

**When 90% Of The Loans Are Exceptions To The Rule, There Is No Rule:
Navigating Through Post-Financial Crisis Regulation And Wall Street's
Caveat Emptor Defense**

Eve Mizerak*

ABSTRACT

The United States is currently recovering from the failure of the residential mortgage backed security (RMBS) market and the consequent Great Recession. In response to the 2007 financial crisis, the Securities and Exchange Commission adopted new regulations, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, to address the lax regulation that created the environment leading up to the financial crisis. This Note explores the collapse of the RMBS market as one of the main drivers of the financial crisis and addresses the inadequacies of the newly adopted regulations. First, this Note provides background to the mechanics of subprime mortgages and discusses the subprime market meltdown. This Note then provides an overview of the current litigation occurring between Wall Street firms and institutional investors. This Note concludes by discussing the newly adopted regulations and arguing that the downfall of the Dodd Frank Wall Street Reform and Consumer Protection Act is the unaddressed issues that create the potential for a similar future crisis.

* J.D. Candidate, 2013, Villanova University School of Law; M.B.A. Candidate, 2013, Villanova University School of Business; B.A., 2010, Rutgers University.

CONTENTS

I.	INTRODUCTION	24
II.	BACKGROUND TO SUBPRIME MORTGAGES: THE DEVIL IS IN THE DETAILS	28
	A. Mechanics of Subprime Mortgages.....	29
	B. Matrix.....	31
	C. Securitization of Subprime Mortgages: What Happens to a Mortgage After the Borrower Signs the Dotted Line.....	32
	D. Due Diligence.....	34
	E. Original Regulation AB.....	35
III.	FINANCIAL CRISIS: SUBPRIME MARKET MELTDOWN	36
IV.	SOPHISTICATED INVESTORS V. WALL STREET	39
V.	STILL NOT THERE: POST-FINANCIAL CRISIS REGULATIONS ARE ONLY STEPPING STONES TO TRANSPARENT DISCLOSURES	45
	A. Post-Financial Crisis Regulations.....	48
	<i>i. Rule 193</i>	50
	<i>ii. Amendments to Item 1111 of Regulation AB</i>	51
	B. Analysis of New Regulations.....	52
VI.	CONCLUSION	57

I. INTRODUCTION

*“[T]he crisis was a result of human mistakes, misjudgments, and misdeeds
that resulted in systemic failures for which our nation has paid dearly . . .
The greatest tragedy would be to accept the refrain that no one could have*

*seen this coming and thus nothing could have been done. If we accept this notion, it will happen again.*⁶²

In 2007, the residential mortgage backed security (RMBS) market failed, causing the United States economy to experience a major financial crisis.⁶³ This crisis is commonly referred to as

⁶² *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, The Financial Crisis Inquiry Commission, Pursuant to Public Law 111-21, at xxiii, xxviii (Jan. 2011), available at <http://www.gpoaccess.gov/fcic/fcic.pdf>.

⁶³ See Rebecca Christie, U.S. Household Losses From Financial Crisis Averaged \$100,000, Study Says, Bloomberg, (Apr. 28, 2010) available at <http://www.bloomberg.com/news/2010-04-28/u-s-households-lost-100-000-on-average-in-financial-crisis-study-says.html> (discussing cost to U.S. households after financial crisis); Kim Gittleson, Teacher pension fund lost \$9 billion last year while costs rose, Gotham Schools, (Feb. 4, 2010) available at <http://gothamschools.org/2010/02/04/teacher-pension-fund-lost-9-billion-last-year-while-costs-rose/> (“[T]he financial crisis sunk [a teacher pension] fund to its lowest level in more than 15 years . . .”); See Nathan Koppel, For Lawyers, No Shortage of Work Expected in Wake of Tumult, Wall St. J., (Sept. 20, 2008) available at http://online.wsj.com/article/SB122186718155258889.html?mod=googlenews_wsj (predicting myriad of lawsuits stemming from financial crisis); Mark Landler, I.M.F. Puts Bank Losses From Global Financial Crisis at \$4.1 Trillion, N.Y. Times, (Apr. 22, 2009) at A6 (discussing global reach of financial crisis).

Although there are many effects and consequences of the financial crisis, a clear snapshot of the detritus left by the financial crisis can be gleaned from a reading of the litigation between investors and the various financial institutions. Since the inception of the financial crisis, individual and institutional investors, charitable organizations, and city and state investment funds have experienced significant monetary losses. As a result of the crisis, injured parties are now seeking recovery in the judicial system. See Joe Coscarelli, AIG Suing Bank of America for Financial Crisis Losses, N.Y. Mag., (Aug. 8, 2011) available at http://nymag.com/daily/intel/2011/08/aig_suing_bank_of_america_for.html (providing that American International Group sued Bank of America Corp. for \$10 billion over mortgage-security related issues); Matthias Rieker, Investors sue over mortgage-related securities, MarketWatch, (Oct. 2, 2011) available at <http://www.marketwatch.com/story/investors-sue-over-mortgage-backed-securities-2010-11-06> (discussing multiple lawsuits faced by investment firms like Wells Fargo & Co., Bank of America Corp., Citigroup Inc., and J.P. Morgan Chase & Co.); Nelson D. Schwartz & Kevin Roose, Federal Regulators Sue Big Banks Over Mortgages, N.Y. Times, (Sept. 3, 2011) at B1 (discussing U.S. governments suit against seventeen financial institutions).

Investors suing the financial institutions have attempted to bring claims under SEC Rule 10b-5, but have been blocked by the heightened pleading standard required to succeed on a 10b-5 claim. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (discussing scienter requirement under 10b-5); *Lawrence v. Cohn*, 325 F.3d 141, 147-49 (2nd Cir. 2003) (providing that in order to prove defendant violated § 10(b) and Rule 10b-5, plaintiffs must prove (1) material misrepresentation or omission by defendant; (2) scienter; (3) connection between misrepresentation or omission and purchase or sale of security; (4) reliance upon misrepresentation and omission; (5) economic loss; and (6) loss causation); *In re American Intern. Group, Inc. 2008 Sec. Litig.*, 741 F. Supp. 2d 511, 528 (S.D.N.Y. 2010) (describing heightened pleading standards for securities fraud and Section 10(b) claims); *Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce*, 694 F. Supp. 2d 287, 299-300 (S.D.N.Y. 2010) (holding that investor failed to adequately plead facts giving rise to inference of scienter); *In re MBIA, Inc., Sec. Litig.*, 700 F. Supp. 2d 566, 586-90 (S.D.N.Y. 2010) (holding that although plaintiff adequately alleged defendants made materially misleading statements, investor failed to show that defendant’s alleged misstatements were materially misleading when they were made and investor failed to plead facts giving rise to inference of scienter).

Others have been faced with retaliating the adage caveat emptor. See, e.g., Dealbook, The Goldman Defense: Caveat Emptor, N.Y. Times, (Apr. 19, 2010) available at <http://dealbook.nytimes.com/2010/04/19/the-goldman-defense-caveat-emptor/> (discussing Goldman, Sachs & Co.’s caveat emptor defense). Other investors have brought claims for negligent misrepresentation, common law fraud, and for violations of Sections 11, 12(a) (2), and 15 of the

the Great Recession, and is generally thought of as the longest and deepest economic crisis since the Great Depression of the 1930s.⁶⁴ Many scholars blame the Securities and Exchange Commission (SEC) for failing to properly regulate the financial services sector and corporate governance policies amongst financial institutions.⁶⁵ Other theorists blame the lack of economic analysis concerning low interest rates and the unprecedented rise in housing prices.⁶⁶ Some scholars even describe the actions of the financial services industry as a “moral-cultural malaise.”⁶⁷ In partial response to these criticisms, the SEC adopted new regulations, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act

Securities Act of 1933. See, e.g., Compl. at 12, Fed. Hous. Fin. Agency v. J.P. Morgan Chase & Co., Case No. 1:2011cv06188 (S.D.N.Y. filed Sept. 2, 2011) (listing actions Federal Housing Finance Agency brought against J.P. Morgan Chase & Co. and Bear Stearns & Co., among others).

⁶⁴ See Chris Isidore, The Great Recession, CNN Money, (Mar. 25, 2009) available at http://money.cnn.com/2009/03/25/news/economy/depression_cmn_comparisons/ (“[T]he longest post-Depression economic decline before the Great Recession was 16 months, which occurred in both the 1973-75 and 1981-82 recessions.”). The financial crisis underlying the Great Recession broke in mid-August 2007 when a series of debilitating events unfolded in the United States financial market. See *Id.* (Discussing the Great Recession). The crisis was first precipitated in 2001 by the Federal Reserve, who in an effort to prevent a 2001 recession (based on the after-effects of the tech bubble burst and the tragic events of 9/11) gradually reduced its target federal funds rate, eventually reaching 1% in 2003. See Historical Changes of the Target Federal Funds and Discount Rates, Fed. Reserve Bank of N.Y. available at <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html> (last visited Sept. 20, 2011) (listing target federal funds and discount rates since 1971). Seeking for ways to gain a higher return, investors began demanding higher yielding investments, such as collateralized debt obligations and asset-backed securities. See William Poole, Essay, Causes and Consequences of the Financial Crisis of 2007-2009, 33 HARV. J.L. & PUB. POL’Y 421, 424 (2010) (commenting that low interest rates and memories of dot-com crash caused investors to search for higher yielding investments). In addition, the Bush Administration and Congress, in an attempt to get every American in a home, began pushing Fannie Mae and Freddie Mac to purchase subprime mortgages (thereby increasing the demand for subprime mortgages and encouraging subprime lending). See Russell Roberts, How Government Stoked the Mania, Wall St. J., (Oct. 3, 2008) at A21 (commenting on role of politicians and policy makers during financial crisis). Consequently, many lenders began originating mortgages to undeserving borrowers who were at high risk of default. See William D. Cohan, How Wall Street Hid Its Mortgage Mess, N.Y. Times, (Oct. 14, 2010) available at <http://opinionator.blogs.nytimes.com/2010/10/14/how-wall-street-hid-its-mortgage-mess/> (providing data reported by Clayton Holdings that revealed amount of mortgages that deviated from underwriting guidelines).

These loans were then securitized into RMBS and collateralized debt obligations. See *Id.* (Discussing how investors invested in subprime loans after they were securitized). Moreover, the expansion of the housing market contributed to the financial crisis because the models securitizing subprime mortgages were built around the expectation that housing prices would continue to rise. See Roberts (arguing that Washington caused housing prices to rise to unprecedented levels).

⁶⁵ See generally Kevin T. Jackson, Article, The Scandal Beneath the Financial Crisis: Getting a View From a Moral- Cultural Mental Model, 33 HARV. J.L. & PUB. POL’Y 735 (2010) (describing lax regulations).

⁶⁶ See, e.g., Poole, *Supra* note 3, at 425-26 (discussing conditions leading to crisis).

⁶⁷ See Jackson, *Supra* note 4, at 736 (discussing moral-cultural aspects of financial crisis).

(the Dodd-Frank Act), to address the calamity of the financial crisis and limit the risk of future similar failures.⁶⁸

This Note explores the collapse of the RMBS market as one of the main drivers of the financial crisis. It suggests that a significant basis for the critical failure in the performance of subprime securitization, and in fact also some prime securitizations, was rooted in the stark truth that the underwriting guidelines touted in the prospectuses were misreported. Furthermore, this Note argues that although the SEC correctly adopted Rule 193 and New Item 1111 of Regulation AB, these new regulations fail to completely address all of the inadequacies present in pre-financial crisis regulations regarding RMBS disclosures.⁶⁹

Part II of this Note provides background to the mechanics of subprime mortgages and RMBS offerings in order to emphasize the complexity of a RMBS and stress the importance of providing data on the underlying assets in a RMBS.⁷⁰ Part III discusses the occurrences of the financial crisis focusing specifically on the subprime market meltdown.⁷¹ Part IV then provides an overview of the faulty disclosures and a discussion of the litigation between investors and Wall Street firms, while arguing that investors, even sophisticated investors, were deceived by the disclosures.⁷² Part V discusses the new regulations provided through Section 945 of the Dodd-Frank Act and argues that the regulation leaves critical components to issuers' good intention rather than mandatory requirements.⁷³ Part VI concludes by arguing that the Dodd-Frank Act lacks the type of regulation needed to prevent a similar financial crisis from occurring.⁷⁴

⁶⁸ For the full text of the Dodd-Frank Act, see H.R. 4173, 111th Cong. (2010).

⁶⁹ For the full text of Rule 193 and new Item 1111 of Regulation AB, see 17 C.F.R. § 230.193 (2011) and 17 C.F.R. § 229.1111 (2011) respectively.

⁷⁰ See *Infra* notes 14-72 and accompanying text.

⁷¹ See *Infra* notes 73-91 and accompanying text.

⁷² See *Infra* notes 92-117 and accompanying text.

⁷³ See *Infra* notes 118-78 and accompanying text.

⁷⁴ See *Infra* note 179 and accompanying text.

II. BACKGROUND TO SUBPRIME MORTGAGES: THE DEVIL IS IN THE DETAILS

The United States mortgage market today is a complex web comprised of originators, borrowers and the secondary mortgage market where mortgages are securitized into investments.⁷⁵ The introduction of subprime mortgages into RMBS offerings introduced a substantial amount of risky investments into the mortgage market by creating a myriad of product choices largely determined by borrower credit history.⁷⁶ Many factors have contributed to the growth of subprime mortgage lending.⁷⁷ Primarily, “it became legal.”⁷⁸ In addition, market changes such as high interest rates in the 1990s and a subsequent decrease in prime lending ignited the search for a new, profitable venture.⁷⁹ In 1995, demand for RMBS offerings backed by subprime loans increased when RMBS offerings with subprime collateral became more attractive to investors.⁸⁰ Since then, the RMBS market has risen to \$6.6 trillion.⁸¹

⁷⁵ See generally Souphala Chomsisengphet & Anthony Pennington-Cross, The Evolution of the Subprime Mortgage Market, FEDERAL RESERVE BANK OF ST. LOUIS REV. (Jan./Feb. 2006) available at <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf> (discussing subprime mortgage history).

⁷⁶ See *Id.* at 31-32 (same).

⁷⁷ See Heather M. Tashman, Article, The Subprime Lending Industry: An Industry in Crisis, 124 BANKING L.J. 407, 410-11 (2007) (discussing evolution of subprime lending).

⁷⁸ See Chomsisengphet, *Supra* note 14, at 38 (discussing changes in lending laws). The ability to charge high rates and fees to borrowers was not possible until the adoption of the Depository Institutions Deregulation and Monetary Control Act in 1980 (which preempted state interest rate caps) and the Alternative Mortgage transaction Parity Act in 1982 (which permitted the use of variable interest rates and balloon payments)). See *Id.* (same). These laws created a fundamental change in lending practices and consequently allowed for the creation of subprime mortgage lending. See *Id.* (adding that subprime lending did not truly gain popularity until the Tax Reform Act of 1986). “The TRA increased the demand for mortgage debt because it prohibited the deduction of interest on consumer loans, yet allowed interest deductions on mortgages for a primary residence as well as one additional home. This made even high-cost mortgage debt cheaper than consumer debt for many homeowners.” *Id.*

⁷⁹ See *Id.* (commenting that mortgage brokers and mortgage companies responded to drops in prime mortgage market by looking to subprime market to maintain volume and business).

⁸⁰ See *Id.* at 41 (commenting that number of subprime fixed-rate-mortgages and adjustable-rate-mortgages originated was approximately 62,000 and 21,000 respectively in 1995 compared to number of subprime fixed-rate-mortgages and adjustable-rate-mortgages peaking at approximately 780,000 and 866,000 respectively since then).

⁸¹ See Statement of Cameron L. Cowan, Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, American Securitization Forum, at 1, available at <http://financialservices.house.gov/media/pdf/110503cc.pdf> (last visited Oct. 12, 2011) (commenting that securitization industry grew to \$6.6 trillion in 2003 in approximately thirty years when first mortgage backed securities arose from secondary mortgage market in the 1970s).

A. Mechanics of Subprime Mortgages

Prime mortgages are typically awarded to credit-worthy borrowers.⁸² Whether a borrower is credit-worthy depends on a variety of factors.⁸³ Such factors include the borrower's FICO rating, the borrower's debt-to-income (DTI) ratio, the borrower's depth of credit, the amount of assets the borrower has on reserve and the loan-to-value (LTV) ratio.⁸⁴ Borrowers awarded prime mortgages thus optimally have a high FICO score, a low DTI ratio, an

⁸² See Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. Times, Feb. 12, 2008, at A1 (describing characteristics of borrowers with prime mortgages).

⁸³ For an in depth discussion of such factors, see *infra* note 23.

⁸⁴ See generally About credit scores, myFICO, available at <http://www.myfico.com/crediteducation/creditscores.aspx> (last visited Oct. 12, 2011) (providing that lenders use FICO scores to assess future risk based solely on credit report data). A FICO score allows lenders to assess a borrower's credit worthiness by taking into consideration a borrower's payment history, current level of indebtedness, types of credit the borrower has used in the past and the length of the borrower's credit history. See *Id.* (discussing FICO scores); See also Lisa Smith, *Too Much Debt For A Mortgage*, Investopedia.com, (Mar. 3, 2009) available at http://www.investopedia.com/articles/07/debt_to_income.asp#axzz1Wj6xUETd (providing that DTI ratio indicates how much borrower's income will be spent per month on his or her mortgage payment). For example, if a borrower has a DTI ratio of forty percent, forty percent of his or her income will be spent on his or her monthly mortgage payment. See *Id.* (explaining DTI ratio). A borrower with a lower DTI ratio is considered a safer borrower because less of his or her monthly income is spent on the mortgage payment, leaving him or her with more disposable income or savings. See *Id.* (providing that lower DTI ratio is better); See also Credit Writing Guidelines, Mortgage Underwriters, available at <http://www.mortgageunderwriters.com/creditg.html> (last visited Oct. 3, 2011) (providing that depth of credit equals amount of credit experience borrower possesses and providing that queries made in analysis of borrower's depth of credit include: How many credit cards are in borrower's name; What is borrower's track record of repaying debt; and What other loans does borrower currently possess); See also Underwriting Guidelines for the Average Mortgage, Credit Infocenter, (May 25, 2011) available at <http://www.creditinfocenter.com/mortgage/guidelines.shtml> (providing that lenders consider borrowers possessing larger number of assets on reserve safer than borrowers with smaller number of assets on reserve); See also Justin Pritchard, *Loan To Value Ratio*, About.com, available at <http://banking.about.com/od/loans/g/loantovalue.htm> (last visited Oct. 3, 2011) (providing that LTV ratio indicates amount of equity the borrowers will bring to the transaction). For instance, if the borrower wants to buy a house costing \$100,000 and the bank lends them a loan for \$100,000, the LTV ratio is 100%: the bank has supplied the total amount of money necessary to buy the house and the borrower has not contributed any money towards the house. See *Id.* (providing similar example). In contrast, if the borrower wishes to buy a house costing \$100,000 and the borrower has savings of \$10,000 to contribute to the price of the house, the borrower will only need to take out a loan for \$90,000, making the LTV ratio ninety percent. See *Id.* (providing similar example). The lower the LTV, the safer is the loan because the borrower has more money invested and is thus more likely to repay their mortgage. See *Id.* (“[H]igher loan value ratios mean higher risk for the lender.”).

extensive prior borrowing history, a large amount of assets on reserve and a low LTV ratio.⁸⁵ The benefit of a prime mortgage is the low interest rate.⁸⁶

In contrast, subprime mortgages are generally awarded to those borrowers with little to no credit-worthiness.⁸⁷ Subprime borrowers typically have a low FICO score, a high percentage of their monthly income directed towards their mortgage payment, weak prior borrowing history, a small amount of savings and a small down payment.⁸⁸ Subprime lending thus expands the pool of available credit to borrowers who otherwise would not qualify for a mortgage.⁸⁹

In order to compensate for the high risk that the borrower will default on a loan, the loan originator will charge a much higher interest rate to subprime borrowers than they would charge to prime borrowers.⁹⁰ In addition, lenders also differentiate subprime from prime borrowers through fixed rate mortgage (FRM) and adjustable rate mortgage (ARM) programs.⁹¹ Lenders use a process known as risk-based pricing to calculate subprime borrowers' mortgage rates and terms.⁹²

⁸⁵ See Adam B. Ashcraft & Til Schuermann, Understanding the Securitization of Subprime Mortgage Credit, Federal Reserve Bank of New York, Staff Report no. 318, at 14-16 (Mar. 2008), available at http://www.newyorkfed.org/research/staff_reports/sr318.pdf (discussing characteristics of subprime mortgages).

⁸⁶ See Prime rate, fed funds, COFI, Bankrate.com, available at <http://www.bankrate.com/rates/interest-rates/prime-rate.aspx> (last visited Oct. 12, 2011) (“The prime rate . . . is among the most widely used benchmark in setting home equity lines of credit and credit card rates.”); Prime Rate, MoneyCafe.com, available at <http://www.moneycafe.com/library/prmerate.htm> (“The Prime Interest Rate is the interest rate charged by banks to their most creditworthy customers.”).

⁸⁷ See Ashcraft, *Supra* note 24, at 14-22 (providing that borrowers who display credit risk characteristics typically receive subprime mortgages).

⁸⁸ See *Id.* 14-16 (discussing subprime mortgager characteristics).

⁸⁹ See Chomsisengphet, *Supra* note 14, at 31 (“Two of the major benefits of [subprime] lending, then, are the increased numbers of homeowners and the opportunity for these homeowners to create wealth.”).

⁹⁰ See *Id.* at 32 “[B]ecause poor credit history is associated with substantially more delinquent payments and defaulted loans, the interest rates for subprime loans are substantially higher than those for prime loans.”).

⁹¹ See Kimberly Amadeo, Fixed Rate Mortgage, About.com http://useconomy.about.com/od/glossary/g/fixed_rate.htm (last visited Oct. 12, 2011) (“The interest rate on a [FRM] stays the same throughout the life of the loan.”). A FRM is a loan accompanied by an interest rate that remains constant throughout the time of the loan (typically thirty years). See *Id.* (describing a FRM). In contrast, an ARM is a loan accompanied by an interest rate that typically begins at a low rate and then rises over the time of the loan.

B. Matrix

Lenders utilize risk-based pricing through a risk-based pricing matrix.⁹³ Before the financial crisis, there were several different kinds of subprime mortgage structures available.⁹⁴ When an originator gave a borrower a mortgage, the originator was required to follow certain guidelines, organized into a risk matrix.⁹⁵ Included in the matrix was a list of lending programs that were available to borrowers based on several lending guidelines and factors.⁹⁶ Such factors included the borrower's FICO rating, the borrower's debt to income ratio, the purpose of the loan, the amount of the borrower's assets on reserve and the LTV ratio.⁹⁷ Each lending program contained variations on these five borrower characteristics and each program possessed varying requirements with respect to each lending guideline.⁹⁸ These characteristics are referred to as "matrix guidelines" and can be seen in the risk-based pricing matrix.⁹⁹

See generally Consumer Handbook on Adjustable-Rate Mortgages, The Fed. Reserve Board (Apr. 6, 2011), available at http://www.federalreserve.gov/pubs/arms/arms_english.htm ("An [ARM] is a loan with an interest rate that changes.").

⁹² *See* Lisa Smith, Subprime Lending: Helping Hand Or Underhanded?, Investopedia.com, available at http://www.investopedia.com/articles/basics/07/subprime_basics.asp#axzz1Y2DyPt6k. ("The worse your credit, the more expensive the loan.").

⁹³ For an example of a matrix, see Eligibility Matrix, FANNIE MAE (Aug. 30, 20110).

⁹⁴ *See* Factbox: Types of subprime loans, Reuters (May 14, 2007), available at <http://www.reuters.com/article/2007/05/14/us-usa-subprime-brokers-factbox-idUSN1138252120070514> (describing 2/28 loans, Interest-only loans, Option ARM loans and FRMs); *See also* Elizabeth Weintraub, Mortgage Loan Types, About.com, available at <http://homebuying.about.com/od/financingadvice/qt/0507loantypes.htm> (last visited Oct. 3, 2011) (describing various prime and subprime mortgages like FRM, FHA Loans, VA Loans, Interest-Only Mortgages, Option ARM Mortgages, Piggyback Mortgage Loans, ARM, Mortgage Buydowns, Streamlined-K-Mortgage Loans, Bridge/Swing Loans, Equity Mortgage Loans, and Reverse Mortgages).

⁹⁵ *See Id.* (showing matrix).

⁹⁶ *See Id.* (same).

⁹⁷ For a description of each lending criteria, see *Supra* note 23.

⁹⁸ *See, e.g., Supra* note 32 (providing matrix with programs and lending guidelines).

⁹⁹ *See, e.g., Supra* note 32 (showing matrix).

In addition, lenders considered “core guidelines” when determining whether or not to lend to a borrower.¹⁰⁰ Thus, the risk matrices allowed originators to lend responsibly to borrowers by indicating which loan program was appropriate for each borrower according to the borrower’s evaluation under the matrix and core guidelines. Violations of either matrix guidelines or core guidelines could be equally detrimental to the repayment likelihood of the loan.¹⁰¹

C. Securitization of Subprime Mortgages: What Happens to a Mortgage After the Borrower Signs the Dotted Line

The initial step in creating a RMBS is the generation of the loans by the loan originators.¹⁰² A sponsor of a RMBS then pools these loans into groups.¹⁰³ After pooling the loans, the sponsor then transfers them to the depositor (which is typically a special-purpose affiliate of the sponsor) to receive and pass on the rights to the pools of loans.¹⁰⁴ After the depositor receives the pool of loans, the loans are then transferred to an issuing trust.¹⁰⁵ In order for the rights to the cash flows from the pool of loans to be sold to investors, the depositor then securitizes the pool in the issuing trust.¹⁰⁶

¹⁰⁰ See generally 12 C.F.R. § 365.2 (2000) (listing real estate lending standards). Core guidelines contain information regarding whether the borrower has experienced a bankruptcy in the past seven years; how many months worth of mortgage payments the borrower possesses on reserve; how many other types of debt the borrower possesses; and whether the borrower has a prior mortgage that is delinquent. See Kurt Eggert, Article, The Great Collapse: How Securitization Caused the Subprime Meltdown, 41 Conn. L. Rev. 1257, 1268 -1276 (referring discussing lending guidelines).

¹⁰¹ See Les Christie, Subprime loans defaulting even before resets, CNNMoney, (Feb. 20, 2008) available at http://money.cnn.com/2008/02/20/real_estate/loans_failing_pre_resets/index.htm (discussing defaults in subprime loans due to lax lending environment prior to 2008).

¹⁰² See Compl. at 9, Allstate Ins. Co. v. Goldman, Sachs & Co., (N.Y. Sup. Ct. Aug. 15, 2011) (No. 652273/2011), available at <http://www.scribd.com/fullscreen/62489609> (last visited Oct. 3, 2011) (providing background to mortgage securitization).

¹⁰³ See *Id.* (providing that Wall Street investment banks sponsor RMBS offerings).

¹⁰⁴ See *Id.* (describing role of sponsor in mortgage securitization).

¹⁰⁵ See *Id.* at 10 (“Upon acquisition, the depositor transfers, or deposits, the acquired pool of loans to an ‘issuing trust.’ The depositor then securitizes the pool of loans in the issuing trust so that the rights to the cash-flows from the pool can be sold to investors.”).

¹⁰⁶ See *Id.* (describing depositor’s duty during securitization process).

Next, the tranches are established.¹⁰⁷ Then, the issuing trust passes the securities back to the depositor, who then passes the securities to underwriters.¹⁰⁸ “The underwriter provides information about the loans and the securities that potential investors . . . use to decide whether to purchase the securities.”¹⁰⁹ Therefore, the cash flow from the pool of loans of a securitization is the source of payment to holders of the securities.

The credit quality of the security depends directly upon the credit quality of the loans in the pool.¹¹⁰ Importantly, the originator making the initial loan maintains the most important information about the credit quality of the underlying loans.¹¹¹ Investors are not given access to the loan files but instead must rely upon the representations made by the investment firms in the security offering materials.¹¹²

¹⁰⁷ *See Id.* (providing that securitization divides securities into different levels of investments called tranches).

The securitization transactions are structured such that the risk of loss is divided among different levels of investment, or “tranches.” Tranches consist of multiple series of related securities offered as part of the same offering, each with a different level of risk and reward. Any losses on the underlying loans – whether due to default, delinquent, or otherwise – are generally applied in reverse order of seniority. As such, the most senior tranches of [RMBS] receive the highest credit ratings because they are the least risky. Junior tranches, being less insulated from risk, typically obtain lower credit ratings, but offer greater potential returns.

Compl. at 10, *Allstate Ins. Co. v. Goldman, Sachs & Co.*, (N.Y. Sup. Ct. Aug. 15, 2011) (No. 652273/2011), available at <http://www.scribd.com/fullscreen/62489609> (last visited Oct. 3, 2011).

¹⁰⁸ *See Id.* (describing what happens to loans after creation of tranches).

¹⁰⁹ *Id.*

¹¹⁰ *See Id.* at 11 (explaining that credit quality of securities particularly depends “on the likelihood that mortgage holders will make their mortgage payments”).

¹¹¹ *See Id.* (arguing that loan originator possesses information important to investors in originator’s loan files). For residential mortgage loans, each loan file normally contains documents including the borrower’s application for the loan; verification of the borrower’s income, assets, and employment; references; credit reports on the borrower; an appraisal of the property that will secure the loan and provide the basis for measures of credit quality, such as LTV ratios; and a statement of the occupancy status of the property. The loan file also typically contains the record of the investigation by the loan originator of the documents and information provided by the borrower, as well as the detailed notes of the underwriter setting forth the rationale for making each loan.

Id. at 11.

¹¹² *See* Compl. at 11, *Allstate Ins. Co. v. Goldman, Sachs & Co.*, (N.Y. Sup. Ct. Aug. 15, 2011) (No. 652273/2011), available at <http://www.scribd.com/fullscreen/62489609> (last visited Oct. 3, 2011) (explaining impossibility of investors reviewing potentially thousands of loan files that underlie each security, making Wall Street firms “responsible for gathering, verifying, and presenting to potential investors accurate and complete information about the credit quality and characteristics of the loans that are deposited in the trust”).

Traditionally, mortgage originators financed their mortgage business by retaining ownership of the loans they originated and through monthly mortgage payments.¹¹³ Therefore, the originator was incentivized to lend only to creditworthy borrowers.¹¹⁴ However, mortgage loan securitization caused a shift in the mortgage business to a new, current model where originators sell the mortgages to investment banks and firms, thereby shifting the risk of non-payment to investors.¹¹⁵ Securitization thus incentivized originators to increase the number of mortgages they issued regardless of credit quality because they no longer bore the risk that borrowers would default on the underlying loans.¹¹⁶ In fact, in their report on the financial crisis, the Financial Crisis Inquiry Commission (FCIC) concluded: “The originate-to-distribute model undermined responsibility and accountability for the long-term viability of the mortgages and mortgage-related securities and contributed to the poor quality of mortgage loans.”¹¹⁷ The real dangers associated with the originate-to-distribute model and low-quality mortgage loans became apparent in the financial crisis.¹¹⁸

D. Due Diligence

Due diligence in the context of mortgage securitization is a loan review process conducted for the purpose of assisting investors in understanding loan-level risks when buying an RMBS offering.¹¹⁹ Due diligence typically involves an understanding of accurate and updated

¹¹³ *See Id.* at 12 (explaining originate-to-hold model).

¹¹⁴ *See Id.* (“When an originator held a mortgage through the term of the loan, the originator also bore the risk of loss if the borrower defaulted and the value of the collateral was insufficient to repay the loan.”).

¹¹⁵ *See Id.* at 12-15 (describing new originate-to-distribute model).

¹¹⁶ *See Id.* at 13 (providing that originate-to-distribute model allowed originators to obtain most of their income from transaction and loan-servicing fees, rather than from monthly mortgage streams).

¹¹⁷ Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, The Financial Crisis Inquiry Commission, Pursuant to Public Law 111-21 (Jan. 2011), available at <http://www.gpoaccess.gov/fcic/fcic.pdf>.

¹¹⁸ For a description of the complaints brought by investors and the nation in general were hurt by the originate-to-distribute model, see *Infra* notes 73-117 and accompanying text.

¹¹⁹ *See* Products & Services, Clayton Holdings LLC, available at <http://www.clayton.com/ProductsServices.aspx> (last visited Oct. 13, 2011) (describing loan review and due diligence services).

loan data.¹²⁰ A loan review also examines the credit quality of loans.¹²¹ Due diligence firms also offer quality control services, which is a loan level review, conducted in order to confirm, “whether loans have been underwritten to risk tolerances, to guideline and program requirements . . . [and] whether [the loans] comply with federal and state regulations.”¹²²

E. Original Regulation AB

Original Regulation AB was published on September 7, 2005 as a principles-based set of disclosure items designed to form the basis for disclosure in both Securities Act of 1933 (Securities Act) registration statements and Exchange Act reports.¹²³ Original Regulation AB was intended to add substantial disclosure requirements relating to the background, experience, performance and roles of various parties involved in an RMBS offering.¹²⁴ Instead of drafting detailed disclosure guides for each asset type that may be securitized, the SEC identified various types of disclosure concepts and provided examples.¹²⁵ Thus, the SEC decided that original Regulation AB would not provide a list of risk factors that may be common to many RMBS transactions.¹²⁶

¹²⁰ *See Id.* (same). Loan data review includes origination data, seller data, servicer data, and updated data (including credit or valuation data from third party providers. *See Id.* (same). The loan data is collected from the loan file and includes re-calculations of LTV and DTI ratios. *See Id.* (same). The loan data review is concluded with reports such as “[d]ata discrepancy reports which identify, by loan, any variances between the provided electronic data and the data as collected by [due diligence firms].” *Id.*

¹²¹ *See Id.* (same). Insight into a loan’s credit quality includes an examination of the “loan’s credit quality at its origination or its current state . . . [and a determination of a loan’s] layered risk, a borrower’s ability to perform, or [an assessment of] a loan’s compliance to original programs and guidelines.” Products & Services, Clayton Holdings LLC, available at <http://www.clayton.com/ProductsServices.aspx> (last visited Oct. 13, 2011)

¹²² *Id.*

¹²³ For full text of original Regulation AB, see 17 C.F.R. § 229.1100 (2005).

¹²⁴ *See generally* Asset-Backed Securities, 70 Fed. Reg. 1506 (discussing final rules for asset-backed securities). Parties include the sponsor, the depositor, the servicer and the trustee. *See id.* at 1511 (discussing parties involved in final rules).

¹²⁵ *See Id.* at 1531 (explaining SEC’s belief that “it would be impractical to provide an exhaustive list of disclosure items”).

¹²⁶ *See Id.* at 1533 (“[A]ny such list would result in boilerplate and generic disclosures in all prospectuses even if not applicable to the particular transaction.”).

In addition, the regulation required no due diligence by issuers but instead only requested information on the entire pool such as yield, cash flows, interest rate sensitivity, total rate of return, and the financial impact of losses.¹²⁷ Furthermore, original Regulation AB also did not require the rating agency rating the security to disclose information such as the pool data it relied on when rating the security.¹²⁸ Additionally, original regulation AB required disclosure of static pool information only if material to the transaction.¹²⁹ Such required information included delinquency data, loss data and prepayment data.¹³⁰

Unfortunately, the financial crisis exemplified the inadequacies of original Regulation AB.¹³¹ For example, original Regulation AB focused on disclosures regarding the repayment record of the obligations placed in a pool being securitized.¹³² A consequence of this focus was the failure of the regulation to take into consideration many factors that precipitated default in the financial crisis, such as the fluctuating interest rates in ARMs.¹³³

III. FINANCIAL CRISIS: SUBPRIME MARKET MELTDOWN

In order to prevent a 2001 recession after the stock market peak of 2000 and the events of September 11, 2001, the Federal Reserve began cutting the federal funds rate to historically

¹²⁷ See Richard E. Mendales, Article, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 U. ILL. L. REV. 1359, 1384 (2009) (arguing that original Regulation AB should have required audits of underlying loans).

¹²⁸ See *Id.* (arguing that original Regulation AB failed “to deal with the rating that is a key element of every securitization.”).

¹²⁹ See *Supra* note 63, at 1538 (“In particular, we proposed to require static pool data with respect to the delinquency and loss experience of the sponsor’s overall portfolio for the past three years . . .”).

¹³⁰ See *Id.* (describing static pool data disclosure requirements).

¹³¹ See Richard E. Mendales, Article, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 U. ILL. L. REV. 1359, 1383 (2009) (indicating it would have been better to follow examples set by Ginnie Mae regulations for RMBS offerings based on pools of large numbers of residential mortgages). The SEC attempted to deal with the regulation of RMBS based on its experience regulating disclosure by operating businesses and thus left it susceptible to the complexities involved in RMBS offerings. See *Id.* (discussing original Regulation AB).

¹³² See *Id.* at 1383 (discussing original Regulation AB’s failure).

¹³³ See *Id.* (discussing original Regulation AB’s failure to account for problems that occurred during the collateralized debt obligation meltdown).

low levels until it arrived at 1% in 2003.¹³⁴ As a result, the economy and the real estate market began to expand and housing prices began to rise.¹³⁵ At the same time, the rate on a thirty-year FRM was at a forty-year low.¹³⁶

As a result, homeowners and investors took advantage of a cheap source of equity, i.e., mortgages. Moreover, with interest rates at a low, investors began looking for investments yielding higher returns.¹³⁷ Consequently, investors (such as insurance companies, hedge, mutual and pension funds) turned to RMBS offerings and collateralized debt obligations (CDOs) backed by subprime mortgages.¹³⁸

Unfortunately, quality of the mortgage-related securities had deteriorated from a lack of adequate due diligence and a waiver of underwriting standards by the firms securitizing the mortgages.¹³⁹ This change in underwriting standards was never disclosed to investors.¹⁴⁰ Therefore, investors continued to invest in the instruments, without knowledge as to the true amount of risk associated with these securities.

¹³⁴ See Kimberly Amadeo, The Federal Funds Rate and How it Works, About.com available at http://useconomy.about.com/od/monetarypolicy/a/fed_funds_rate.htm (last visited Oct. 12, 2011) (“A higher fed funds rate means banks are willing to borrow money to keep their reserves at the mandated level. This means that they will lend less money out . . . When the fed funds rate is decreased, the opposite occurs.”).

¹³⁵ See Marc Faber, Synchronized Boom, Synchronized Bust, Wall St. J., (Feb. 18, 2009) available at <http://online.wsj.com/article/SB123491436689503909.html> (blaming Federal Reserve’s easy money policy for housing bubble); But see Alan Greenspan, The Fed Didn’t Cause the Housing Bubble, Wall St. J., Mar. 11, 2009) available at <http://online.wsj.com/article/SB123672965066989281.html> (providing that easy money policies of Federal Reserve did not cause United States housing bubble).

¹³⁶ See HSH’s National Monthly Mortgage Statistics: 2003, HSH.com (Jan. 15, 2010) available at <http://www.hsh.com/natmo2003.html> (providing national monthly averages in 2003 for 15-Year FRMs, 30-Year FRMs and 1-Year FRMs).

¹³⁷ See Vikas Bajaj, Mortgages Grow Riskier, and Investors Are Attracted, N.Y. Times, *Sept. 6, 2006) available at <http://www.nytimes.com/2006/09/06/business/06place.html?ref=creditcrisis> (explaining that in 2006 investors had “few options for earning relatively high returns” because of low interest rates, making “[m]ortgage bonds attractive to investors because they pay more than Treasury securities . . .”).

¹³⁸ See Poole, *Supra* note 3, at 424 (discussing conditions leading to financial crisis).

¹³⁹ See Eggert, *Supra* note 39, at 1276-1281 (2009) (providing explanation of securitization and underwriting standards).

¹⁴⁰ See *Supra* note 1, at 187 (“Potential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities.”).

Tellingly, the United States mortgage market began seeing an increase in the number of foreclosures in 2006.¹⁴¹ In early 2007, reports issued by financial institutions such as New Century Financial, NovaStar Financial and HSBC Finance indicated that rising default rates were causing them to lose millions of dollars.¹⁴² As a result of similar reports from other financial institutions and reports indicating that the housing market would weaken even further, stocks began falling in March 2007.¹⁴³ A decrease in housing prices was also reported, with the median price of a new home dropping by the largest amount on record in May 2007.¹⁴⁴

Additionally, Freddie Mac reported its decision to no longer buy the most risky subprime mortgages and mortgage-related securities.¹⁴⁵ In June 2007, Wall Street firms began to show their wounds as firms such as Goldman, Sachs & Co. and Bear Stearns & Co. reported flat profits and decreased net income.¹⁴⁶ In the summer of 2007, Standard and Poor's (S&P) and

¹⁴¹ See Bloomberg News, *Foreclosures Are Up on Some Mortgages*, N.Y. Times, (Sept. 14, 2006) (available at <http://www.nytimes.com/2006/09/14/business/14home.html?ref=creditcrisis> (commenting that foreclosures on prime ARMs rose to four year high in second quarter of 2006 and share of loans entering foreclosure rose to 0.27% at end of June 2006, up from 0.21% three months earlier); Jeremy W. Peters, *Bankers Report More Mortgages Being Paid Late or Not at All*, N.Y. Times, (Dec. 14, 2006) (available at <http://www.nytimes.com/2006/12/14/business/14mortgage.html?ref=creditcrisis> (commenting that number of delinquent subprime ARMs rose to 13.2% in third quarter of 2006 from 12.2% in second quarter)).

¹⁴² See Vikas Bajaj & Julie Creswell, *Home Lenders Hit by Higher Default Rates*, N.Y. Times, (Feb. 22, 2007) (available at <http://www.nytimes.com/2007/02/22/business/22lend.html?ref=creditcrisis> (describing impact of increased default rates on lenders); Vikas Bajaj & Julie Creswell, *Mortgage Crisis Spirals, and Casualties Mount*, N.Y. Times, (Mar. 5, 2007) (available at <http://www.nytimes.com/2007/03/05/business/05lender.html?pagewanted=1&ref=creditcrisis> (describing shock to subprime business caused by weakening home prices and rising default rates)).

¹⁴³ See Vikas Bajaj, *Bad Loans Put Wall St. in a Swoon*, N.Y. Times, (Mar. 14, 2007) (available at <http://www.nytimes.com/2007/03/14/business/14lend.html?ref=creditcrisis> (describing impact of rising default rates on stock market)).

¹⁴⁴ See The Associated Press, *Home Sales Climb, but Prices Plummet*, N.Y. Times, (May 25, 2007) (available at <http://www.nytimes.com/2007/05/25/business/25econ.html?ref=creditcrisis> (providing that new home sales in April 2007 rose while “the median price of a new home dropped by the largest amount on record”).

¹⁴⁵ See generally *The Financial Crisis A Timeline of Events and Policy Actions*, Federal Reserve Bank of St. Louis, available at <http://timeline.stlouisfed.org/index.cfm?p=timeline> (last visited Oct. 3, 2011) (providing financial crisis timeline, dating from February 2007 to April 2011). Freddie Mac was created by Congress in 1970 in order “to stabilize the nation’s residential mortgage markets and expand opportunities for home ownership and affordable rental housing.” *Company Profile, Freddie Mac*, available at http://www.freddiemac.com/corporate/company_profile/ (last visited Oct. 12, 2011).

¹⁴⁶ See Jenny Anderson, *Wall St. Firms Hurt by the Subprime Lending Fallout*, N.Y. Times, (June 15, 2007) (available at <http://www.nytimes.com/2007/06/15/business/15wall.html?ref=creditcrisis> (describing early impacts of financial crisis on Wall Street firms); Vikas Bajaj & Julie Creswell, *Mortgages Give Wall St. New Worries*, N.Y.

Moody's Investor Services (Moody's) downgraded over 100 bonds backed by second-lien subprime mortgages and S&P placed 612 securities backed by subprime residential mortgages on a credit watch.¹⁴⁷ In September 2007, the SEC began an investigation into whether the credit rating agencies improperly rated mortgage-related securities.¹⁴⁸ Also in September 2007, the Fed began to cut the federal funds rate, finally reducing it to three percent in June 2008.¹⁴⁹ In March 2008, major Wall Street firms began to fail.¹⁵⁰ Then in August 2008, real signs of a recession emerged when the Labor Department reported that 4,000 jobs were lost from July to August.¹⁵¹ As a result of low unemployment, high default rates and the failure of major financial institutions, the United States economy suffered a severe credit crunch, putting pressure on consumers and businesses and causing a decline in economic activity.¹⁵² The result was the Great Recession.

IV. SOPHISTICATED INVESTORS V. WALL STREET

“Investors were not given sufficient information to make the decisions that they needed to make to see if they were going to buy these securities . . . They

Times, (June 19, 2007) available at <http://www.nytimes.com/2007/06/19/business/19mortgage.html?ref=creditcrisis> (describing ways in which subprime mortgage business failure could hurt Wall Street firms).

¹⁴⁷ See The Financial Crisis A Timeline of Events and Policy Actions, Federal Reserve Bank of St. Louis, available at <http://timeline.stlouisfed.org/index.cfm?p=timeline> (last visited Oct. 3, 2011) (describing events occurring during the financial crisis).

¹⁴⁸ See Stephen Labaton, S.E.C. Inquiry Looks for Conflicts in Credit Rating, N.Y. Times, (Sept. 27, 2007) available at <http://www.nytimes.com/2007/09/27/business/27credit.html?ref=creditcrisis> (“[R]ating agencies have come under renewed scrutiny by regulators and lawmakers.”).

¹⁴⁹ See Historical Changes of the Target Federal Funds and Discount Rates, Fed. Reserve Bank of N.Y., available at <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html> (last visited Oct. 3, 2011) (displaying changes in target federal funds rate and discount rates from 1971 to present).

¹⁵⁰ See Poole, *Supra* note 3, at 422 (providing that Bear Stearns & Co. failed first and was ultimately bailed out by the Federal Reserve and then bought by J.P. Morgan Chase & Co). Soon after, Lehman Brothers Holdings Inc. realized significant losses but was not bailed out by the Federal Reserve. See *Id.* at 423 (describing the failure of Lehman Brothers Holdings Inc.). Next was the failure of American International Group, which was also bailed out by the Federal Reserve. See *Id.* (describing the failure of American International Group).

¹⁵¹ See David Leonhardt & Jeremy W. Peters, Unexpected Loss of Jobs Raises Risk of Recession, N.Y. Times, (Sept. 8, 2007) available at <http://www.nytimes.com/2007/09/08/business/08econ.html?ref=creditcrisis> (describing increases in unemployment in 2007).

¹⁵² See Michael J. de la Merced, Companies Under Pressure, N.Y. Times, (Sept. 26, 2008) at C1 (discussing harmful effects of expensive credit on businesses).

should have been given loan-level detail for every pool for which securities were issued . . . Instead, they got vague, boilerplate language about ‘underwriting,’ and that there were ‘substantial exceptions,’ . . . Why weren’t investors given that information which was in the hands of the people that were selling the securities?’¹⁵³

As the financial crisis turned into the Great Recession, an outraged public began placing blame on everyone from government regulators to Wall Street investment bankers to the average American citizen.¹⁵⁴ In particular, there has been much litigation attributed to the argument between sophisticated investors and financial institutions.¹⁵⁵ The arguments injured parties are bringing focus mainly on Wall Street’s alleged misrepresentations with respect to the sale of RMBS offerings.¹⁵⁶

¹⁵³ Cowan, *Supra* note 20.

¹⁵⁴ See Ben Steverman & David Bogoslaw, The Financial Crisis Blame Game, Bloomberg Businessweek, Oct. 18, 2008, available at http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm id. (summarizing individuals and entities to blame for financial crisis).

¹⁵⁵ See Koppel, *Supra* note 11 (commenting that Morgan Stanley, American International Group, Fannie Mae and Merrill Lynch were being sued in September 2008); Compl. at 1-3, MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010) (describing MBIA Insurance Corp.’s action against Bank of America Corp. over alleged fraud perpetrated by Countrywide Financial Corp. and its executives that included Countrywide’s sale of MBS to MBIA Insurance Corp.’s insureds); Gretchen Morgenson, Mortgage Investors Turn to State Courts for Relief, N.Y. Times, (July 11, 2010) at BU1 (providing that Cambridge Place Investment Management is suing fifteen banks for misrepresenting billions of dollars of MBS); Louise Story & Gretchen Morgenson, A.I.G. to Sue Bank on Loss in Fiscal Crisis, N.Y. Times, (Aug. 8, 2011) at A1 (discussing American International Group suit against Bank of America Corp. over MBS offerings); *Supra* note 15, at 2-12 (containing the Federal Housing Finance Agency’s suit against J.P. Morgan Chase & Co. over the offer and sale of MBS offerings to Fannie Mae and Freddie Mac); Mark Jewel, Allstate Sues Goldman Sachs Over Toxic Investments, The Huffington Post, (Aug. 11, 2011) available at http://www.huffingtonpost.com/2011/08/16/allstate-sues-goldman-sachs-over-toxic-investments_n_928550.html (providing that Allstate Insurance Co. sued Goldman, Sachs & Co. over toxic investments including more than \$123 million in mortgage backed securities).

¹⁵⁶ See generally Compl., MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010) (discussing MBIA Insurance Corp.’s causes of action against Bank of America Corp.). MBIA Insurance Corp. also argued that Countrywide Financial made false statements regarding their business in 2003 and 2004, 2005, 2006, and the first part of 2007. See *Id.* (same). In addition, in its complaint against Goldman, Sachs & Co. Allstate Insurance Co. alleged that Goldman, Sachs & Co. made misrepresentations in its offering materials regarding underwriting standards and practices, due diligence results, owner-occupancy statistics, LTV and combined LTV ratios, the sufficiency of borrower income, credit ratings, credit enhancement and underwriting exceptions. See generally *Supra* note 41 (discussing Allstate Insurance Co.’s causes of action against Goldman, Sachs & Co.). Similarly, the Federal Housing Finance Agency sued J.P. Morgan Chase & Co., Bear Stearns & Co., Washington Mutual, and Long Beach arguing the falsity of statements in the registration statements and prospectus supplements (specifically

Disclosure of the characteristics of the underlying assets is generally of interest to RMBS investors.¹⁵⁷ The lack of due diligence and underwriting reports contained in the disclosures for the RMBS in the years leading up to the financial crisis deprived investors of information needed to make informed, rational decisions.¹⁵⁸ The disclosures presented to investors with respect to the RMBS offerings possessed three flaws that proved disastrous to investors.¹⁵⁹ First, the disclosures failed to include due diligence reports containing a review of the underlying loans.¹⁶⁰ Second, the disclosures did not indicate the amount of exceptions granted to guidelines contained in the pool of underlying loans, i.e., exception loans.¹⁶¹ Third, the disclosures lacked information regarding the reasoning behind the granting of the exception loans.¹⁶²

The need for regulating disclosures regarding underwriting guidelines and exceptions was made clear in the aftermath of the 2008 financial crisis.¹⁶³ For example, in its suit against

the falsity of the owner-occupancy data and the loan-to-value data). See generally *Supra* note 2 (discussing Federal Housing Finance Agency's causes of action against J.P. Morgan Chase & Co, Bear Stearns & Co., Washington Mutual, and Long Beach). The seriousness of including exception loans into securities is evidenced in the catastrophic losses these securities experienced once borrowers began defaulting on their loans. For example, a forensic loan review conducted in late 2007 "revealed that approximately 91% of the defaulted or delinquent loans in the Countrywide securitizations that were reviewed by MBIA show material discrepancies from the underwriting guidelines that Countrywide represented it would follow." *Compl., MBIA Ins. Corp. v. Bank of Am. Corp.* (Cal. Super. Ct. June 21, 2010).

¹⁵⁷ See generally *Issuer Review of Assets in Offerings of Asset-Backed Securities*, 76 Fed. Reg. 4231, 42538 (discussing information essential to investors).

¹⁵⁸ For an analysis of the inadequacies in the disclosures, see *infra* notes 103-17 and accompanying text.

¹⁵⁹ For a discussion of the insufficient disclosures required under original Regulation AB, see *Supra* note 62-71 and accompanying text.

¹⁶⁰ See Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, (Jan. 12, 2008) available at <http://www.nytimes.com/2008/01/12/business/12lend.html?pagewanted=all> (providing that Wall Street investigations have been "focusing on whether Wall Street banks withheld crucial information about the risks posed by investments linked to subprime loans").

¹⁶¹ See *Id.* (commenting that prospectuses included language like exceptions accounted for substantial or significant portions of the loans); Eggert, *Supra* note 39, at 1306 (commenting that use of exceptions appeared to be increasing beginning in 2005).

¹⁶² See *Supra* note 1, at 169-70 (questioning usefulness of mortgage-related securities disclosures due to lack of "disclosure made to the investors with regard to the quality of the files they were purchasing").

¹⁶³ See *Id.* at 165-70 (discussing quality control issues in disclosures and due diligence as causes of the financial crisis).

[T]he integrity of the market depended on two critical checks. First, firms purchasing and securitizing the mortgages would conduct due diligence reviews of the mortgage pools, either

Countrywide Financial Corp. (Countrywide), MBIA Insurance Corp. (MBIA) argued that beginning in 2003, Countrywide altered the type and quality of the mortgage loans it originated and pooled into MBS offerings, did not disclose this change to the public and “kept this change hidden from the public through material misrepresentations and omissions in its public statements.”¹⁶⁴ Furthermore, the FCIC concluded that firms “failed to perform adequate due diligence on the mortgages they purchased and at times knowingly waived compliance with underwriting standards.”¹⁶⁵ The FCIC further concluded, “[p]otential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities.”¹⁶⁶

Because the loans backing the securities were not properly characterized in the disclosures, the investors could not have possibly understood the risk associated with the securities.¹⁶⁷ “Each misrepresentation and omission created an additional, hidden layer of risk well beyond that known to be associated with an ‘adjustable rate mortgage’ or a ‘home equity loan’ in the abstract.”¹⁶⁸

using third-party firms or doing the reviews in-house. Second, following [SEC] rules, parties in the securitization process were expected to disclose what they were selling to investors. Neither of these checks performed as they should have.

Id. at 165.

¹⁶⁴ Compl. at 14, *MBIA Ins. Corp. v. Bank of Am. Corp.* (Cal. Super. Ct. June 21, 2010). MBIA argues that one of Countrywide’s “fraudulent schemes” was its “consistent and pervasive misrepresentation of its credit and underwriting standards to convince the public between 2004 and 2007 to invest in its securities backed by loans it had originated.” *Id.* at 1. The depth of Countrywide’s abandonment of its underwriting standards and misrepresentations about its underwriting “infected all of Countrywide’s securities offerings during those three years.” *Id.*

¹⁶⁵ *Supra* note 1 at 187.

¹⁶⁶ *Id.*

¹⁶⁷ *See Supra* note 41, at 16 (providing examples of how securities were improperly characterized in disclosures provided by Goldman, Sachs & Co). For example, in its complaint Allstate Insurance Corp. alleged that Goldman, Sachs & Co.:

(1) overstated how many loans were owner-occupied (owner-occupied properties have lower risks), (2) understated the loan pool’s average LTV and CLTV ratios (suggesting the borrowers had more of an equity ‘cushion’ than they did), (3) misrepresented the loans’ adherence to standard underwriting practices, and (4) failed to inform investors such as Allstate that high numbers of defective loans were ‘waived’ into the mortgage pools (making representations regarding the quality of the underwriting process even more misleading).

Id. at 16.

¹⁶⁸ *Id.* at 16-17.

In addition to a lack of due diligence reporting, the disclosures generally inadequately and inaccurately described the underlying assets.¹⁶⁹ Moreover, the broad language used in the disclosures about the inherent risk associated with these types of securities changed little as the banks adopted riskier lending practices.¹⁷⁰ Additionally, the prospectuses discussing exceptions to the underwriting guidelines only mentioned that such exceptions would be granted to borrowers if there were ‘favorable compensating factors present.’¹⁷¹ Furthermore, the disclosures that mentioned loan exceptions did not mention whether the banks were making case-by-case or bulk exceptions to the underwriting guidelines.¹⁷² This is important to an investor because ‘[a] disclosed guideline is factually irrelevant – and indeed misleading – from a risk-analysis perspective if large numbers of loans were peremptorily excused from those standards.’¹⁷³

It is clear that the originator banks made irresponsible lending decisions based on the fact that most of the loans that started out with high AAA or AA ratings have now all been

¹⁶⁹ See Bajaj, *Supra* note 99 (discussing disclosures regarding underlying loans).

¹⁷⁰ See *Supra* note 103, at 35 (“[T]he broad language written in prospectuses about the risky nature of these securities changed little in recent years, even as due diligence reports noted that the number of exception loans backing the securities was rising.”).

¹⁷¹ *Id.* at 41 (discussing prospectus supplements for Countrywide CWHEQ 2005-E note offering). This statement was misleading because at Countrywide, for example, exceptions to the underwriting guidelines “were made as a matter of course through the Exception Processing System, which was a system designed to ensure acceptance of loans regardless of their quality.” *Id.* at 43.

Additionally, “Goldman represented that it made only case-by-case exceptions to the disclosed underwriting standards, based on compensating factors that balanced out the risks of a loan application and thereby improved the quality of a loan application.” *Supra* note 41 at 29. For example, the Offering Materials for GSAMP Trust 2006-HE5 and GSAMP Trust 2006-HE7 stated that “[i]n certain instances, compensating factors demonstrated by a prospective borrower may warrant [Goldman Sachs Mortgage Company] to make certain exceptions to these [underwriting] guidelines.” *Id.* However, “[t]hese representations were false and misleading. Loans were routinely granted outside of the stated guidelines, without regard to whether there were any purported ‘countervailing features’ justifying a lending or underwriting exception.” *Id.* at 29-30.

¹⁷² See *Supra* note 1, at 169 (discussing problems with disclosures). “Only a small portion – as little as 2% to 3% - of the loans were in any deal were sampled, and evidence from Clayton shows that a significant number did not meet stated guidelines or have compensating factors.” *Id.*

¹⁷³ *Supra* note 41, at 29.

downgraded to “junk” by the rating agencies.¹⁷⁴ In addition, the securities that were supposed to be long-term, stable investments have experienced payment problems well beyond what should have occurred for properly underwritten loan pools.¹⁷⁵ Findings that the issuers failed to disclose both their underwriting practices and that of originators is also evident in the due diligence reports conducted by third party firms such as Clayton Holdings or The Bohan Group.¹⁷⁶ As the FCIC report concluded: “many prospectuses indicated that the loans either met guidelines outright or had compensating factors, even though Clayton’s records show that only a portion of the loans were sampled, and that of those that were sampled, a substantial percentage of Grade 3 Event loans were waived in.”¹⁷⁷ The FCIC further concluded that “[p]rospectuses for the ultimate investors in the mortgage-backed securities did not contain this information, or information on how few of the loans were

¹⁷⁴ See generally Carl Levin & Tom Coburn, United States Senate Permanent Subcommittee on Investigations, Wall Street And The Financial Crisis: Anatomy of a Financial Collapse, Committee on Homeland Security and Government Affairs (Apr. 13, 2011), available at http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (providing financial crisis background and analysis) [hereinafter SPSI]. According to the SPSI:

From 2000 to 2007, Long Beach and WaMu together securitized tens of billions of dollars in subprime loans, creating mortgage backed securities that frequently received AAA or other investment grade credit ratings. Although AAA securities are supposed to be very safe investments with low default rates of one to two percent, of the 75 Long Beach mortgage backed security tranches rated AAA by Standard and Poor’s in 2006, all 75 have been downgraded to junk status, defaulted, or been withdrawn. In most of the 2006 Long Beach securitizations, the underlying loans have delinquency rates of 50% or more.

Id. at 55.

¹⁷⁵ See *Supra* note 41, at 30 (explaining five Goldman, Sachs & Co. securities payment problems). As Allstate Insurance Co. illustrated “approximately 36.79% of the Mortgage Loans underlying the [securities] that Allstate invested in have already had to be written off, and approximately 32.40% of the remaining loans are currently 30, 60, 90 or more days delinquent – all within a few years of when the loans were made.” *Id.* note 41, at 30.

¹⁷⁶ See *Id.* at 40 (describing third party due diligence firms’ role in securitization process). Third party due diligence firms were tasked with reviewing whether the loans met banks’ standards. See *Id.* (same). Most Wall Street firms conducted due diligence to determine whether the mortgage loan complied with their underwriting guidelines. See *Id.* (same). To make these determinations, the banks employed third party firms “who reviewed a sample of the purchased loans to confirm that they both conformed to the representations made by the originators and complied with the company’s own credit policies.” See *id.* (same). “For each loan pool it was hired to review, [the due diligence firms] checked for: (1) adherence to seller-credit underwriting guidelines and client-risk tolerances; (2) compliance with federal, state local regulatory laws; and (3) the integrity of electronic loan data provided by the seller to the prospective buyer.” *Id.*

¹⁷⁷ *Supra* note 1, at 167. Grade 3 Event loans failed to meet guidelines. See *id.* at 166 (discussing Grade 3 Event loans).

reviewed, raising the question of whether the disclosures were materially misleading, in violation of the securities laws.¹⁷⁸

V. STILL NOT THERE: POST-FINANCIAL CRISIS REGULATIONS ARE ONLY STEPPING STONES TO TRANSPARENT DISCLOSURES

One argument posed is that securitization caused the subprime crisis.¹⁷⁹ Scholars following this argument believe that securitization has structural flaws in that it created subprime lenders, amplified the effect of rising loan defaults and encouraged a degradation of the underwriting process.¹⁸⁰ Although securitization may possess structural flaws, it was not securitization in general that caused the financial crisis.¹⁸¹ Instead, it was the lack of regulation over the RMBS market.¹⁸²

Because of lax regulation regarding the inclusion of underwriting guidelines in the disclosures, the underwriting culture on Wall Street became an environment where overall loan volume became more important than creditworthiness.¹⁸³ Without any sort of

¹⁷⁸ *Id.* at 170.

¹⁷⁹ *See* Eggert, *Supra* note 39, at 1311-12 (arguing that securitization caused subprime meltdown because it allowed and encouraged “each step of the lending and securitization process to be done at the margins, at the highest level of risk tolerance permitted;” “encouraged brokers and sales agents to push borrowers to borrow the maximum possible;” and “allowed originators to bargain down the quality standards of other market participants, including their due diligence in examining loans, the effectiveness of the rating agencies and the level of credit enhancements needed to create a large percentage of AAA-related securities.”).

¹⁸⁰ *See Id.* (discussing flaws of securitization).

¹⁸¹ *See* Cowan, *Supra* note 20, at 6-7 (discussing benefits of securitization). There are many benefits of securitization such as more available and low-cost credit, a dispersion of capital to areas that may otherwise be deprived of credit options, and the relocation of risk from financial institutions to investors. *See supra* note 20, at 6-7 (discussing these benefits).

¹⁸² *See* Mendales, *Supra* note 66, at 1415 (attributing problems in financial services industry to problems in securities regulation.)

¹⁸³ *See* generally *Supra* note 103, at 14 (discussing changes in Countrywide Home Loans’ originating practices from 2003 to 2007). For example, prior to 2003, Countrywide Home Loans originated loans each year that were mainly “traditional long term, fixed rate, first lien mortgage loans to prime borrowers that met the guidelines for sale to Fannie Mae and Freddie Mac.” *Supra* note 103, at 14. However, two changes occurred in the late 1990s and early 2000s that were catalysts for dramatic shifts in Countrywide Financial Corp.’s lending practices. *See Id.* (discussing lending practice changes). First, the market experienced an increase in demand for securitizations, which required increased loan origination to generate the loans behind the MBS. *See Id.* (same). Second, Countrywide Financial

regulation requiring Wall Street to disclose their precise underwriting guidelines and the amount of exception loans, there was never any protection for the public.¹⁸⁴ Banks were free to include as many loan exceptions as possible without warning the public that the securities were backed by loans belonging to borrowers that were quite the opposite of the ideal borrower described in the guidelines.¹⁸⁵

Corp. decided to lend to different types of borrowers using various types of lending programs in order to expand market share and capitalize on this increased demand. *See Id.* (same). The result was a “culture change” starting in 2003 where Countrywide Financial Corp. began lending riskier loans and began an initiative to increase its market share from 13% in 2003 to an unprecedented 30%. *See Id.* (same). MBIA claims that “Countrywide Financials desire to expand its already enormous market share during the mortgage lending boom from 2004 to 2007 led to a systematic pattern and practice of secretly abandoning its own underwriting guidelines in pursuit of loan origination and market share at all costs.” Compl. at 16, *MBIA Ins. Corp. v. Bank of Am. Corp.* (Cal. Super. Ct. June 21, 2010). In fact, senior management at Countrywide Financial Corp., particularly David Sambol, former President and Chief Operating Officer of Countrywide Financial Corp., who ran Countrywide Financial Corp.’s loan production “sent a clear message to loan origination and underwriting employees that overall volume was far more important than creditworthiness.” *See Id.* at 17 (discussing Mr. Sambol’s role changing Countrywide Financial Corp.’s culture).

Moreover, in its complaint against Goldman, Sachs & Co., Allstate Insurance Co. argued that originators “systematically abandoned their stated guidelines” by:

- Coaching borrowers to falsely inflate their income on loan applications to appear to qualify for mortgage loans that the borrowers could not afford to repay
- Falsely inflating a prospective borrower’s income to qualify the borrower for a loan he or she could not afford to repay;
- Steering borrowers to loans that exceeded their borrowing capacity;
- Encouraging borrowers to borrow more money than they could afford by guiding them to “stated income” loans – loans on which the borrowers could simply make up, or “state,” inflated incomes that would not be verified;
- Approving borrowers based on “teaser rates” for loans, despite knowing that the borrower would not be able to afford the payment when the loan rate adjusted; and
- Allowing non-qualifying borrowers to be approved for loans they could not afford under exceptions to the underwriting standards based on so-called “compensating factors” when such “compensating factors” did not in fact exist or did not justify approving the loans

Supra note 41, at 47-48.

¹⁸⁴ *See Mendales, Supra* note 66, at 1414-15.

[The problem with securities regulation began] with the development of securities . . . that became so complex that investors could not rely on securities law disclosure concerning their payment characteristics. This void was filled by the [credit] rating system, although the latter was largely outside the scope of securities regulation. The result was that securities were bought, sold, and used as the basis for derivative agreements solely on the strength of ratings that, as the housing bubble swelled, became progressively further removed from reality.

Id.

¹⁸⁵ *See Supra* note 103, at 17 (discussing Countrywide Financial Corp.’s culture change).

Countrywide Financial and Countrywide Home Loans knowingly: (1) loaned billions of dollars to borrowers who could not afford to repay the loans; (2) approved loans for borrowers who made gross misstatements in their loan applications regarding their income and ability to pay, often with the assistance and encouragement of Countrywide Home Loans’ employees and brokers; and (3) approved borrowers who otherwise did not satisfy the basic risk criteria for prudent and responsible lending that Countrywide Financial and Countrywide Home Loans claimed to use.

Id.

Furthermore, investors justifiably relied on the banks' false representations and misleading omissions when they decided to invest in the securities or recommend the securities as investments to third parties.¹⁸⁶ The public was not in a position to assess the banks' loan-origination processes or appreciate the true risk inherent in these investments.¹⁸⁷ In addition, the complexity of RMBS offerings prevented investors from analyzing the underwriting of the underlying loans.¹⁸⁸ Because the loans were packaged into securities and bought and sold countless times, it was nearly impossible for an investor to locate each underlying loan in the security they were buying an interest in and then review the underwriting guidelines under which the loan was given.¹⁸⁹ As a result, many investors did not conduct an independent analysis of their own due diligence, but instead relied on the rating agencies' analysis or the disclosures in the product offering materials provided by the investment firms.¹⁹⁰ Furthermore, the prospectuses and other offering materials were often hundreds of pages long, leaving little time for investors to thoroughly read the offering materials and sort through the complexity of RMBS offerings.¹⁹¹

¹⁸⁶ See *Id.* at 197 (arguing that if MBIA Insurance Corp. had known "the true facts regarding the underwriting practices and quality of the loans" at Countrywide Financial Corp. they would not have purchased loans).

¹⁸⁷ See Eggert, *Supra* note 39, at 1304 (identifying relationships between popularity of securities market, high value of securities and consequent consumer trust in securities).

¹⁸⁸ See *Id.* (discussing complexity of RMBS offerings).

¹⁸⁹ See generally Steven L. Schwarcz, Essay, Protecting Financial Markets: Lessons From the Subprime Mortgage Meltdown, 93 MINN. L. REV. 373 (2008) (discussing failure of regulatory protections and lack of proper disclosures leading up to financial crisis).

¹⁹⁰ See *Supra* note 1, at 119 ("Many investors . . . relied on credit ratings because they had neither access to the same data as the rating agencies nor the capacity or analytical ability to assess the securities they were purchasing.").

¹⁹¹ See Schwarcz, *Supra* note 128, at 383 (indicating effects of lengthy prospectuses); See *id.* at 405 (discussing how complexity can deprive investors and other market participants of information needed for efficient markets). "Investors were not given information that could have alerted them to the decline in underwriting that occurred in the subprime market in the years leading up to the subprime crisis, and so they kept investing in securities backed by those loans." Eggert, *Supra* note 39, at 1307 (referencing Randall S. Krasner, Governor, Bd. of Governors of the Fed. Res. Sys., Improving the Infrastructure for Non-Agency Mortgage-Backed Securities, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), available at <http://www.federalreserve.gov/newsevents/speech/kroszner20081204a.htm>

("The paucity and inaccessibility of data about the underlying home loans was, in my opinion, one of the reasons that private-label MBS was able to expand so rapidly in 2005 and 2006 despite a deterioration in underwriting and prospective credit performance.").

Another reason investors relied on the securities is because securitization protects investors from credit risk through sequential tranches.¹⁹² Those investors who were extremely risk-averse (and who thus believed they were covering their bases) purchased AAA tranches, which were thought to possess the most reliable underlying assets.¹⁹³ The AAA tranche is also retired first, thus assuring a AAA investor that their investment will be returned to them should the security begin to lose value.¹⁹⁴

In addition, credit agencies historically rated subprime offerings with a conservative risk assessment.¹⁹⁵ In other words, investors may have believed that their holdings actually deserved a higher credit rating than S&P and Moody's gave them, providing investors with a false sense of security.¹⁹⁶ Moreover, securities are understood to be diversified investment instruments in that they contain loans from borrowers with different geographical backgrounds, credit risk, and prepayment risk, which may also have provided investors with a false sense of security.¹⁹⁷

A. Post-Financial Crisis Regulations

“The challenge for the Commission is to develop a rule that addresses these twin problems: 1) that the asset reviews that were conducted were inadequate to reveal the extent of problems with assets underlying the securities; and 2) that, where problems were uncovered by the reviews, they were neither

¹⁹² See Kathleen C. Engel & Patricia A. McCoy, Article, Turning A Blind Eye: Wall Street Finance of Predatory Lending, 75 FORDHAM L. REV. 2039, 2054-47 (2007). (discussing tranche system).

¹⁹³ See *Id.* (same).

¹⁹⁴ See *Supra* note 1, at 71-74 (providing in-depth discussion of tranches).

¹⁹⁵ See *Id.* at 2055 (providing that S&P's reports for 2003 through 2006 expressly provided data demonstrating that S&P tended to overestimate credit risk of senior subprime tranches and upgrades outnumbered downgrades until 2006).

¹⁹⁶ See *Supra* note 1, at 221-23 (discussing downgrades in 2007). In hindsight, it is clear that the holdings were actually much worse than what S&P and Moody's rated them. See *Id.* (same).

¹⁹⁷ See Engel, *Supra* note 131, at 2057 (“Diversification is another means by which securitization reduces investor's risk . . .”).

*rectified nor clearly disclosed to investors. To solve these problems, the Commission must counteract the strong incentives investment banks and others in the securitization supply chain have to under-invest in due diligence and to hide potential problems from investors.*¹⁹⁸

The SEC adopted two regulations attempting to rectify the financial crisis. First, the SEC adopted Rule 193.¹⁹⁹ Second, the SEC adopted amendments to Item 1111 of Regulation AB.²⁰⁰

¹⁹⁸ Comment from Barbara Roper, Director of Investor Protection, Consumer Federation of America, at 4 (Nov. 13, 2010) available at <http://sec.gov/comments/s7-26-10/s72610-15.pdf> (File No. S7-26-10).

¹⁹⁹ For the full text of Rule 193, see 17 C.F.R. § 230.193 (2011).

An issuer of an “asset-backed security,” as that term is defined in Section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), offering and selling such a security pursuant to a registration statement shall perform a review of the pool assets underlying the asset-backed security. At a minimum, such review must be designed and affected to provide reasonable assurance that the disclosure regarding the pool assets in the form of prospectus filed pursuant to § 230.424 of this chapter is accurate in all material respects. The issuer may conduct the review or an issuer may employ a third party engaged for purposes of performing the review. If the findings and conclusions of the review are attributed to the third party, the third party must be named in the registration statement and consent to being named as an expert in accordance with § 230.436 of this chapter.

Id.

²⁰⁰ For the full text of Rule 193, see 17 C.F.R. § 229.1111 (2011).

Describe the pool assets, including the information required by this Item 1111 . . . In addition to presenting the number, amount and percentage of pool assets by distributional group or range, also provide statistical information for each group or range by variables, to the extent material, such as, average balance, weighted average coupon, average age and remaining term, average loan-to-value or similar ratio and weighted average standardized credit score or other applicable measure of obligor credit quality.

(a) Information regarding pool asset types and selection criteria. Provide the following information: . . .

(7)(i) The nature of a review of the assets performed by an issuer or sponsor . . . including whether the issuer of any asset-backed security engaged a third party for purposes of performing the review of the pool assets underlying an asset-backed security; and

(ii) The findings and conclusions of the review of the assets by the issuer, sponsor, or third party described in paragraph (a)(7)(i) of this section . . .

(8) If any assets in the pool deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets, or any assets in the sample or assets otherwise known to deviate if only a sample was reviewed, disclose how those assets deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets and include data on the amount and characteristics of those assets that did not meet the disclosed standards. Disclose which entity (e.g., sponsor, originator, or underwriter) or entities determined that those assets should be included in the pool, despite not having met the disclosed underwriting standards or other criteria or benchmark used to evaluate the assets, and what factors were used to make the determination, such as compensating factors or a determination that the exception was not material. If compensating or other factors were used, provide data on the amount of assets in the pool or in the sample that are represented as meeting each such factor and the amount of assets that do not meet those factors. If multiple entities are involved in the decision to include assets

i. Rule 193

Effective March 28, 2011 the SEC adopted Rule 193 in order to implement Section 945 of the Dodd-Frank Act and Section 7(d) of the Securities Act in an attempt to address the lack of information regarding a RMBS offering disclosed to investors.²⁰¹ The SEC ultimately decided to include a reasonable assurance minimum review standard in Rule 193 requiring that the review be designed and effected to provide reasonable assurance that the disclosure in the prospectus regarding the assets is accurate in all material respects.²⁰² When choosing to adopt Rule 193, commentators voiced mixed feelings regarding the inclusion of a reasonable assurance minimum review standard.²⁰³ In fact, commentators possessed mixed feelings

despite not having met the disclosed underwriting standards, this should be described and each participating entity should be disclosed.

Id.

²⁰¹ See generally *Supra* note 96 (containing review of proposed rules, comments on proposed rules and final rules). “Section 945 of the Dodd-Frank Act was created because due diligence practices in [RMBS] offerings eroded.” S. Rep. No. 111-176, at 133 (2010).

²⁰² See *Supra* note 96, at 4234-35 (describing reasonable assurance standard). The reasonable assurance standard “encompasses the full range of reviews an issuer may perform to ensure that its review is designed and effected to provide reasonable assurance that the prospectus regarding the pool assets is accurate in all material respects.” *Id.* at 4235. “Thus, for example, if the prospectus disclosed that the loans are limited to borrowers with a specified minimum credit score, or certain income level, the review, as designed and effected, would be required to provide reasonable assurance that the loans in the pool met this criterion.” *Id.* at 4234.

²⁰³ See, e.g., Comment from Jeffrey W. Rubin, Committee on Federal Regulations of Securities, American Bar Association, at 2 (Nov. 17, 2010), available at <http://sec.gov/comments/s7-26-10/s72610-50.pdf> (favoring reasonable assurance standard) (File No. S7-26-10).

The reasonable assurance standard could provide a workable approach [because] any issuer of securities registered under the [Securities Act], is already liable for any misstatement of a material fact in its disclosure, and for any omission necessary to make the statements it does make in that disclosure not misleading in any material respect. Therefore, every issuer already should be taking appropriate steps to ensure the accuracy of its disclosure in order to avoid potential liability for material misstatements or omissions.

Id.; But see Comment from Tom Deutsch, Executive Director, American Securitization Forum, at 4-5 (Nov. 15, 2010), available at <http://sec.gov/comments/s7-26-10/s72610-44.pdf> (File No. S7-26-10) (expressing dislike for reasonable assurance standard).

[The reasonable assurance minimum review standard] . . . is inappropriate and unnecessary . . . [because] the new requirements mandated by [the Dodd-Frank Act] should address a review of the assets, not a review of the disclosure about the assets . . . Issuers already have strict liability for any untrue statement of a material fact in the prospectus or any omission to state a material fact required to be stated therein or necessary to make the statements made not misleading. Effectively, the “reasonable assurance” standard if applied to Rule 193 would require issuers to describe what they did to get comfortable that they met their disclosure obligations. This disclosure requirement could expose issuers to liability for failing to have used procedures that provided such “reasonable assurance”, or for not having accurately described the nature of the procedures and their findings and conclusions, even if there was no material error or omission as

about including a minimum review standard at all in Rule 193 due to the fact that “[RMBS] do not lend themselves to a one-size-fits-all approach to asset reviews.”²⁰⁴ Moreover, Rule 193 permits the sampling of assets as a way to satisfy the asset review requirement.²⁰⁵ Issuers are also required to disclose in the registration statement whether they relied on a third party’s assistance in conducting a review and the name of that third party.²⁰⁶

ii. Amendments to Item 1111 of Regulation AB

Also effective on March 28, 2011 was the decision to adopt the amendments to Item 1111 of Regulation AB in order to satisfy Rule 193.²⁰⁷ Under New Item 1111(a)(7), an issuer is required to disclose the findings and conclusions of the review performed by the issuer or by a third party who conducted the review.²⁰⁸ Furthermore, under New Item 1111(a)(8) of Regulation AB, issuers are required “to disclose how the assets in the pool deviate from the disclosed underwriting criteria and include data on the amount and characteristics of those assets that did not meet the disclosed standards.”²⁰⁹ Importantly, the amendment requires issuers to disclose the entity responsible for determining that such assets are included in the pool, despite the deviation from the disclosed underwriting standards, and what factors were used to make the determination.²¹⁰ Moreover, for loans granted with the use of compensating

to the actual disclosure in the prospectus about the pool assets. We think [RMBS] issuers, like other issuers, should be required only to meet their disclosure obligations, and not go further and disclose what procedures they followed to give themselves “reasonable assurance” that they met their disclosure obligations.

Id.

²⁰⁴ See Roper, *Supra* note 137, at 6 (noting that it would be near impossible “to write a detailed, prescriptive rule outlining exactly how asset reviews should be conducted in each circumstance”).

²⁰⁵ See *Supra* note 96, at 4235 (discussing allowance of sampling).

²⁰⁶ See *Id.* at 4236-37 (discussing requirements for third party reviews).

²⁰⁷ See *Id.* at 4237 (stating SEC’s purpose in amending Item 1111 was to ensure disclosures provide clear pictures for investors of review undertaken and results of such review).

²⁰⁸ See *Id.* at 4237-38 (providing that new Item 1111(a)(7) of Regulation AB requires issuers of RMBS offerings to disclose nature of review it conducts to satisfy Rule 193). New Item 1111(a)(7) requires disclosure as to “whether the issuer has hired a third-party firm for the purpose of reviewing the assets . . . a description of the scope of the review . . . and what kind of sampling technique was employed . . .”). *Id.*

²⁰⁹ *Id.* at 4238.

²¹⁰ See Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231, 4238 (providing that this explanation “could include compensating factors, such as those included in an issuer’s waiver policies for

or other factors, New Item 1111(a)(8) requires issuers to provide data on the amount of assets in the pool or sample “that are represented as meeting each factor and the amount of assets that do not meet those factors.”²¹¹

B. Analysis of New Regulations

In response to critics of the reasonable assurance standard, it is correctly argued that a minimum standard of review is necessary to “reintroduce due diligence” into the securitization process.²¹² A minimum review standard is essential to regulating RMBS offerings because allowing issuers to satisfy the statutorily required review without following a proscribed minimum standard, “potentially could undercut the statutory purpose by erroneously suggesting that due diligence was conducted.”²¹³ Hence, it is unfortunate that the SEC did not write Rule 193 to require the issuer to conduct a specific type of review.²¹⁴

including in the pool loans that fail to meet the disclosed underwriting criteria, or a determination that the exception was not material.”).

²¹¹ *Id.*

We also believe that this information will help provide investors with a more complete understanding of the quality and extent of the issuer’s review of the assets (through hiring a third-party or otherwise) and how that relates to a determination to either include a loan in the pool or exclude it from the pool.

Id.

²¹² *See Id.* at 4234 (citing Senate Committee testimony by Professor John Coffee) (citation omitted). Absent a minimum standard of review, it would be possible for the issuers to satisfy new Rule 193 with a review that was not designed or carried out in a way that addresses the concerns behind the creation of Section 7(d)(1). *See id.* (discussing SEC’s reasoning for including minimum standard of review). *See also* Roper, *Supra* note 137, at 6 (supporting minimum review standard).

Indeed, if issuers’ and underwriters’ responsibility to ensure accurate disclosures were adequate to discipline this process, it should have worked in the past. The fact that it did not should serve as sufficient reason not to rely on it to do so now. Similarly, investors’ inability to force more extensive or more timely disclosures with regard to asset-backed securities strongly suggests that they will be similarly unable to exert sufficient market power to improve the quality of asset reviews absent a Commission requirement that those reviews meet some minimum standard.

Id.

²¹³ *Supra* note 149, at 4234.

²¹⁴ *See Id.* at 4235 (providing explanations of various credit reviews).

First, a credit review examines the sample loans to ascertain whether they have been originated in accordance with the originator’s underwriting guidelines. This would include a review of whether the loan characteristics reported by the originator are accurate and whether the credit profile of the loans is acceptable to the sponsor. A second type of review could be a compliance review, which examines whether the loans have been originated in compliance with applicable laws, including

The SEC should have mandated a minimum review standard of the assets underlying RMBS transactions.²¹⁵ In fact, as one commentator correctly noted, “[i]n order to make a review of underwriting guidelines meaningful, it is imperative that issuers be required to disclose the applicable underwriting to investors.”²¹⁶ Although the SEC did not mandate an inclusion of a credit review in the adoption of Rule 193, it did suggest that an asset review at a minimum should include information regarding credit quality.²¹⁷ Nevertheless, without a mandatory credit review, the disclosures following the adoption Rule 193 may potentially defeat the goal of the new regulation.²¹⁸

Furthermore, by failing to require a specific review for RMBS offerings, the SEC left the door open for Wall Street to manipulate the review to their desire. The only requirement the issuer is now obligated to follow is to include “material” facts and conduct the review in a way that provides “reasonable assurance.”²¹⁹ Thus, all Rule 193 has done is perpetuate the “notoriously slippery concept” of materiality and create potential new litigation surrounding

predatory lending and Truth in Lending statutes. Third, a valuation review entails a review of the accuracy of the property values reported by the originators for the underlying collateral. This could include a review of each original appraisal to assess whether it appeared to comply with the originator’s appraisal guidelines, and the appropriateness of the comparables used in the original appraisal process.

Id. at 4235.

²¹⁵ For example,

[I]n order to comply with Section 945 on RMBS transactions, the review of the assets should include the following: (i) verification of data (i.e., confirmation that the information on the mortgage loan schedule matches what appears in the actual mortgage loan files), (ii) credit re-underwriting to the loan requirements set forth in the originator’s underwriting guidelines, (iii) compliance with underwriting guidelines (including noting exceptions made to underwriting guidelines and describing compensating factors), (iv) compliance with the originator’s property valuation guidelines, and (v) compliance with applicable consumer protection laws and noting any violations thereof. For seasoned loans, a review of compliance with underwriting guidelines should not be required. Instead, a review of borrower payment history should be conducted.

Comment from Steven Cohen, Senior Vice President and General Counsel, Clayton Holdings LLC, at 9 (Nov. 15, 2010), available at <http://sec.gov/comments/s7-26-10/s72610-42.pdf> (File No. S7-26-10).

²¹⁶ *Id.*

²¹⁷ See *Supra* note 149, at 4235 (“The minimum review standard we are adopting will necessarily include credit quality and underwriting of the assets . . .”).

²¹⁸ See *Id.* at 32 (indicating SEC’s goal was to “increase investor protection”).

²¹⁹ See *Id.* at 4235-35 (discussing final issuer review requirement rule under Rule 193).

the meaning of reasonable assurance.²²⁰ The Supreme Court has warned against a bright-line rule.²²¹ Nevertheless, a determination of what to include in the disclosures should not rely solely on “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him.”²²² With respect to RMBS disclosures, it seems apparent that reasonable investors would benefit from a bright-line rule requiring issuers to disclose due diligence reports on asset reviews and the amount of exception loans contained in the RMBS offerings.²²³ Therefore, a materiality-based disclosure is no longer appropriate and the SEC has faultily kept the materiality scapegoat alive for issuers.

The SEC should also have required a minimum percentage of loans be reviewed for different asset classes or require the samples satisfy a specific statistical confidence interval.²²⁴ Permitting issuers to review and report on only a sample of the underlying assets contributed to the problem surrounding the financial crisis.²²⁵

²²⁰ See Richard C. Sauer, Article, The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws, 62. BUS. LAW. 317, 317-20 (2007).

The disclosure requirements at the heart of the federal securities involve a delicate and complex balancing act. Too little information provides an inadequate basis for investment decisions; too much can muddle and diffuse disclosure and thereby lessen its usefulness . . . Materiality [] is a highly judgmental standard, often colored by a variety of factual presumptions.

Id. at 317; *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (“Where . . . the event is contingent or speculative in nature, it is difficult to ascertain whether the ‘reasonable investor’ would have considered the omitted information significant at the time.”).

²²¹ See *Basic Inc. v. Levinson*, 485 U.S. at 236 (“A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions.”)

²²² *Id.*

²²³ For examples of investors’ complaints over inadequate reporting of due diligence reports and sampling, see *Supra* notes 98-117 and accompanying text.

²²⁴ See Robert Peck Christen & Mark Flaming, Due Diligence Guidelines for the Review of Microsoft Loan Portfolios, at 28 (2009) available at http://www.cgap.org/gm/document-1.9.36521/DueDiligence_TechGuide_ENG.pdf (explaining confidence intervals in sampling).

²²⁵ See, e.g., *Supra* note 2, at 153 (providing that J.P. Morgan Chase & Co., Bear Stearns & Co. and Washington Mutual were informed that 27 percent, 16 percent, 27 percent, and 9 percent of loans reviewed by [third party due diligence firms] for J.P. Morgan Acquisitions, EMC, Washington Mutual Bank, and Washington Mutual Securities, respectively, were not underwritten according to represented underwriting standards). Instead of increasing the sample size to see why the sample deviated from the underwriting standards, the investment firms “continued to carry on with their own poor internal underwriting and work with problematic originators.” *Id.* at 154. Had there been a regulation requiring these firms to sample a minimum amount of assets or to increase the sample size when confronted with a sample that was inconsistent with their underwriting standards, it would have been more difficult

Next, the SEC also mistakenly permitted issuers to rely on third party reviews in conducting the asset review.²²⁶ Allowing an issuer to engage a private third party creates a conflict of interest similar to the conflict of interest that was apparent between the issuers and the credit rating agencies prior to 2008.²²⁷ One protection Rule 193 offers in response is the requirement that third parties consent to expert liability in accordance with Section 7 and Rule 436 of the Securities Act, which would provide accountability and thus create stronger incentives by the third parties to perform high-quality reviews.²²⁸

for the firms to sell the resulting securities to investors. See *Supra* note 1, at 108 (discussing problems with sampling).

²²⁶ See *Supra* note 149, at 4236-37 (discussing requirements for third party reviews).

²²⁷ See, e.g., Elliot Blair Smith, 'Race to Bottom' at Moody's, S&P Secured Subprime's Boom, Bust, Bloomberg (Sept. 25, 2008), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo (discussing adjustment of rating requirements for securities conducted by Moody's and S&P in order to block threat of losing business from Wall Street banks). The third parties are incentivized to produce faulty reviews and report inaccurate findings by perhaps overlooking deviations from the guidelines in order to maintain the issuers as continuous clients. See *Id.* (same).

²²⁸ See *Supra* note 149, at 4236 (discussing requirement under Rule 193 that issuers may rely on third-party's review provided third party is named in registration statement and consents to expert status).

In response to this requirement, commentators voiced their opinion that requiring third party due diligence firms to consent to expert liability would deter these third parties from conducting the review for the issuers. See, e.g., Rubin, *Supra* note 142, at 5-6 (expressing American Bar Association's belief that third party due diligence firms will not consent to being named experts). This, commentators argue, would be harmful to investors because less experienced firms would then be left to conduct the reviews. See *Id.* ("If any third party due diligence provider were required to be named as an expert, that requirement would significantly increase the likelihood that review of the pool assets will be performed only internally by the issuer and, accordingly, decrease the likelihood of independent review. We believe that this result would not be beneficial for investors."); See also Comment from Christeena G. Naser, Assistant General Counsel, American Bankers Association Securities Association, at 2 (Nov. 16, 2010), available at <http://sec.gov/comments/s7-26-10/s72610-49.pdf> (File No. S7-26-10) ("[It is] likely that few third-party due diligence providers would be willing to subject themselves to such liability but would rather withdraw their services in such instances.");

Even if issuers were able to engage skilled third parties who were willing to consent to be named as experts . . . such third parties would likely be inclined to perform a far more limited, "check the box" style review than they would perform if incurring expert liability was not a concern. Alternatively, the quality of loan review by existing providers of these services could be maintained, but at a much higher cost reflecting additional procedures required in order to operate under the higher liability standard, which would result in higher costs of credit to be borne by borrowers. It is also possible that the industry could see an influx of newly formed Third Party Diligence Providers who would be thinly capitalized and therefore more willing to take on expert liability. Such reviews would likely be substantially poorer in quality than those performed by the skilled and experienced providers currently active in the market.

Deutsch, *Supra* note 142, at 6-7.

One alternative to requiring third party due diligence firms to accept expert liability as a solution to the conflict of interest concern that has been recommended is to require the third party due diligence firms to provide a certification stating that they were not involved in a conflict of interest.²²⁹ However, including a certification in the disclosures or disclosing that the issuer pays the third party is not adequate protection for investors.²³⁰ Requiring only these toothless options as a solution to the conflict of interest problem is to mitigate the unethical choices members of the rating agencies and the issuers made prior to the financial crisis.²³¹

There are other options to the conflict of interest problem. For example, the SEC could audit the third party due diligence providers or conduct due diligence reviews itself so as to ensure the reviews are truthfully reported.²³² However, this would require the SEC to acquire a higher level of examination and enforcement power than even the recent authority granted to the SEC through the Dodd-Frank Act. Auditing the third parties would encourage the third parties to conduct thorough, truthful and complete reviews due to the threat of a potential audit.²³³

²²⁹ See Deutsch, *Supra* note 142, at 9 (discussing alternatives to third party due diligence problem).

[W]e propose that Third Party Diligence Providers . . . hired by issuers to perform the review required by proposed Rule 193 be required to provide a certification stating that (i) the Third Party Diligence Provider was not subject to any coercion or duress that either limited the scope of the review or limited the provider's ability to conduct an independent and thorough review and (ii) the review was conducted in accordance with specified loan-level review standards provided by the party engaging the Third Party Diligence Provider (which could be the standards of the rating agencies or of the underwriter, or the sponsor's underwriting standards or those of the originator). This is similar to the certification currently provided by Third Party Diligence Providers to rating agencies on RMBS transactions.

Id.

²³⁰ See Rubin, *Supra* note 142, at 7 (“[T]o the extent that there are any conflict of interests issues for hired due diligence providers, disclosure of the conflict should be a sufficient cure.”).

²³¹ See Gretchen Morgenson, Credit Rating Agency Heads Grilled by Lawmakers, N.Y. Times, (Oct. 23, 2008) at B1 (discussing impact of conflict of interests on performance of credit rating agencies in assessing risks of MBS offerings).

²³² See Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (Feb. 2011), available at <http://www.sec.gov/about/offices/ocie/ocieoverview.pdf> (discussing expansions of SEC's examination authority to include several additional types of entities/persons).

²³³ See Benefits of an Audit, Auditing, available at <http://www.auditing.arollo.com/benefits.html> (last visited Oct. 13, 2011) (discussing benefits of auditing).

Moreover, many commentators argued that a mandated disclosure of the findings and conclusions of the review is not mandated by Section 945 of the Dodd-Frank Act.²³⁴ Nevertheless, the SEC was correct in requiring that the issuer disclose the findings and conclusions of a review in its registration statement.²³⁵ Disclosure of the findings and conclusions of the review is necessary to provide investors with a clear picture of the security.²³⁶ Absent a report on the findings of the asset reviews, issuers could be incentivized “to conduct the review themselves to avoid making publicly available the findings and conclusions of any review of the assets underlying the [RMBS].”²³⁷ Additionally, a reporting of the findings of the review will provide investors with useful information and will “help elicit information in areas that became problematic in the recent financial crisis.”²³⁸ In order to solve the problem of investor ignorance as to the underlying assets, the “asset reviews themselves [need to be] sufficient to reveal the existence and extent of problem assets.”²³⁹

VI. CONCLUSION

New regulation should “not take away from the citizen his inalienable right to make a fool of himself. It [should] simply [attempt] to prevent others from making a fool of him.”²⁴⁰ It is not until investors possess all necessary information to make informed decisions that

(Nov. 29, 2012).

²³⁵ See Rubin, *Supra* note 142, at 8 (discussing American Bar Association’s view that Congress could have required disclosure of findings and conclusions of issuer’s due diligence review but chose to not make this requirement); Naser, *Supra* note 167, at 2-3 (“[I]t is inappropriate for the Commission to substitute its judgment and impose a requirement to disclose due diligence findings under the Securities Act.”). But See Roper, *Supra* note 137, at 4 (applauding SEC’s decision to require disclosure of asset review findings).

²³⁶ See *Supra* note 149, at 4238 (discussing SEC’s intention “to make clear that disclosure of the findings and conclusions necessarily requires disclosure of the criteria against which the loans were evaluated, and how the evaluated loans compared to those criteria along with the basis for including any loans not meeting those criteria”).

²³⁷ Roper, *Supra* note 137, at 4.

²³⁸ *Id.* (approving SEC’s disclosure proposal because the disclosures will provide information to investors regarding deviation from disclosed underwriting criteria, number and characteristics of assets that do not meet disclosed criteria and entity responsible for determining that such assets should be included).

²³⁹ *Id.*

²⁴⁰ A Brief History of Securities Regulation, State of Wisconsin Department of Financial Institutions, available at <http://www.wdfi.org/fi/securities/regexemp/history.htm> (last visited Oct. 4, 2011).

investors can be blamed for their investment choices and the defense of caveat emptor be employed.

As outlined in this Note, the shortfall of post-financial crisis regulations is the door left open. Issuers are still permitted to perform sample reviews with all the dangers of under-disclosure that accompanies sampling. The new regulations also leave a murky pool of uncertainty as to how to ensure deal transparency. Moreover, the great unanswered question in the Dodd-Frank Act is how to ensure that issuers do not exert undue influence on due diligence providers without retribution from a strong audit requirement either by its corporate auditors or a SEC with sufficient resources to adequately police issuers and protect investors.

These are the imperative, unaddressed issues in the Dodd-Frank Act that have the ability to recreate the financial crisis in the future. No suitable answers have been posed. It seems predictive that true financial reform is destined to be iterative as underlying flaws in the current legislation are uncovered and then subsequently addressed in future legislation.