funds adequate warning of unsuitable risks in the CDO market. CRARA did not even attempt a meaningful reform of the agencies’ business model, in which they are paid by the issuers of the securities that they rate,205 and Dodd-Frank does not completely deal with this problem. While it would prove helpful to give the agencies a due diligence obligation in formulating their ratings that resembles that assumed by other participants in the issuance of securities,206 there are three obstacles that stand in the way of making such duties effective in protecting public benefit funds against unwise investments in unconventional securities: (1) many of these securities may be sold to benefit funds without registration under the 1933 Act, a problem that would be addressed by the reform of Regulation 506 described above; (2) present national politics indicate that it is

Rule 506. Of course, state legislatures and regulators would also be free to require that state-affiliated benefit funds hold only registered securities.

205 See Mendales, Collateralized Explosive Devices, supra n. [40], at 1385-1387.

206 See Mendales, Collateralized Explosive Devices, supra n. [40], at 1412-13.
not legislatively possible to amend the 1933 Act so as to include credit rating agencies among the parties required to perform due diligence in the issue of new securities—a step that Dodd-Frank carefully avoids; and (3) the credit rating agencies’ pockets are not deep enough to make whole public benefit funds injured by cutting corners in the rating process.

Realizing this, the SEC has, in its proposed rulemakings under Dodd-Frank, proposed to eliminate ratings by the agencies from the process of issuing asset-backed financial instruments wherever possible. Not only is this required by Dodd-Frank, but it makes sense as a matter of policy. This is true both because instruments more complex than basic RMBS may not be susceptible to meaningful rating, even in the absence of the conflicts faced by rating agencies, and so the use of ratings, however formulated, may be inherently deceptive as to the risks inherent in a rated security. Disposing with ratings, however, leaves open the question of how benefit funds, especially smaller and less sophisticated ones, are to deal with the problem of correlating yield with risk when offered new instruments with temptingly high yields. As suggested above, a first step would be to amend Rule 506 to eliminate smaller and less sophisticated funds from eligibility for private placements, which would have the dual effect of making them eligible for relief for material misstatements and omissions in offering materials under the more relaxed standards of the 1933 Act, and giving their investments the additional liquidity provided by SEC registration. This leaves the problem of protecting larger funds, which despite their size have still been victimized by material misrepresentations and omissions in deliberately opaque offering memoranda.

\[207\] This is because the complexity of the mathematical models used in formulating ratings may be chaotic in nature. This would make any deviation from initial assumptions used in the rating process in the performance of the collateral and structure of a complex financial instrument lead to unpredictably large changes in the probability of eventual default. See supra, n. [86].
The traditional approach of requiring full and fair disclosure under the 1933 and Exchange Acts suggests a promising approach to this thicket of political and practical problems. The sellers of derivative obligations to municipal entities would be required to follow the SEC’s “plain English” rules, governing disclosure in prospectuses issued to investors since 1998, in describing how the securities worked and the benefits derived by all entities concerned with their issuance. This would include clearly drafted “Risk Factor” sections that would clearly identify risks in the order of their severity. This would make it easier for prospective buyers (1) to identify conflicts of interest on the part of sellers of securities being offered; (2) to identify clear risks involved in the purchase of instruments being offered, while barring sellers from hiding major risks in a thicket of verbiage detailing minor risks; and (3) as a result, to be able to make more effective risk-benefit analyses connected with any purchase. Moreover, the clarity of disclosure would make it easier to state causes of action under the securities laws in the event of material misstatements or omissions of material facts, since it would make it more clear that such deceptions were made with the element of scienter required for stating claims under Exchange Act § 10(b) and Rule 10b-5.

Moreover, following disclosure practices required by the Food and Drug Administration (FDA) for prescription drugs, the disclosure would be required to include risk models based on

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

experience with similar collateral, or, in the case of complex securities, to include experience-based risk models for the instruments in the pool on which the securities were based.

A further useful borrowing from the FDA would be to require, in disclosure dealing with high risk structures and/or collateral, or with securities on which little or no experience-based data is available, that issuers place such disclosure within bold black borders—the equivalent of “black box” disclosure on prescription drugs.211 Risks of this kind would include concrete risks of sudden and complete or near-complete loss of value in a security, such as that imposed by the existence of a “trigger” enabling a holder of a senior tranche to liquidate all the collateral underlying a security on occurrence of an event such as a downgrade by a credit rating agency.212

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

211 See Food and Drug Administration, Specific requirements on content and format of labeling for human prescription drugs, 21 C.F.R. § 201.57(e).

212 See Gibson, supra n. [82], at 17.
E. Regulations with new teeth: Working with Dodd-Frank and making better use of earlier statutes to protect benefit funds

The SEC, the CFTC, and other federal agencies have begun the task imposed upon them by Dodd-Frank to propose regulations to prevent new financial crises of the kind with which we are still dealing. Proposed regulations based on Dodd-Frank have been slow in emerging from the agencies, however. Because the statute they interpret is huge, combines an unrealistically large number of objectives, and is riddled with compromises that rob it of directness and force, it does not provide the firm foundation for regulations provided by more straightforward statutes such as the 1933 Act and the Sarbanes-Oxley Act.

The deficiencies of the new statute and regulations based on it to date are both substantive and procedural. Substantively, the statute does require the removal of ratings from substantially all regulations promulgated by Federal agencies, from the SEC to the Comptroller of the Currency. However, it does not establish a satisfactory substitute for the rating process. Moreover, since there is no uniform substitute for the rating process established by the statute


214 Dodd-Frank also deals with other complex issues such as the coordination of the federal agencies jointly charged with its administration, the regulation of previously unregulated financial entities such as hedge funds, problems associated with preventing financial institutions from becoming “too big to fail,” the receivership of large financial institutions, the public clearing of heretofore unregulated financial instruments such as swaps, and the protection of consumers from abuses by financial institutions. See generally, Pub. L. 111-203, 124 Stat. 1376 (2010).

and regulations, it is inevitable that ratings will continue to be used, particularly in private placements, by buyers of securities in evaluating their quality—and here, Dodd-Frank not only leaves in place the prohibition of substantive regulation of the rating process by the SEC established by CRARA, but retains CRARA’s requirement that in formulating regulations to enforce the limited rules that Dodd-Frank establishes for the rating agencies, regulatory bodies such as the SEC are to construe the limits on the rating agencies narrowly.216

Procedurally, Dodd-Frank and the regulations based on it are far less helpful than they appear at first sight for vindicating the rights of benefit funds sold paper of dubious quality because Dodd-Frank looks chiefly toward agency enforcement, and in fact raises a bar against private actions based on misleading ratings even higher than that set by the PSLRA for more traditional actions for securities fraud.217 As we have seen, even with the combined forces of federal regulatory agencies, staffing has not been sufficient to prevent abuses under prior law. In view of this, and since Congress has blocked the funding provisions built into Dodd-Frank to expand agency staffing,218 it is unreasonable to expect the agencies to be fully effective in enforcing the vastly more complex regulatory structure that Dodd-Frank, as implemented by regulations still being drafted, will create. This Article therefore proposes a strategy to deploy existing resources in a way that will more fully take advantage not only of the vast, nebulous, and untried regulatory structure created by Dodd-Frank, but of older, more clearly drafted

217 See supra, TAN [147].
218 See supra, TAN [21].
statutes such as 1933 Act § 17(a)(2) and (3), and the Advisers Act, which heretofore have been enforced exclusively by the SEC.

The key to more efficient deployment of existing resources will be to pool and make the best allocation of scarce federal and state securities regulatory capability by establishing, pursuant to regulations to be promulgated by the SEC, a framework under which states, whose subdivisions and agencies are the primary sponsors of the benefit funds discussed by this Article, can work directly with federal agencies (including not only the SEC but also the CFTC, the FDIC, and the Comptroller of the Currency) in enforcing laws and regulations that heretofore have been the exclusive preserve of the federal agencies. The SEC, which has the greatest experience in bringing enforcement actions among the federal agencies involved in this sphere, should take the lead by creating within itself an Office of State Coordination. This office would serve as a regular channel for state instrumentalities to the SEC to request help by its Enforcement Division in obtaining relief for violations of the federal securities laws. It would also provide for standardization of SEC training for state professionals in bringing their own securities law enforcement actions (now being done on an ad hoc basis), and would locate and

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219 15 U.S.C. § 77q(a)(2) and (3). These provisions authorize the SEC to order the disgorgement of funds obtained by misrepresentation or omission of material facts, without the need to prove scienter as under Rule 10b-5. See SEC v. J. P. Morgan Securities LLC, Complaint, S.D.N.Y., 11-Civ.-4206, June 21, 2011 and SEC Litigation Release No. 22008, June 21, 2011 (J. P. Morgan agreed to pay $153.6 million to investors to settle charges that it failed to disclose to investors, including a not-for-profit beneficial organization, that securities pooled in a CDO sold to the investors were in part selected by a hedge fund that held a short position in those securities).

220 See, e.g., SEC v. Edward S. Steffelin, Complaint, S.D.N.Y., 11-Civ.-4204, June 21, 2011, and SEC Litigation Release No. 22008, June 21, 2011 (employee of investment advisory firm that marketed CDO to investors and failed to disclose that securities pooled in a CDO which it marketed were subject to a short position held by a large hedge fund charged with violations of Advisers Act, with relief sought including disgorgement of profits, injunctive relief, and civil penalties).
assign SEC personnel to lead teams of state professionals in bringing enforcement actions under statutes such as the Advisers Act which can now be enforced only by the SEC.

**F. Indirect consequences of effective regulation**

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

Legally, it should reduce the penumbra of unnecessary deterrence of meritorious actions by benefit funds under the federal securities laws by the PSLRA, and encourage bringing them in federal court.\(^{221}\) This is desirable not only because the federal courts are generally more experienced in dealing with securities law cases than the state courts, but it will produce greater national uniformity in dealing with securities law issues,\(^{222}\) and in turn make it easier for transactional lawyers in and out of the U.S. to effectively advise their clients on minimizing the risk of litigation resulting from securities transactions.

It will also have broader effects on world financial markets. By providing more effective deterrence against deceptive promises of safety combined with unrealistically high yield, it will

\(^{221}\) *See supra*, TAN [24] ff.

\(^{222}\) *See supra*, TAN [149].
reduce the sheer volume of exotic securities with dubious value, and thereby help to stabilize financial markets generally. Moreover, by reducing the availability of exemptions from registration to securities and purchasers to those actually intended by the drafters of the 1933 Act, and compelling more extensive and clearer disclosure even for securities still exempt from actual registration, it will increase the transparency of the securities markets for large financial institutions both in the U.S. and overseas. This will help both to prevent new freeze-ups of world credit markets such as occurred in 2008, and encourage investment in productive activity as opposed to mere trading.

**Conclusion**

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

The most effective mechanism for recovering losses on pre-crisis benefit fund investments, particularly in view of the Supreme Court’s increasingly restrictive views of private
rights of action under the federal securities laws,\textsuperscript{223} will be to make the best use of scarce SEC resources by coordinating SEC enforcement efforts with state agencies in under provisions of the federal securities laws that would not be available to the states acting without SEC authority. The establishment of an Office of State Coordination within the SEC will help to train state and municipal lawyers in making effective use of the securities laws against abuses already committed, help the SEC pick targets worthy of its direct attention, draw the SEC’s attention to abuses best addressed by statutes enforceable only by SEC action, such as the Investment Advisers’ Act of 1940, and thereby not only redress past securities violations but enhance general deterrence against such conduct in the future.

Going forward, the protection of benefit funds from improvident investment will require the amendment of SEC rules. First, smaller and less sophisticated funds should be taken out of the “accredited investor” category that has enabled them to buy unregistered securities.\textsuperscript{224} This will benefit them in at least three ways: (1) it will provide maximum disclosure to them on the risks of their investments; (2) it will provide them with greater liquidity for their investments; and (3) in the event that disclosure documents concerning their investments include materially misleading statements and omissions, particularly concerning risk, it will enable them to obtain

\textsuperscript{223} See Janus Capital Group, Inc., et al. v. First Derivative Traders, 564 U.S. ___, 113 S. Ct. 2296, 2302 (2011)(Thomas, J. for 5-4 majority)(though existence of private right of action under Exchange Act § 10(b) and Rule 10b-5 “is now settled,” it must be given narrow scope).

\textsuperscript{224} As noted above, supra TAN [132-135], Dodd-Frank § 943 and new SEC rules and forms based thereon purport to apply to unregistered as well as registered asset-backed securities for the first time—but their coverage is limited to requiring securitizers who have assumed contractual duties to replace or repurchase defective assets in pools collateralizing securities to report when they have done so, a requirement that even the SEC does not expect to have very much impact.
redress through the less stringent standards of Securities Act § 11, rather than forcing them through the higher hurdles required for actions based on Exchange Act § 10(b) and Rule 10b-5.

Secondly, the SEC should make its “Plain English” rules mandatory for all securities-related disclosure, including disclosure in private placement memoranda. These rules will require risks to be stated plainly and in order of their importance by issuers, who are in a better position to be aware of them than even sophisticated investors receiving disclosure documents, and will, by forcing issuers to focus on risks, reduce their ability to engage in fraudulent practices such as “lulling” investors by concealing risks in a mass of optimistic-sounding verbiage. There is no utility in permitting issuers to conceal risks known to them in thickets of obscure language, and even in the real paradigm for allowing the placement of unregistered securities—enabling investors to buy into new businesses not yet ready to go public—clear disclosure of risk should promote rather than discourage investment.

In the context of public benefit funds, the “Plain English” rules will, by forcing issuers to clearly describe inherent risks in order of severity, furnish a more realistic way to judge investment quality than ratings. The rules will help deter deception by making it more difficult to hide material misstatements and omissions behind obfuscatory language, and easier for plaintiffs to prove that material deceptions and omissions were made with the scienter required

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225 15 U.S.C. § 77k(a) and (b). Section 11(a) and (b) impose liability on issuers, underwriters, and other persons participating in the issuance of securities for inaccuracies in registration statement, and, by requiring them to establish their due diligence as a defense, requires plaintiffs to merely to prove negligence to recover, rather than the higher burden of proving scienter (knowing or reckless misrepresentation) required to establish liability in private actions under Exchange Act § 10(b) and Rule 10b-5.

226 “Lulling” consists of communications to investors to lead them to believe that their investments are secure, contrary to the knowledge of the communicators, and thus constitutes an intentional violation of the federal securities laws that can give rise to criminal as well as civil liability. See U.S. v. Love, 535 F.2d 1152, 1159 (9th Cir.), cert. denied, 429 U.S. 847 (1976).
for buyers to bring successful actions under the federal securities laws. They will also make it easier for fiduciaries running large funds that remain accredited to resist political pressures and pressures from beneficiaries to make investments carrying too much risk in acquiring privately placed securities for their portfolios. This would be further amplified by requiring issuers to “black box” major risks, which would enable state legislatures to simply bar state instrumentalities from investing in instruments carrying such “black box” warnings.

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227 See Exchange Act § 10(b) and SEC Rule 10b-5; Ernst & Ernst v. Hochfelder, 525 U.S. 185 (1976).