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Burning Down the House or Simply Rolling the Dice: A Comment on Section 621 of the Dodd-Frank Act and Recommendation for Its Implementation

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Abstract

Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act modifies the Securities Act of 1933 to prohibit the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an asset-backed financial product from betting against that very product for one year after the product's initial sale. The rule prohibits anyone who structures or sells an asset-backed security or a product composed of asset-backed securities from going short, in the specified timeframe, on what they have sold, and labels such transactions as presenting material conflicts of interest. This Comment discusses traces this new law's development through the Financial Crisis by recounting the events involving alleged material conflicts of interest that gave rise to Section 621's drafting as well as statements of its drafters. The Comment then argues that adding a disclosure exemption to Section 621 via the corresponding SEC regulation implementing it would be preferable to an outright prohibition because a disclosure exemption would 1) be more consistent with the securities laws; 2) provide purchasers with sufficient protection while still allowing the markets to operate with limited restriction; and 3) allow buyers to price the risk of securities affected by material conflicts of interest.

KEYWORDS: Dodd-Frank, Law, Business, Wall Street, Consumer Protection, Securities, Assets, Finance, Conflict

*J.D. 2012, Fordham Law School; A.B. 2007, Brown University. I am truly grateful to my wife, Kate, for all her support and advice. Likewise, I am most appreciative of my parents. Throughout this entire process, Professor Richard Scott Carnell has been nothing short of an amazing and inspiring mentor. I am indebted to him for all his help. Likewise, I must thank Professors Russell Pearce, Douglass Seidman, Marcella Silverman, and Elizabeth Maresca for all their guidance over the past two years. Their dedication has greatly improved my legal writing, and I cannot thank them enough.

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ABSTRACT

Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act modifies the Securities Act of 1933 to prohibit the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an asset-backed financial product from betting against that very product for one year after the product's initial sale. The rule prohibits anyone who structures or sells an asset-backed security or a product composed of asset-backed securities from going short, in the specified timeframe, on what they have sold, and labels such transactions as presenting material conflicts of interest. This Comment discusses traces this new law's development through the Financial Crisis by recounting the events involving alleged material conflicts of interest that gave rise to Section 621's drafting as well as statements of its drafters. The Comment then argues that adding a disclosure exemption to Section 621 via the corresponding SEC regulation implementing it would be preferable to an outright prohibition because a disclosure exemption would 1) be more consistent with the securities laws; 2) provide purchasers with sufficient protection while still allowing the markets to operate with limited restriction; and 3) allow buyers to price the risk of securities affected by material conflicts of interest.

INTRODUCTION

Section 621 ("Section 621") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Dodd-Frank Act") modifies the Securities Act of 1933 to prohibit the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an asset-backed financial product from betting against that very product for one year after the product's initial sale.[1] The rule prohibits anyone who structures or sells an asset-backed security ("ABS") or a product composed of asset-backed securities from going short, in the specified timeframe, on what they have sold.[2] This runs counter to the established principles of the the federal securities laws, which focus primarily on disclosure and include few *per se* bans on transactions.[3]

In the midst of the Financial Crisis, the SEC and Congress launched investigations focused on alleged misdeeds by one of Wall Street's biggest players, Goldman, Sachs & Co ("Goldman").[4] At the core of the government's interest in Goldman lay several structured financial products. Among those products was "ABACUS 2007-AC1," a highly controversial offering because it referenced a portfolio of subprime residential mortgage backed securities chosen by a party that went short, or bet against, that same referenced portfolio.[5] At the same time,

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1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1631-32 (2010) (to be codified at 15 U.S.C. § 77z-2a). In the wake of the Financial Crisis, Congress drafted Dodd-Frank for the following purposes: "[1] to promote the financial stability of the United States by improving accountability and transparency in the financial system, [2] to end 'too big to fail', [3] to protect the American taxpayer by ending bailouts, [4] to protect consumers from abusive financial services practices, and for other purposes." *Id.* at preamble.

2. *Id.* at 1632.

3. *See infra* Part V.

4. *See infra* Part III.

5. Complaint, SEC v. Goldman, Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. Apr. 16, 2010) [hereinafter *Abacus Complaint*]; STAFF OF S. SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 318-639 (Comm. Print 2011), [hereinafter ANATOMY OF A FINANCIAL COLLAPSE], *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

Goldman structured and sold a series of similar products that the institution itself shorted.[6] Alarmed, Senator Carl Levin of Michigan and Senator Jeffrey Merkley of Oregon labeled such deals as "Designed to Fail," and drafted Section 621 in response.[7]

From their understanding of Goldman's alleged misdeeds, Section 621's authors argue that assembling asset-backed securities and selling them should require heightened duties to one's clients because such assemblers have extraordinary "control over whether a security is intended to succeed or fail."[8] Despite this potential for control, the securities laws already provide sufficient remedies for those damaged by such assemblers and thus, provide incentives against such misdeeds.[9]

By enacting Section 621, Congress, in essence, responded "No" to the following question: Would you allow someone to live in a house where the house's electrician had an insurance policy that rewarded him in the event the building were to burn down?[10]

Now, consider the following question: Is it illegal or unacceptable for a casino[11] to set odds on the outcome of a sports game, take bets from gamblers and then profit from the spread of odds and the losses incurred by the gamblers? No, because it is expected that casinos will set odds in their favor (and no one forces the gambler to wager his money) and the gambler is privy to the same information that the casino has. In the end, the casino will only profit if the gambler fails, yet this is

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*I take no position on the veracity of all allegations discussed in this Comment. For the purposes of this Comment, I treat all such accusations as true solely for the purpose of illustrating the types of activity that Section 621 is designed to prevent.

6. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 9.

7. Jeffrey Merkley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 523 (2011) [hereinafter *Policy Essay*].

8. *Id.* at 549-50.

9. *See infra* Part V.

10. 156 CONG. REC. S4057 (May 20, 2010) (statement of Sen. Jeffrey Merkley); 156 CONG. REC. S5894 (July 15, 2010) (statement of Sen. Carl Levin) (making a similar comparison using a mechanic who fixes a car's brakes while simultaneously taking out a life insurance policy against the life of the car's driver).

11. For an interesting analysis comparing and applying securities regulation of structured financial products to gambling laws, see Christopher B. Chuff, Comment, *"Rolling the Dice" on Financial Regulatory Reform: Gambling Law as a Framework for Regulating Structured Investments*, 18 VILLANOVA SPORTS & ENT. L.J. 569 (2011). In the United States, investments are more leniently regulated than gambling. *Id.* at 613.

perfectly acceptable because the gambler is aware of the risk assumed and because the gambler understands that the casino is on the other side of the wager.

The securities laws, the essence of which is fundamentally disclosure, function much like the casino question because the securities laws place a premium on both sides having equal information and do not focus on categorically restricting transactions.[12] This comment examines existing principles of disclosure and fraud in the securities laws to show why Section 621 is overly restrictive and runs counter to general conceptions of securities regulation. With proper disclosure and existing remedies for fraud and misstatements, there is little reason to restrict a buyer from purchasing a product even when the product's structurer or seller stands to profit from its demise.[13]

In Part I, the text and meaning of Section 621 are examined. Part II examines four transactions arranged by Goldman and their effect on the drafters of Section 621. Through statements made by Senators Merkley and Levin and a review of the government's investigations and allegations against Goldman, the transactions' profound influence on Section 621 are highlighted. Part III examines the legislative history of Section 621, part of the Merkley-Levin Provisions, and further reinforces how much Goldman's alleged misdeeds influenced the substance of Section 621. Part IV reviews the existing securities laws in light of their emphasis on disclosure. In Part IV, this Comment argues that the categorical ban found in Section 621 is not consistent with the fundamentals of disclosure because the securities laws are premised not on the underlying quality or characteristics of securities, but rather are focused on ensuring that investors receive adequate information about those securities. Finally, Part V outlines this Comment's ultimate recommendation: the creation of a disclosure exemption to Section 621 which would be included in the SEC rule implementing Section 621. This Park argues that an outright right ban on the sale or distribution of securities affected by material conflicts of interest is not preferable to a simple disclosure requirement because: 1) the markets exist in part for parties to take opposite positions and material conflicts of interest do not alter this fact; 2) adequate disclosure will facilitate investment, despite the existence of material conflicts of interest; and 3) buyers will price

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12. *See infra* Part V.A.
13. *See infra* Part VI.A

risk associated with material conflicts of interest into agreements. From there, this Part discusses ways a disclosure requirement or exemption could be created, ultimately recommending that SEC Rule 127B, the rule that will regulate Section 621 now being explored and drafted by the SEC, contain a disclosure exemption.[14] This recommendation is based on the SEC's authority to create exemptions and because this avenue offers a more streamlined and efficient way of adding the exemption when compared to the alternatives.

I. TEXT AND MEANING OF SECTION 621

Section 621 adds Section 27B to the Securities Act of 1933.[15] It provides:

> An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 78c of this title, which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.[16]

It goes on to create three exemptions from this general prohibition: 1) risk mitigating or hedging activities arising out of the underlying security; 2) liquidity commitments involving the underlying security; and 3) bona fide market making for the security's sale.[17]

Section 621's authors explain that their intention in drafting the prohibition with the term "material conflict of interest" is essentially to block the structurer or seller of an asset-backed security (or synthetic

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14. *See* SEC Proposed Rule on Conflicts of Interest, SEC (Sept. 19, 2011) [hereinafter SEC Proposed Rule 127B], *available at* http://www.sec.gov/rules/proposed/2011/34-65355.pdf. The current draft of SEC Rule 127B solicits comments about a possible disclosure exemption but contains no such exemption. *Id.* at 89-95.

15. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1631-32 (2010) (to be codified at 15 U.S.C. § 77z-2a).

16. *Id*. § 621(a).

17. *Id*. § 621(c).

equivalent) from taking a short position on that same security.[18] They make it clear that such short positions are banned, explicitly noting that disclosure of such a short position is not adequate to mend the conflict of interest.[19] This Comment argues that a disclosure exemption is not only appropriate, but preferable to any outright prohibition of transactions affected by material conflicts of interest.

II. THE GOLDMAN CDOS AND THEIR EFFECT ON SECTION 621

The four structured financial products sold by Goldman discussed is Subparts A and B (the "Goldman CDOs") became the hallmarks of the need for Section 621 in the eyes of Congress. Indeed, these specific Credit Default Obligation ("CDO") products are referenced and admonished throughout the legislative history of Section 621 and again when Section 621's authors lauded their work's final passage into law. To understand how the drafters of Section 621 viewed Goldman's actions and the profound effect those actions had on the drafters, this Part focuses on the Goldman CDOs' treatment in: 1) a report by the Senate's Permanent Subcommittee on Investigations,[20] chaired by Senator Levin; 2) various statements and writings by Senators Merkley and Levin; as well as 3) the SEC's litigation against Goldman and Fabrice Tourre, a Goldman Sachs vice president, who helped structure

18. *See Policy Essay*, *supra* note 7, at 549 ("A firm that underwrites an asset-backed security would run afoul of the provision . . . if it takes the short position in a synthetic asset-backed security that references the same assets it created because this results in the firm essentially betting against assets that it previously packaged.") (citing 156 CONG. REC. S2599 (daily ed. July 15, 2010) (statement of Sen. Carl Levin)); *Regulation Developments 2010*, 66 BUS. LAW. 665, 726 (2011) ("The legislative history of section 621 indicates that Congress intended to address blatant conflicts of interest in which an underwriter or sponsor creates an [asset-backed security] that is designed to fail and then profits by betting against it, by means of short sales or otherwise.") (quotations omitted).

19. *Policy Essay*, *supra* note 7, at 550 ("Even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has—or might in the future—bet against that asset will not cure the material conflict of interest."); Letter from Senators Jeffrey Merkley & Carl Levin to SEC Chairman Mary Schapiro, et al. (Aug. 3, 2010) ("[T]he utility of disclosures must be carefully examined, and not be seen as a cure for the conflicts.") [hereinafter Merkley-Levin Letter], *available at* http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-2.pdf.

20. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5.

Abacus.[21] This treatment shows that, in large part, Section 621 is a reaction to the outrage at Goldman's practices in developing and selling the CDOs explored in this Comment, and details the government's accusations of fraud and misstatements against Goldman. In viewing these transactions, it seems that Goldman's misdeeds stem more from non-disclosure or misstatements concerning conflicts of interest than the underlying conflicts.

A. ABACUS 2007-AC1 ("ABACUS")

In 2006 and early 2007, Goldman began developing and issuing investments in Abacus, a $2 billion synthetic CDO referencing mid and subprime residential mortgages that were rated BBB at the time they were selected for inclusion in the deal.[22] Abacus was unique among the Goldman CDOs examined here because Goldman allowed a third party client, hedge fund Paulson & Co. ("Paulson"), to pick the underlying mortgages.[23] Not only that, but the entire CDO was, according to *Anatomy of a Financial Collapse* and the SEC, arranged at Paulson's request.[24]

Paulson, convinced that subprime mortgages were overvalued and that many of them were destined to fail, sought to take positions where it could capitalize in the event of major defaults in the subprime market.[25] As one of Goldman's largest clients in the residential mortgage-backed securities ("RMBS") arena, Paulson had tremendous sway with Goldman.[26] At the same time, the SEC's Complaint against Goldman and Tourre goes on to allege that Goldman "recognized that market conditions were presenting challenges to the successful marketing of CDO transactions backed by mortgage-related securities."[27] Paulson

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21. SEC v. Goldman Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. filed Apr. 16, 2010).

22. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 395.

23. *Id.* at 396. The report characterizes this activity as allowing the third party, here Paulson, to "rent" the CDO because its actual structure is set up by Goldman, which also markets the CDO to clients. *Id*.

24. *Id.*; *Abacus Complaint*, *supra* note 5, ¶ 3.

25. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 396; *Abacus Complaint*, *supra* note 5, ¶ 15-17.

26. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 396.

27. *Abacus Complaint*, *supra* note 5, ¶ 18; Logically, this allegation makes much sense to include in the Complaint. First, it allows the SEC to show that Goldman was

approached Goldman in mid to late 2006 looking for an opportunity to short a portfolio of RMBS that Paulson itself could select.[28] The SEC alleged that Goldman and Tourre knew that disclosing Paulson's level of involvement with the selection of the underlying assets and its short position on layers within the overall CDO would make Abacus a tough sell to investors seeking to go long on the CDO.[29] To remedy this issue and remove Paulson from the face of Abacus, Goldman or Paulson sought out a third party portfolio selection agent, eventually hiring ACA Management LLC ("ACA").[30] ACA's involvement then would mask Paulson's role in Abacus and additionally, bolster Abacus's credibility with investors by making it seem as though the underlying assets in the

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cognizant of the difficulties presented by going long on subprime mortgages and thus the difficulties in finding anyone willing to buy such positions without getting into the CDO activities Goldman undertook to short that subprime securities for its own accounts, which would be too much of a frolic and detour in a relatively pithy complaint. Second, it details an extra incentive for Goldman to hire ACA, discussed below, in an attempt to cover up Paulson's involvement in the selection process because again it shows that Goldman realized how difficult it would be to sell these investments generally let alone with a likely-biased hedge fund selecting the underlying assets. Third, it allowed the SEC to introduce the world to "Fabulous" Fabrice Tourre by quoting and thereby publicizing tête-à-tête emails where Tourre describes the destruction the "exotic" CDOs caused while admitting he himself never quite understood them: "More and more leverage in the system, The whole building is about to collapse anytime now . . . . Only potential survivor, the fabulous Fab[rice Tourre] . . . standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstruosities [*sic*]!!!" *Id*. Tourre's now infamous emails were quoted widely, making Tourre a poster boy for the bankers who contributed to the Financial Crisis. *See, e.g.*, Dana Milbank, *Wall Street's Mr. Fabu-Less*, WASH. POST, Apr. 28, 2010, at A02; Hugo Dixon & Richard Beales, *Major Distraction Hinders Goldman*, N.Y. TIMES, Apr. 19, 2010, at B2.

Citing the same email, ANATOMY OF A FINANCIAL COLLAPSE argues "Goldman did not view any of the four CDOs examined in this Report [including Abacus] as sound investments for the clients to whom it sold the securities." *Supra* note 5, at 620. The sole source cited on this sentence's point is one of Tourre's emails. *Id.*

28. *Abacus Complaint*, *supra* note 5, ¶ 15; ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 561.

29. *Abacus Complaint*, *supra* note 5, ¶ 19.

30. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 567. Understandably, Paulson and Goldman point fingers at each other here: Tourre claims Paulson sought to employ a portfolio selection agent while a Paulson Managing Director testified in a deposition that Goldman suggested the idea. *Id.*

CDO were selected by a well-regarded, neutral third party.[31] Emails written by Tourre and other Goldman employees suggest that they believed it was essential that the portfolio selection agent be willing to allow Paulson to select the underlying assets for Abacus.[32] Despite ACA's neutral appearance, Paulson played an intimate role in selecting the assets underlying Abacus.[33]

From January to March 2007, Paulson worked closely with Goldman and ACA to select the assets that Abacus would reference.[34] After analyzing BBB-rated mortgages and bonds comprised of such mortgages, Paulson developed a set of criteria that Goldman could reference in selecting the assets that would comprise Abacus.[35] Using the criteria, Goldman selected securities and returned a database containing those selections to Paulson for review.[36] From that database of candidates, Paulson selected 123 securities, which Goldman then passed on to ACA.[37] Through alleged representations by Goldman, ACA believed that Paulson was going long on Abacus.[38] Over the next few months, ACA worked with Paulson to finalize the portfolio.[39] The CDO

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31. *Abacus Complaint*, *supra* note 5, ¶ 22-24; ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 565 (quoting an internal Goldman memorandum stating: "We expect to leverage ACA's credibility and franchise to help distribute this transaction."). The *Abacus Complaint*, *supra* note 5, also references the same quote at paragraph 24.

32. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 562-63.

33. *Abacus Complaint*, *supra* note 5, ¶ 25-35; ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 396-97.

34. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 565-66.

35. *Id.*; *Abacus Complaint*, *supra* note 5, ¶ 25. As for the criteria Paulson developed: "[it] included a high percentage of adjustable rate mortgages, relatively low borrower FICO scores, and a high concentration of mortgages in states like Arizona, California, Florida and Nevada that had recently experienced high rates of home price appreciation." *Id.*

36. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 566.

37. *Id.*

38. *See id.* at 396, 569. This misrepresentation and various actions by Goldman surrounding this issue are discussed *infra* Part V.B.i. Tourre "categorically" denied these allegations when testifying to the Subcommittee on Investigations. *See Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. (2010) [hereinafter *Investment Banks Hearing*] (statement of Fabrice Tourre).

39. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 566.

reference portfolio was finalized on March 22, 2007 with Paulson and ACA agreeing to include 90 Baa2 rated mid and subprime RMBS issued after January 1, 2006.[40] Of the 90 securities underlying Abacus, Paulson proposed 49 and ACA proposed 41 with both sides approving every security included.[41] With the reference portfolio finalized, Goldman sought to have Abacus rated by Moody's.[42]

Without being cognizant of Paulson's involvement in Abacus, Moody's issued AAA ratings to two of Abacus's six tranches.[43] Later, before Senator Levin's Subcommittee on Investigations, a former Moody's director who worked on appraising Abacus testified that knowing about Paulson's involvement would have been an important consideration in rating Abacus.[44] A finalized portfolio and solid rating in hand, Goldman began issuing Abacus securities to investors.[45]

Abacus closed and issued securities on April 26, 2007, with three investors taking the long side and one going short on the CDO.[46] The three long investors purchased slightly more than $1 billion in Abacus securities: 1) IKB, a German commercial bank, bought $150 million AAA-rated Abacus securities; 2) ACA, the portfolio selection agent, purchased $42 million AAA-rated Abacus securities to place in another CDO it was managing; and 3) ACA's parent, ACA Financial Guaranty Corp., went long $909 million on assets referenced by the most senior Abacus tranche.[47] At the same time, Goldman took the short side of these investments, and, unknown to the three aforementioned investors,

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40. *Id.*

41. *Id.* at 569.

42. *Id.* at 568.

43. *Id.*; *Investment Banks Hearing*, *supra* note 38, statement of Sen. Carl Levin.

44. *Wall Street and the Financial Crisis: The Role of Credit Ratings Agencies: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. (2010) (statement of Eric Kolchinsky, Former Managing Director, Moody's Investors Services) ("[Knowing about Paulson's involvement in the portfolio selection process and its short position] just changes the whole dynamic on [Abacus], where the person who is putting it together, choosing it, wants it to blow up.").

45. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 572.

46. *Id*.

47. *Id.*

transferred those short interests to Paulson.[48] As a result of this transfer, Paulson's bet against the CDO went unknown to the long investors.[49]

The value of the securities underlying Abacus fell dramatically in the year following Abacus's closing.[50] By October 24, 2007, 83% of those RMBS were downgraded by the ratings agencies.[51] By January 29, 2008, 99% of them were downgraded.[52] Abacus's three long investors lost more than $1 billion combined while Paulson, as the corresponding and only short investor, collected a profit of about $1 billion from the CDO.[53] Abacus securities are currently worthless.[54]

B. Three CDOs That Goldman Itself Shorted

The following three CDOs are grouped together because they are similar in nature and also because Goldman itself took short positions on their performance.

1. Hudson Mezzanine 2006-1 ("Hudson")

Hudson was a $2 billion synthetic CDO referencing $1.2 billion in ABX assets owned by Goldman and $800 million in Credit Default Swaps ("CDS") based on subprime RMBS and CDO securities.[55] Additionally, all assets referenced by Hudson were rated BBB or BBB-.[56] *Anatomy of a Financial Crisis* argues that Hudson was used by Goldman to transfer the risk of that $1.2 billion in declining ABX assets to its clients, buyers of Hudson securities, while, at the same time, choosing an additional $800 million in subprime securities to package,

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48. *Id.* It is noteworthy here that the even if Goldman held on to the short position in Abacus, it still would have run afoul of Section 621 despite the fact investors are alleged to be under the impression that ACA selected the underlying portfolio.

49. *Id.*

50. *Id*. at 573.

51. *Id.* at 573 (citing *Abacus Complaint*, *supra* note 5, ¶ 5).

52. *Id.* (citing *Abacus Complaint*, *supra* note 5, ¶ 5).

53. *Id.* (citing *Abacus Complaint*, *supra* note 5, ¶ 5).

54. *Id.* at 10.

55. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 390. ABX is an index that charts the performance of U.S. subprime residential mortgage based credit default swaps.

56. *Id.*

sell, and short.[57] Goldman owned the entire short interest in Hudson, giving it direct profits if any part of Hudson lost value.[58]

To structure the transaction, Goldman established a special purpose entity ("SPE") to issue Hudson securities.[59] Using CDS trades, Goldman synthetically moved the $1.2 billion in aforementioned assets off its books, along with the $800 million worth of additional securities it selected, to the SPE.[60] Goldman made payments to the SPE in exchange for the SPE's promise to pay Goldman the full value of the referenced securities should they default or experience other specified adverse credit events.[61] Goldman's payments enabled the SPE to make interest payments to long side investors.[62] On the short side, Goldman would stop making payments on the referenced securities to the SPE at specified triggering events such as a mass default on the underlying mortgages, then the SPE would stop paying the long investors, and then Goldman would begin receiving payments from the SPE.[63] It is most important to note that Goldman's interests here are directly opposed to those of the long investors, its clients.[64] Indeed, Goldman sold long interests in the CDO to its clients as investment opportunities as it went short on the same CDO.[65] In the end, Goldman gleaned a $1.7 billion profit from Hudson while one of the largest Hudson investors, Morgan Stanley, lost about $960 million.[66]

2. Anderson Mezzanine 2007-1 ("Anderson")

Issued March 2007, Anderson was a synthetic CDO referencing $305 million worth of BBB and BBB- rated subprime RMBS.[67] Goldman did not select the underlying assets, but instead hired GSC

57. *Id.*
58. *Id.*
59. *Policy Essay*, *supra* note 7, at 524 (citing *Investment Banks Hearing*, *supra* note 38).
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. *See id.*
66. *Id.* at 525; ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 392.
67. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 392.

Partners, a hedge fund managed by former Goldman employees, to perform that task.[68] GSC Partners selected the underlying assets and Goldman then approved them.[69] Goldman owned 40% of the short side of Anderson.[70] Within seven months of Anderson's issuance, its underlying securities were downgraded by the ratings agencies, and almost all of those securities are currently worthless.[71]

With an intimate knowledge of the underlying securities, Goldman had positioned itself to take advantage of the poor performance of the assets underlying Anderson.[72] More than 45% of those assets originated from a company called New Century.[73] The Subcommittee's report notes that Goldman had purchased a number of New Century loans on its own, but was in the process of demanding repayment due to the loans' exceptionally poor performance.[74] Although Goldman lost money on the overall transaction, this loss was in part offset by the $131 million it gained via its short positions on the CDO.[75]

3. *Timberwolf I ("Timberwolf")*

Timberwolf was a $1 billion hybrid CDO.[76] Timberwolf referenced 56 different A-rated securities from other CDOs, which themselves referenced more than 4,500 RMBS securities with less attractive credit ratings, generally BBB.[77] Like Hudson, Goldman did not select the securities that Timberwolf referenced, leaving that task to Greywolf Capital Management which, like GSC Partners, is a hedge fund run by former Goldman employees.[78] Goldman took a short position on 36% of

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68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.* at 393.
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.* at 540.
76. *Id.* at 393.
77. *Id.* The fact that Timberwolf referenced CDOs, which themselves referenced asset-backed securities makes Timberwolf a hybrid.
78. *Id.* Greywolf selected the assets and submitted them to Goldman for approval. *Id.* at 542.

Timberwolf's securities.[79] From that short interest, Goldman made $330 million at the direct expense of long side investors.[80] But, despite the earnings from the short position, Goldman lost about $455 million on Timberwolf overall due to its inability to sell all the long side shares in the structure.[81]

C. STATEMENTS ABOUT THE GOLDMAN CDOS BY SECTION 621'S DRAFTERS

Throughout the legislative history of Section 621, Senators Levin and Merkley repeatedly referenced the Goldman CDOs and linked them to the need for prevention of material conflicts of interest. This subpart examines how Senator Levin's opening statement at the *Investment Banks Hearing* set the stage for his argument that Goldman's actions involving transactions where it had material conflicts of interest contributed to the Financial Crisis. From there, this subpart looks at statements during the development and passage of Section 621. From this analysis, it is clear that the Goldman CDOs played a major role in the justification for Section 621 in the eyes of its drafters.

In his opening statement at the *Investment Banks Hearing*, Senator Levin explained his understanding of the implications of Goldman's actions regarding the Goldman CDOs. He argued:

> "Goldman's actions demonstrate that it often saw its clients not as valuable customers, but as objects for its own profit. This matters because instead of doing well when its clients did well, Goldman Sachs did well when its clients lost money. Its conduct brings into question the whole function of Wall Street, which traditionally has been seen as an engine of growth, betting on America's successes and not its failures."[82]

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79. *Id.* at 393. Goldman earned $330 million in revenue from this short position, but this only helped to offset the total losses Goldman incurred with Timberwolf. *Id.* at 559. In fact, Goldman earned that $330 million along with $3 million in interest while losing $562 million on Timberwolf securities it failed to sell and another $226 million in securities used to secure the CDO that lost value. *Id.* In all, Goldman lost $455 million on Timberwolf. *Id.*

80. *Id.* at 559.

81. *Id.*

82. *Investment Banks Hearing*, *supra* note 38 (statement of Sen. Carl Levin).

Senator Levin's opening statement frames the issue as one where Goldman betrayed its clients for the sake of its own profits.[83] According to Senator Levin's remarks, when Goldman realized that subprime mortgages were destined to lose value en masse, it packaged them together and sold them to long investors (its clients) while it took the short side, insisting to those investors that the mortgages were still good investments despite Goldman's own short positions on them.[84]

Senator Levin's floor statements before the Senate further illustrate how Goldman's connection led him to draft Section 621. On May 10, 2010, Senator Levin, in explaining Section 621, called on the Senate to "end to the self-dealing" after saying that his Subcommittee's investigation found that "Goldman Sachs act[ed] as its own secret client, betting against its customers."[85] In a May 20, 2010 floor speech, Senator Levin echoed the statements from his May 10 speech and then went on to characterize the Goldman CDOs and Goldman's actions surrounding them as "one of the most dramatic findings" of his Subcommittee's investigation into the Financial Crisis.[86] On July 15, 2010, Senator Levin explained to the Senate that Section 621 "addresses the blatant conflicts of interest in the underwriting of asset-backed securities highlighted in a hearing with Goldman Sachs before the Permanent Subcommittee on Investigations . . . ."[87] Here, it is clear that the Goldman CDOs influenced Section 621's drafters and the Senators who voted to include it in the final version of Dodd-Frank.

After Section 621 was placed into Dodd-Frank and Dodd-Frank was signed into law, Senators Levin and Merkley continued to explain the significance of their work while linking it back to Goldman and the Goldman CDOs. In their policy essay published in Summer 2011, the Senators explained: "Hudson Mezzanine and other similar transactions represent securities underwriting, derivatives dealing, and proprietary trading at their most conflicted. Goldman Sachs intentionally designed the product to take a proprietary trading position against the firm's own

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83. *Id.* ("Goldman Sachs also made out big time in its bet against its own products and its own clients.").

84. *Id.*

85. 156 CONG. REC. S3470 (May 10, 2010) (statement of Sen. Carl Levin). Note Senator Levin's language faulting Goldman for "secret" actions, implicitly arguing that part of the issue is, indeed, a lack of disclosure by Goldman of its short positions.

86. 156 CONG. REC. S 4058 (May 20, 2010) (statement of Sen. Carl Levin).

87. 156 CONG. REC. S 5899 (July 15, 2010) (statement of Sen. Carl Levin).

risky exposure, and it then marketed the CDO it had designed to fail."[88] Similarly, in an August 2011 letter to Mary Shapiro,[89] Chairman of the SEC, regarding the implementation of Section 621, the Senators wrote: "The Permanent Subcommittee on Investigations hearing on Goldman Sachs highlighted a blatant example of this practice [firms taking short positions on securities they structure or sell]: the firm assembled asset-backed securities, sold those securities to clients, bet against them, and then profited from the failures."[90] Thus, the Senators asked that the SEC draft "regulations implementing [S]ection 621 . . . [that] put an end to those conflict-ridden practices."[91] Again, in presenting the purpose and goals of Section 621, whether to the general public and legal community in the *Policy Essay* or the regulators charged with drafting the rules implementing Section 621 in the Letter to Chairman Shapiro, Senators Merkley and Levin were steadfast in linking Section 621 back to the Goldman CDOs.

III. LEGISLATIVE HISTORY AND BACKGROUND

Section 621 is part of the Merkley-Levin Provisions, which are part of the Dodd-Frank Act.[92] As relevant to Section 621, Dodd-Frank's core goals are to protect: 1) the U.S. economy from suffering another debilitating financial crisis; and 2) taxpayers from again being called upon to rescue failed financial firms.[93] Adding Sections 619-621 to Dodd-Frank, the Merkley-Levin Provisions amend and augment Dodd-Frank as originally proposed, and in doing so, seek to "strengthen [it] by

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88. *Policy Essay*, *supra* note 7, at 525. Immediately after, the Senators reemphasized their point: "Goldman Sachs, pursuing its own self-interest, created a product so that it could obtain the short exposure it wanted and then sold the long exposure to clients. It not only bet against its clients; it loaded the dice." *Id.* The Senators' reference to "load[ing] the dice" is similar to the casino example at Part I, *supra*, though here the Senators accuse Goldman of cheating and not simply taking an adverse or conflicted position.

89. Merkley-Levin Letter, *supra* note 19, is addressed to the heads of all the agencies responsible for drafting the regulations implementing the Merkley-Levin Provisions. Because the SEC will write the rules implementing Section 621, only Mary Shapiro is listed for the purposes of this essay.

90. Merkley-Levin Letter, *supra* note 19.

91. *Id.*

92. *Policy Essay*, *supra* note 7, at 532.

93. *See supra* note 1; *Policy Essay*, *supra* note 7, at 515.

seeking to limit the damage . . . proprietary transactions can inflict on [the] economy and end the conflicts of interest which too often accompany them."[94] Both Senator Levin and Senator Merkley participated extensively in investigating the causes of the Financial Crisis and responding to them.[95] Their work in the investigation informed the process of drafting and enacting the Merkley-Levin Provisions.[96]

Senator Levin's involvement began in November 2008, when the Senate Committee on Homeland Security and Governmental Affairs' Permanent Subcommittee on Investigations, chaired by Senator Levin, began its investigation into the "key causes" of the Financial Crisis with the goals of creating a record of facts, informing legislative discourse about the need for financial reforms, and helping to protect ordinary Americans from the excesses of Wall Street.[97] In Spring 2010, Senator Levin's Subcommittee held four hearings, each on a different "root" cause of the Financial Crisis.[98] One of those hearings, examining "Investment Banking Abuses," dealt closely with Goldman and the Subcommittee required CEO Lloyd Blankfein and Tourre, among others, to testify.[99] In April 2011, Senator Levin's Subcommittee issued *Anatomy of a Financial Crisis*, a report that extensively details the findings of the Subcommittee's investigation into the causes of the Financial Crisis.[100]

Senator Merkley traces his involvement to Spring 2009, when he raised the issue of proprietary trading among banks in hearings

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94. 156 CONG. REC. S3470 (May 10, 2010) (statement of Sen. Carl Levin).

95. *See infra* notes 97-110 and accompanying text.

96. *Id.*

97. *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 1; *Investment Banks Hearing*, *supra* note 38 (statement of Sen. Carl Levin) ("Our Subcommittee's goal is to construct a record of the facts in order to deepen public understanding of what went wrong; to inform the ongoing legislative debate about the need for financial reform; and to provide a foundation for building better defenses to protect Main Street from the excesses of Wall Street.").

98. *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 2.

99. *Id.* at 7-10; *see also Sachs and the Shitty: A Ghastly Day on Capital Hill for Goldman's Top Brass*, ECONOMIST, Apr. 29, 2010, http://www.economist.com/node/16009137.

100. *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5.

conducted by the Senate Banking Committee.[101] By Summer 2009, Senator Merkley was collaborating with Paul Volcker, Chairman of the President's Economic Advisor Board, on issues concerning proprietary trading.[102] As result of the collaboration, a proposal was made for the Government Accountability Office to study the issue of proprietary trading.[103] Eventually, this study became a springboard for the Volcker Rule, which is Section 619 of the Dodd-Frank Act.[104]

Senator Dodd's original financial reform bill did not contain any restrictions on proprietary trading, although it did contain the study on the topic requested by Senator Merkley.[105] On February 2, 2010, Chairman Volcker argued for restrictions on proprietary trades and the conflicts of interest that often accompany such trades in testimony before the Senate Banking Committee.[106] On March 4, 2010 the Treasury Department released its proposal regarding the method for enacting Volcker's suggestions, and the proposal did not mention conflicts of interest.[107] On March 10, 2010, Senators Levin and Merkley, along with three colleagues, introduced Protect our Recovery through Oversight of Proprietary Trading Act ("PROP" Trading Act), their version of the Volcker Rules.[108] Among other changes to the Treasury proposal, the PROP Trading Act included the prohibition on material conflicts of interest contained in the final Section 621.[109] Despite the

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101. *See Policy Essay*, *supra* note 7, at 531 (citing *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 37 (2009) (statement of Sen. Jeffrey Merkley)).

102. *Policy Essay*, *supra* note 7, at 531-32.

103. *See id*.

104. *See Policy Essay*, *supra* note 7, at 535-37.

105. *Id.* at 532 (citing Restoring American Financial Stability Act of 2009, 111th Cong. § 989 (2009) (Discussion Draft)).

106. *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 5-8, 49-53 (2010) (statement of Paul Volcker, Chairman, President's Economic Recovery Advisory Board). These restrictions were dubbed the Volcker Rule. The Volcker Rule is embodied by Dodd-Frank Section 619, the first of the Merkley-Levin Provisions. *See* 156 CONG. REC. S5894 (July 15, 2010) (statement of Sen. Jeffrey Merkley).

107. *See Policy Essay*, *supra* note 7, at 533-34.

108. PROP Trading Act, S. 3098, 111th Cong. § 6 (2010).

109. *Id.* § 27B(a)(1) (amending the Securities Act of 1933). Interestingly, the PROP Trading Act is stricter than Section 621, as it contains a catchall clause prohibiting any

PROP Trading Act, Senator Dodd revised his financial reform bill to include a modified version of the Treasury Proposal, which prompted Senators Merkley and Levin, flanked by over twenty co-sponsors, to introduce on May 10, 2010 a modified version of PROP as an amendment to Sen. Dodd's bill.[110] Following successful reconciliation, the Merkley-Levin Provisions were incorporated into the final version of Dodd-Frank.[111]

In explaining the rationale behind Section 621, Senator Levin was clear that the Subcommitte's investigation had a profound effect on the development of the rule. Senator Levin stated Section 621 "address[es] one of the most dramatic findings of [the Subcommittee on Investigations]," which was that "firms [were] betting against financial instruments they are assembling and selling."[112] He specifically mentioned Goldman, arguing that Goldman was "betting against its customers."[113]

IV. SECTION 621 RUNS COUNTER TO ESTABLISHED PRINCIPLES OF FEDERAL SECURITIES REGULATION, WHICH ALREADY REGULATE MATERIAL CONFLICTS OF INTEREST

Authorities are clear that the bedrock of federal securities regulation is disclosure. In enacting the major securities statutes, Congress rejected the so-called merit-based approach to securities regulation, the approach espoused in many state securities laws, which allows the government to approve of each and every offering on its merits (*i.e.* assess the actual qualities possessed by the securities offered). Instead, Congress opted for a disclosure-based approach. The logic behind the disclosure approach employed by Congress is that proper disclosure allows investors to make informed decisions about their purchases while market forces decide what is and what is not an acceptable investment.

At the same time, information barriers are worthwhile tools already used in federal securities regulation in the context of conflicts of

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conflict of interest that would "undermine the value, risk, or performance of the asset-backed security." *Id.* § 27B(a)(2).

110. *See Policy Essay*, *supra* note 7, at 535-37.

111. *Id.* at 537-38.

112. 156 CONG. REC. S3470 (May 10, 2010) (statement of Sen. Carl Levin).

113. *Id.*

interest. By keeping information within companies separate in response to or in anticipation of conflicts of interest, regulators are able to prevent misuse of information.

This section uses the aforementioned aspects of the securities laws to show why Section 621 is not only a misfit among existing principles of securities regulation but also why it should be modified, in light of these principles.

A. THE BEDROCK OF FEDERAL SECURITIES REGULATION IS DISCLOSURE

In the wake of the Great Depression, Congress created the two fundamental federal statutes governing securities offerings and market trading, the Securities Act of 1993 (the "Securities Act")[114] and the Securities Exchange Act of 1934 (the "Exchange Act").[115] Among other reasons, these statutes were enacted to prevent another depression or similar financial disaster.[116] The two statutes create a series of mandatory disclosure requirements for businesses that wish to issue or trade securities in certain contexts.[117] This is because the statutes' drafters focused on disclosure, determining it was the preferred method to ensure the markets were well-regulated and functional.[118] The disclosure premise of the securities laws seeks to create information parity between buyers and sellers, which allows the securities in the market to reach their fair market value as efficiently as possible.[119] The

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114. 15 U.S.C. § 77a *et seq.* (2006).

115. *Id.* § 78a *et seq*.

116. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1223-36 (1999).

117. *Id.* Williams identifies four categories of disclosure under these laws: 1) the Securities Act requires initial disclosure in association with the first offering for sale of a security to public; 2) the Exchange Act requires quarterly (also called "periodic") reporting on securities; 3) proxy disclosures are required in connection with elections conducted at shareholders' meetings; 4) disclosure is required in connection with certain events such as mergers, tender offers, or sales of the business. *Id.* at 1207.

118. *See* AM. JUR. 2D *Securities* § 60.

119. *See In re* Faberge, Inc., 45 S.E.C. 249, 254 (1973) ("Congressional committees have stressed the importance of providing full information for both the buyer and the seller . . . . The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price . . . . The objective of a fair market cannot be achieved when one

SEC's website today bears this credo when describing the SEC's purpose and the philosophy of federal securities regulation.[120]

Perhaps the most famous edification of disclosure comes from Justice Louis D. Brandeis, who wrote: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[121] In developing the securities laws, Congress rejected arguments for merit-based regulation, popular among states securities regulatory regimes at the time, which would have allowed government approve of each and every offering on its merits, and other more stringent regulation of securities in favor of the eventual disclosure-based approach.[122] In doing so, Congress decided that investors and markets were protected sufficiently by full and fair disclosure.[123] In other words, Congress

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of the parties to the transaction has inside information unavailable to the other.") (quotations omitted).

120. *See* The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, SEC, http://www.sec.gov/about/whatwedo.shtml ("The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment . . . .") (last visited Dec. 5, 2011).

121. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914), *available at* http://ia600309.us.archive.org/32/items/otherpeoplesmone00bran/otherpeoplesmone00bran.pdf. Though he was not directly involved in drafting either statute because he was sitting on the Supreme Court by the 1930s, Justice Brandies had great influence on then-Professor Felix Frankfurter and President Franklin D. Roosevelt, who were both instrumental in the development of the statutes. *See* Williams, *supra* note 116, at 1212-13.

122. *See* LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 32-45 (Aspen 5th ed. 2004) (explaining that Justice Brandeis's disclosure approach was picked instead of then-Professor William O. Douglas's arguments for greater control over the securities markers); THOMAS LEE HAZEN, FEDERAL SECURITIES LAW I.A (2003) ("After considerable debate, Congress decided not to adopt the merit regulatory approach of the state acts, opting instead for a system of full disclosure.").

Despite this history of a disclosure-based approach, there is support for installing the merit approach at the federal level. *See, e.g.*, Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. RICH L. REV. 647 (2010).

123. HAZEN, *supra* note 122, at I.A; AM. JUR. 2D *Securities* § 60 ("The basic objective of the Securities Act is to protect the public, securities investors, and domestic securities markets, from the manipulation of stock prices, by requiring, particularly in

employed a philosophy of regulating what could or needed to be said about securities to their purchasers and the public, rather than implementing a regime that regulated the quality of securities offered for sale.[124] In fact, the disclosure regime allows investors to sell risky or even unsafe securities as long as proper disclosure is made.[125] This underlying philosophy of disclosure is recognized by the Supreme Court throughout its canon.[126]

B. EXISTING LAW ON FRAUD AND MATERIAL MISSTATEMENTS AND OMISSIONS SUFFICIENTLY GOVERNS MATERIAL CONFLICTS OF INTEREST

There are several provisions under the Securities Act and the Exchange Act and associated rules that provide investors and the SEC with a cause of action for alleged violations of the securities laws.[127] Although a detailed analysis of the various provisions and rules is beyond the scope of this Comment, it is important to note the basic principles here to frame the allegations made by the SEC and investors discussed below. These laws are premised on protecting investors from fraud and focus on the materiality of the disclosures they require. For liability to be imposed for a misstatement or omission regarding a security, that misstatement or omission must relate to a "material fact."[128] The SEC's rules governing Sections 11 and 12 of the Securities Act states that a fact is material if there is a "substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security" at issue.[129] Similarly, although the SEC has not expressly defined "material fact" under Section 10(b) of the Exchange

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regard to the initial distribution of securities, full disclosure of information thought necessary to informed investment decisions.").

124. HAZEN, *supra* note 122, at I.A.

125. *See* Stephen M. Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 95 MINN. L. REV. 1779, 1801 (2011).

126. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) ("The design of the [Securities Act] is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."); Pinter v. Dahl, 486 U.S. 622, 646 (1988) ("[T]he purpose . . . of the [Securities] Act . . . [is] to promote full and fair disclosure of information to the public in the sales of securities.").

127. *See, e.g.*, 15 U.S.C. §§ 77i, 77q, 78j(b) (2006); 17 C.F.R. § 240.10b5-1 (2009).

128. 14 FLETCHER CYCLOPEDIA *Corporations* § 6862 (2011).

129. 17 C.F.R. § 230.405.

Act (and Rule 10b-5[130] by extension) courts have stated a fact is material "if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor" in deciding whether or not to purchase or sell the security in question.[131] Failure to disclose a conflict of interest has produced liability because conflicts of interest have been found by courts to be material.[132]

Rule 10b-5 is the primary remedy for securities suits stemming from allegations of fraud.[133] This Rule is especially expansive because it covers any purchase or sale of any security by any person, unlike other causes of action under the securities laws which generally deal with registered offerings or mandatory disclosure statements.[134] Rule 10b-5 implicates fraud and therefore requiresa showing of scienter, or "intent to deceive, manipulate, or defraud."[135] There is disharmony among the circuit courts, but some circuits recognize "severe" or "fact-specific" recklessness as sufficient to show scienter.[136] One of the main purposes of Rule 10b-5 is to achieve information parity in the market by eliminating insider trading.[137]

Subparts i-iii explain how the allegations made by the government against Goldman fall under these traditional causes of action made pursuant to the securities laws.[138] These Subparts further highlight

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130. *Id.* § 240.10b5-1.

131. Basic Inc. v. Levinson, 485 U.S. 224, 224 (1988).

132. *See, e.g.*, Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir.1970) ("[F]ailure to inform the customer fully of its possible conflict of interest . . . was an omission of material fact . . . .").

133. HAZEN, *supra* note 122, at IV.E.

134. *Id.*

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

136. *See, e.g.*, Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282-83 (11th Cir. 1999) (discussing circuit split).

137. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974) (Rule 10b-5 is "based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.") (citation omitted).

138. There is an argument to be made here that such allegations and lawsuits had to be made pursuant to established securities laws because there was no prohibition on material conflicts of interest until Section 621 became law. While I agree that these allegations would, of course, have to be tailored to the law in effect at the time the allegations were made, my point is not simply that the existing securities laws can be used to fashion such allegations. My point here, rather, is that the securities laws provide a sufficient, and even preferable, basis for doing so.

private litigation and SEC regulatory action against Goldman and another defendant for alleged securities laws violations.

1. The Government's Allegations Against Goldman Implicate Traditional Securities Laws

The government's allegations surrounding the Abacus transaction directly implicate existing securities laws. On April 16, 2010, the SEC filed a complaint in the Southern District of New York against Goldman and Tourre under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act.[139] The allegations stem from misstatements and fraud.[140] Specifically, the government alleged: 1) failure to disclose Paulson's involvement in the portfolio selection process to Abacus buyers; 2) failure to disclose Paulson's short interest to ACA; 3) misrepresenting that Paulson had a long interest to ACA; 4) failure to disclose Paulson's involvement in the portfolio selection process to the ratings agencies; and 5) failure to disclose Paulson's short interest to long investors in light of its role in structuring the portfolio.[141]

Anatomy of a Financial Crisis makes several allegations of securities laws violations against Goldman relating to disclosure and fraud in its communications with buyers of Hudson securities. First, it is alleged that Goldman's marketing materials stated that Goldman's interests were aligned with long investors because Goldman was slated to purchase part of Hudson's equity tranche.[142] Second, it is alleged that Goldman failed to mention that it was shorting the entire portfolio referenced by Hudson.[143] Third, it is alleged that Goldman led investors to believe that the portfolio referenced by Hudson was picked by neutral parties when the portfolio was actually picked by Goldman and, furthermore, $1.2 billion of the portfolio came straight off of Goldman's

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139. *Abacus Complaint*, *supra* note 5, ¶ 67-74.

140. *Id.*

141. *Id.*

142. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 391 (quotation omitted); *Policy Essay*, *supra* note 7, at 525.

143. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 391. Despite this representation, Goldman did disclose that it "may" invest short in Hudson. *Id.* Thus, Goldman disclosed that it had the potential to be short when, in fact, it was short. For a discussion about why Goldman's actions here are insufficient disclosure under emerging federal case law, *see infra* Part V.C.

books.[144] Fourth, it is alleged that Goldman did not disclose that all assets referenced by Hudson were priced by Goldman and not by referencing third party sales of those assets.[145] Fifth, it is alleged that the Subcommittee's report evidences that Goldman dragged its feet in responding to client requests that it begin selling Hudson assets that were declining in value because Goldman's short position was gaining more value as the assets declined.[146]

Again, like Abacus and Hudson, *Anatomy of a Financial Collapse* makes a number allegations under existing securities laws against Goldman for its actions relating to Anderson. First, it is alleged that despite Goldman's understanding that New Century, the originator of many of the underlying mortgages referenced by Anderson, was in financial trouble and that Goldman was in the process of demanding repayments of many loans on its books from New Century, Goldman did not disclose its own negative views of New Century to potential long investors in Anderson.[147] Second, it is alleged that Goldman actually claimed to be "comfortable" with New Century's products and even issued talking points to sales staff aimed at assuaging potential clients' fears about the company.[148] Third, it is alleged that Goldman did not disclose its short position in Anderson.[149] Fourth, it is alleged that not only did Goldman fail to disclose its short position, but it actually led investors to believe it had a 50% stake in Anderson's equity tranche, meaning it was long on Anderson.[150] Fifth, it is alleged that Goldman did not tell investors that it nearly cancelled Anderson due to falling values of the structure's underlying securities.[151]

The Subcommittee's report is critical of Goldman's actions involving Timberwolf on many fronts, but it does not outline many strong securities laws violations.[152] The strongest allegation in the report

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144. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 391; *Policy Essay*, *supra* note 7, at 525.

145. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 391.

146. *Id.* at 391-92.

147. *Id.* at 393.

148. *Id.*

149. *Id.*

150. *See* ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 541.

151. *Id.*

152. Although Timberwolf seems to have the least clear violations of securities laws when compared to the other examined Goldman CDOs and Timberwolf resulted in a

regarding Timberwolf is that Goldman withheld its short position from investors.[153] It is also alleged that Goldman failed to disclose its internal analyses showing that Timberwolf was losing value.[154] *Anatomy of a Financial Collapse* also provides examples to support its allegations that Goldman "targeted" its sales towards clients inexperienced with purchasing CDOs, while at the same time offering those customers as little information on Timberwolf as possible.[155]

2. *Some Goldman CDOs Result in Prosecution and Settlement Under Existing Securities Laws*

In July 2010, Goldman settled with the SEC ending its portion of the Abacus case.[156] In the settlement Goldman agreed to pay $535 million in civil penalties and disgorge $15 million.[157] Although Goldman did not admit or deny the complaint's allegations, the settlement stated that Goldman's failure to disclose Paulson's role in the portfolio selection process was a "mistake" because Paulson's interests were adverse to the CDO's other investors.[158] Although Goldman's lack of admissions fails to provide collateral opportunities for private

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net loss for Goldman, Timberwolf does present the report's authors with several excellent storylines in furtherance of condemning Goldman. First, the report details two victims of Timberwolf: a Korean life insurance company that had no experience in the CDO market and an Australian hedge fund that went bankrupt in part from its exposure to Timberwolf. *Id.* at 549-55. Second, an eminently quotable email, featuring a Goldman trader calling Timberwolf "one shitty deal," came to represent the sentiment of many at Goldman about the long side of the transaction. *Id.* at 395, 554, 561. Senator Levin continually quoted the email in berating its author's supervisor. *See* Brian Montopoli, *Levin Repeatedly References "Sh**ty Deal" at Goldman Hearing,* CBS NEWS, Apr. 27, 2010, http://www.cbsnews.com/8301-503544_162-20003526-503544.html.

153. *Id.* at 559.

154. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 559.

155. *Id.*

156. *See* Consent of Defendant Goldman, Sachs & Co., SEC v. Goldman, Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. July 15, 2010); *see also* Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), http://www.sec.gov/news/press/2010/2010-123.htm [hereinafter SEC Goldman Settlement Press Release].

157. Consent of Defendant Goldman, Sachs & Co., SEC v. Goldman, Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. July 15, 2010).

158. *Id.*

litigants (*i.e.* the long-side investors harmed by Abacus's failure),[159] Goldman's civil penalty is remarkable because of its size as compared to the actual profits it gleaned from the transaction. The civil penalty was the largest settlement ever assessed by the SEC against a financial services firm and its size dwarfs the $15 million in actual profits that Goldman gained from Abacus.[160] It is unclear what the outcome will be for Tourre because as of the settlement date his case was still pending.[161] Likewise, private actions against Goldman regarding Abacus have also been initiated.[162]

Goldman also faces liability in a variety of private lawsuits, including class actions and derivative suits, stemming from the other CDOs examined in this comment.[163] In fact, these lawsuits, when combined, seek to collect $15.8 billion in rescission alone from Goldman.[164] In a regulatory filing, Goldman classifies such suits as "generally alleging that the offering documents for the securities . . .

159. Settlements that contain admissions can, in certain situations, be used against the admitting party in subsequent actions by plaintiffs harmed by the same circumstances giving rise to the settled case. *See generally* 18A CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PROCEDURE AND PRACTICE § 4443 (West 2d Ed. 2011) (explaining the applicability of consent judgments to later litigations).

160. *See* SEC Goldman Settlement Press Release, *supra* note 156. One federal judge even remarked upon the size of this penalty in deciding that settlement in a similar case brought by the SEC, discussed *infra* at Part V.B.iii, was insufficient. *See* Order and Opinion 13 n.7, SEC v. Citigroup Global Markets, Inc., No. 11 Civ. 7387 (S.D.N.Y. Nov. 28, 2011) (Rakoff, J.) [hereinafter Citigroup Order]. In other words, the size of this settlement may act as a lodestar for actions to come.

161. *See* SEC Goldman Settlement Press Release, *supra* note 156. *See also* Docket, SEC v. Goldman, Sachs & Co., No. 10 Civ. 3229 (S.D.N.Y. Apr. 16, 2010).

162. *See, e.g.*, ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., No. 650027/2011 (N.Y. Sup. Ct. filed Jan. 6, 2011). In this case, Goldman responds, *inter alia*, to ACA's complaint of fraud and material misstatements by asserting that Paulson's investment strategy is not a material fact and therefore, did not need to be. Goldman further responded that ACA never asked Goldman or Paulson for information regarding Paulson's position. *See* Reply Memorandum of Law in Further Support of Defendant's Motion to Dismiss the Amended Complaint, ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., No. 650027/2011 (N.Y. Sup. Ct. Aug. 8, 2011). This motion has not yet been decided.

163. *See, e.g.*, ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., No. 650027/2011 (N.Y. Sup. Ct. filed Jan. 6, 2011).

164. *See* The Goldman Sachs Group, Inc., Quarterly Report (Form 10-Q) 96 (Nov. 8, 2011).

contained untrue statements of material facts and material omissions" and furthermore "[c]ertain of these complaints allege fraud and seek punitive damages."[165] From this, it seems clear that traditional securities laws have provided an ample basis for both the government and private litigants to sue Goldman for perceived misdeeds surrounding the conflicted CDOs that gave rise to Section 621.

3. Cases Similar to the Goldman CDOs Result in Prosecution Under Existing Securities Laws

On October 19, 2011, the SEC filed a Complaint against Citigroup Global Markets, Inc. ("Citigroup") for securities laws violations involving circumstances similar to the Goldman CDOs described in this Comment.[166] The Complaint alleged that Citigroup had selected a series of mortgage-backed securities from its own books that it believed would perform poorly.[167] From there, it is alleged that Citigroup packaged those assets and others into a CDO and proceeded to sell long interests in that CDO, labeling them strong investments and representing to investors that it had hired an independent advisor to select the CDO's underlying assets.[168] On the same day that it filed the complaint, the SEC asked the District Court to approve a consent judgment to settle the case where Citigroup would disgorge $160 million in profits gleaned from the CDO, pay $30 million in interest owed on those profits, and pay a civil penalty of $95 million.[169] The consent judgment did not require Citigroup to admit or deny any of the allegations in the complaint.[170] The presiding judge, the Honorable Jed S. Rakoff, refused to sign the consent judgment for a number of reasons stemming from the SEC's not requiring Citigroup to admit any of the allegations in the

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165. *Id.*

166. SEC v. Citigroup Global Markets, Inc., No. 11 Civ. 7387 (S.D.N.Y. filed Oct. 19, 2011). The SEC specifically charged violations of Sections 17(a)(2) and (3) of the Securities Act. Complaint ¶ 65, SEC v. Citigroup Global Markets, Inc., No. 11 Civ. 7387 (S.D.N.Y. Oct. 19, 2011).

167. Complaint ¶¶ 1, 2, SEC v. Citigroup Global Markets, Inc., No. 11 Civ. 7387 (S.D.N.Y. Oct. 19, 2011).

168. *Id.* ¶¶ 1, 2, 58.

169. Citigroup Order, *supra* note 160, at 3.

170. *Id.*

complaint.[171] Despite the fact that there is not yet a conclusion in this case, the point to be made is that the SEC can use the existing securities laws to bring enforcement actions against defendants for perceived misdeeds associated with similar conflicts of interest as those described in this Comment. Again, the actual misdeed comes from lack of disclosure and misstatements about the conflict of interest rather than anything inherently wrong with the conflict of interest.

C. A FEDERAL COURT'S DECISION CONCERNING DISCLOSURE OF CONFLICTS OF INTEREST CAN BE APPLIED TO THE GOLDMAN CDOS

In 2006, the SEC convinced a Central District of California court that a defendant made material misstatements in violation of Section 10(b) of the Exchange Act, Rule 10b-5, and Section 17(a) of the Securities Act for stating that his company's employees "may" have an interest in the securities that the defendant's company recommended via its website when the defendant "knew" his employees actually "had a biased interest" in those securities.[172] The decision allows for liability under the securities laws for making an assertion that one may potentially have a conflict of interest with the buyer that person actually knows that such a conflict of interest already exists or intends for it to exist in the future.[173] The *Czuczko* decision relies on *SEC v. Blavin*, a Sixth Circuit decision where liability was found when the issuer of an investment newsletter stated its employees "may" trade in stocks the newsletter recommended, thusgiving the impression that the newsletter's management was unsure of this practice, when in fact the newsletter was owned as a sole proprietorship and the owner indeed held interests in the recommended stocks.[174]

Applying the case to the Goldman CDOs, *Anatomy of a Financial Crisis* cites *Czuczko* quite broadly: "A federal court has held that disclosing a potential adverse interest, when a known adverse interest already exists, can constitute a material misstatement to investors."[175] This differs from the analysis at Part IV.B *supra* because the *Czuczko* Court goes a step further in holding that disclosure of a potential conflict

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171. *Id.* at 15.
172. SEC v. Czuczko, No. CV 06-4792, slip op. at 8, (C.D. Cal. Dec. 7, 2007).
173. *Id.*
174. 760 F.2d 706 (6th Cir. 1985).
175. ANATOMY OF A FINANCIAL COLLAPSE, *supra* note 5, at 617.

of interest is not proper when an actual conflict of interest exists.[176] The analysis at Part IV.B *supra* only dealt with general lack of disclosure of a conflict of interest.[177] It is important to note that many boilerplate disclosures include language of unspecific potential conflicts of interest. An example of such a disclosure is found in the promotional materials for Hudson, which only disclosed Goldman's potential to have a conflict of interest with the long investors when Goldman, in fact, already had an actual conflict of interest.[178]

There are limits to *Czuczko*'s utility in finding liability in the cases of the Goldman CDOs or transactions that involve similar facts. It is unclear whether further application will be made to the Goldman CDOs because litigation involving these products is only at the early stages. More importantly, the *Czuczko* decision has not been relied upon by any federal courts to date.[179] Thus, if this decision is to have any further application to the Goldman CDOs or similar cases, it is currently at the nascent stage.

D. Existing Law Concerning Information Barriers Can Be Applied to the Material Conflicts of Interest That Section 621 Seeks to Prevent

Existing securities laws and case law seek to prevent conflicts of interest in some circumstances by requiring institutions to adopt information barriers.[180] These barriers are systematic, self-enforced policies and structures, commonly called "Chinese walls" or "ethical walls," designed to stop the flow of information between the institutions' various units in order to prevent conflicts of interest.[181] One

176. SEC v. Czuczko, No. CV 06-4792, slip op. at 8 (C.D. Cal. Dec. 7, 2007).

177. *See supra* Part IV.B.

178. *See* Anatomy of a Financial Collapse, *supra* note 5. at 617-18, 624; (citing Goldman Sachs, Hudson Mezzanine 2006-1 LTD. Offering Circular at 56 (Dec. 3, 2006)).

179. The decision remains unpublished in the Federal Reporter and Federal Appendix and unavailable on the two major electronic databases, Lexis and Westlaw. Furthermore, searches for citations to *Czuczko* in either law review articles or case citations on both Lexis and Westlaw yielded no results.

180. *See, e.g.*, 15 U.S.C. § 76o(g) (2006); 17 C.F.R. § 240.10b5-1(c)(2) (2009).

181. The wall is "a self-enforced informational barrier consisting of systematic, as opposed to ad hoc, procedural and structural arrangements . . . designed to stem the flow of knowledge . . . between different divisions within a multi-capacity financial

use of such barriers is to prevent firms from utilizing material non-public information they glean from one business unit as a way to trade on insider information via another business unit.[182] In fact, Section 15(f) of the Exchange Act requires Broker-Dealers to institute policies and procedures to prevent the spread of material non-public information among the various units of their firms.[183] At the same time, Rule 10b-5[184] promulgates a defense to insider trading allegations when a defendant can show that an effective information barrier exists and the person making the trade was not aware that others at the firm were in possession of the material non-public information.[185] These existing tools would do much to protect buyers from the same transactions that Section 621 seeks to prevent.

If effective information barriers were in place, "designed to fail" transactions would have limited purpose in aiding the firms that structure them. When a firm's trading unit is unaware that the same firm's financial products structuring unit has designed a specific transaction to fail, the trading unit cannot go short on the transaction with any certainty of a return. Although this is a simplification, it holds up against the Goldman CDOs if they are to serve as an example. In Abacus, Tourre contacted all the major players in the deal, helped structure the transaction, and then sold the product to investors.[186]

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intermediary with conflicting interests and obligations." Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, Symposium, 4 J.L. ECON. & POL'Y 311, 313 n.2 (2008) (quoting HARRY MCVEA, FINANCIAL CONGLOMERATES AND THE CHINESE WALL: REGULATING CONFLICTS OF INTEREST 123 (1993)); *see also* Peat, Marwick, Mitchell & Co. v. Superior Court, 245 Cal. Rptr. 873, 887-88 (Cal. Dist. Ct. App. 1988) (Low, P.J., concurring) (lamenting the ethnic overtones and metaphorical inaccuracies of the term "Chinese wall" and calling for courts to abandon its use).

182. *See* Norman S. Poser, *Chinese Walls or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91, 103 (1988) ("[T]he Chinese Wall was created as a preventive measure to control the specific problem of misuse of inside information by multi-service securities firms.").

183. 15 U.S.C. § 76o(g). *See* Barry W. Rashkover & Laurin Blumenthal Kleiman, *SEC Enforcement and Examinations Concerning Hedge Funds*, 52 N.Y.L SCH. L. REV. 599, 607 (2007).

184. 17 C.F.R. § 240.10b5-1.

185. *Id.* § 240.10b5-1(c)(2). *See* Rashkover & Kleiman, *supra* note 183, at 608.

186. *See supra* Part III.A.

Likewise, the Goldman units that structured Hudson, Anderson, and Timberwolf all did so with some intent that Goldman was to short those products.[187] Furthermore, Goldman structuring units, according to Congress, aggressively pushed Goldman's selling units to peddle the products while knowing Goldman had a short position.[188] Without knowing such products were structured to fail, Goldman could not be as certain of getting return.

V. RECOMMENDATION

Thus far, this Comment has described the events prompting the creation of Section 621 and explained why those events implicate and are sufficiently regulated by traditional securities laws. In Part VI.A, this Comment argues that outright ban on securities affected by material conflicts of interest is not an appropriate solution. This Part also introduces the notion of a disclosure requirement for material conflicts of interest in the sale and distribution of securities affected by them. This requirement would aid in creating information parity in such transactions while alerting buyers to conflicts of interest. IPart IV.B, I highlights ways that such a requirement could be promulgated in light of the current Section 621 and the rule proposed by the SEC implementing Section 621. From there, this Partproposes the best method, adding a disclosure exemption to the SEC's rule implementing Section 621, for achieving this result and dismissing the other solutions examined. Finally, Part VI.B.iv.a, provides a recommended draft of this SEC Rule with an explanation.

A. DISCLOSURE OF MATERIAL CONFLICTS OF INTEREST AND UNDERLYING INFORMATION IS PREFERABLE TO AN OUTRIGHT BAN ON SECURITIES AFFECTED BY SUCH CONFLICTS

The market for securities is based on legitimate differences between participants. Material conflicts of interest do not change this fact. Furthermore, as described above, Section 621's categorical ban clashes with the securities laws because it eliminates the transactions it governs rather than facilitating them via disclosure requirements.

187. *See supra* Part III.B.
188. *See id.*

Disclosure requirements here would better allow buyers to understand their purchases and help the market make its own decision about the value and appropriateness of transactions affected by material conflicts of interest.

1. *Markets Are Driven By Competing Views and Material Conflicts of Interest Do Not Change This Principle*

The capital markets exist largely so that a variety of positions can be taken by market participants based on their various tolerances for uncertainty.[189] In other words, the markets allow participants with differing views of the value and the potential value of securities to increase or decrease their exposure to such price fluctuations without regard for whether a participant has a negative or positive view of such value.[190] Participants that have legitimate disagreements over the values of securities, for any number of reasons, can come together and enter into contracts that allow them manage their exposure to such securities.[191] Indeed, parties can and will have differing views about the quality and prospects of many investments.[192] Even in light of a material conflict of interest between the structurer and seller of such investments, incentives to make trades will still exist.[193] Accordingly, an outright ban on such transactions is not preferable when disclosure and curing of information asymmetries can be regulated.

2. *Adequate Disclosure*

Parties can have competing views about the prospects and value of an investment, but more is needed to facilitate their investment

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189. *See* Robert J. Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514, 532-33 (2009) ("The capital and insurance markets . . . exist precisely because people have different views not only of the expected value of future income but also of the risk associated with that income.") (citing FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 268-71 (Dover 2006) (1921)).

190. *Id.*

191. *Id.*

192. *Id.*

193. *See* D. Bruce Johnsen, *The SEC's 2006 Soft Dollar Guidance: Law and Economics,* 30 CARDOZO L. REV. 1545, 1550 (2009).

relationship.[194] Building on the principles of the securities laws, adequate disclosure is the best method to facilitate investment.[195] If sellers and structurers provided the underlying information[196] they used in their development of the securities being sold, then the goal of information parity would be furthered.[197] If counterparties have access to the same information as the party that designed a security to fail, all that remains is a true difference of opinion or other motivations to make the trade. Because the parties are privy to the same information when proper disclosure is made, the securities law would deem that both parties have adequate information for assessing the value of the underlying security regardless of any material conflict of interest.[198]

There are two primary ways to promulgate a disclosure requirement in the context of material conflicts of interest. One way to structure this requirement would be to create a fiduciary relationship triggered by a material conflict of interest created by the structurer or seller of a security.[199] In essence, the structurer or seller who bets against its own securities would have a fiduciary duty to the buyer mandating disclosure of the information it has about those securities along with its status of any potential material conflict of interest.[200] Another solution would be keep Section 621's ban on material conflicts of interest but add a

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194. *See* The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, SEC, http://www.sec.gov/about/whatwedo.shtml (explaining that the Securities Laws facilitate investment) (last visited Mar. 12, 2012).

195. *See supra* Part V.A.

196. The term "underlying information," as used here m refers to the raw information the seller or structurer has exclusive or semi-exclusive access to. This does not include publically available information or information that derives from a party's analysis of any raw data.

197. *See* Rhee, *supra* note 189, at 548-49.

198. *See supra* Part V.A; *cf.* Ryan Skylar, Note, *Hedges or Thickets: Protecting Investments from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3316 (2009) ("The disclosure of [conflicts of interests involving hedge fund managers and their funds] could facilitate investment decisions that direct funds into more suitable investment vehicles . . . .").

199. Rule 10b-5's prohibition on insider trading is premised on eliminating information asymmetry by creating a fiduciary relationship between various classes of people having inside information and the security issuer's shareholders. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 660 (1983).

200. *Id.*

disclosure exemption to the rule. In that instance, transactions involving securities affected by material conflicts of interest would still be banned unless adequate disclosures were made to the buyer. Part VI.B, highlights the most effective way to promulgate such a disclosure exemption.

3. Investors Can and Should Price Risk Associated with Material Conflicts of Interest into Their Agreements if Adequate Disclosure Is Made

Once the conflict of interest and relevant underlying information are disclosed, buyers can price the risk associated with them.[201] Buyers here have several options depending on their ability to understand and value the assets underlying the securities affected by the material conflict of interest. This Section examines three instances where buyers can attempt to place values on securities affected by material conflicts of interest. In all instances, disclosure allows buyers to arrive at appropriate resolutions.

In the first instance, buyers who are confident in their understanding of the conflicted securities can use the supplied information about underlying assets and price accordingly.[202] Buyers do this knowing the conflicted seller or structurer was required to disclose all the relevant information about the structure's underlying assets.[203] As such, information parity is more closely achieved and the conflicted structurer or seller and buyer merely have differing opinions about the prospects of the securities being sold.[204]

In the second instance, buyers who are not confident in their ability to judge the prospects of the securities affected by the conflict of interest based on the disclosed information may still want to purchase the

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201. *See* Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1094 (2007) ("Pricing risk is one of the essential functions of the securities markets, and disclosure of information improves market participants' ability to assess and price risk."); *see also* Merritt B. Fox et al., *Law, Share Price, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331 (2003) (empirical study suggesting that public disclosure laws increase share price accuracy).

202. *See* Fox et al., *supra* note 201, at 380-81.

203. *See infra* Part VI.B (discussing implementation of a disclosure requirement).

204. *See* Rhee, *supra* note 189, at 548-49.

affected securities.[205] Here, they can price the very notion of the conflict of interest into their investment decision.[206] If most buyers find themselves in this situation, the market could face an adverse selection or "lemon" problem, where legitimate products on the market are devalued because buyers cannot parse them from similar but somehow defective or less desirable counterparts due to information asymmetry between buyers and sellers.[207] There, even legitimate, higher quality securities will be undervalued due to the conflicts of interest they entail. To differentiate themselves from sellers and structurers who have designed their transactions to fail, legitimate structurers and sellers could take additional steps toward providing information parity and assurances.[208] While there are anticipated counterarguments that such additional disclosure places a burden on legitimate firms, it is important to remember that for the lemon problem to become pervasive, an inability to evaluate the offered products must be widespread among buyers.[209] Therefore, once the lemon problem starts to affect legitimate sellers and structurers and possibly burden them, it is because there is such a lack of understanding of their offerings in the market that the market is demanding they take further action.[210] More simply put, legitimate sellers or structurers of securities affected by conflicts of interest would not become burdened as a result of the lemon problem until the market actually demanded that they act to differentiate themselves.[211]

In the third instance, buyers unable to make sense of the disclosed information, but alarmed by the existence of a material conflict of interest would simply abstain from purchasing the securities. Knowing

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205. *See* Johnsen, *supra* note 193, at 1550.

206. *See* Dalley, *supra* note 201, at 1094.

207. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 495 (1970).

208. *Cf.* Manuel A. Utset, *Complex Financial Institutions and System Risk*, 45 GA. L. REV. 779, 804-05 (2011) (suggesting that issuers seek to prevent lemon problems and cure information asymmetry by submitting to the SEC's disclosure regimes). *But see* James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC*, 95 VA. L. REV. 941, 955-56 (2009) (suggesting that issuers who stand to have higher share prices by combating the lemon problem by proving their superiority may not respond in a such a manner all the time).

209. *See* Akerlof, *supra* note 207.

210. *See supra* note 208.

211. *Id.*

the parameters of the potential investment and their ability to value it, the buyer decides the risk of being fleeced is too strong.[212] While certain buyers will miss the opportunity to participate in legitimate transactions, others will not experience losses from their investments and later sue to recoup their losses based on claims of non-disclosure, misstatements, and fraud.

B. RECOMMENDED IMPLEMENTATION

This final Part discusses several alternatives and their limitations, and presents this Comment's ultimate recommendation.

1. Dismissing Information Barriers

If implemented effectively, information barriers would address the most salient concerns about material conflicts of interest.[213] That is, information barriers would create a more "equal" scenario because both seller and buyer would be unaware of the seller's short position.[214] But the drawbacks of information barriers make them an unfavorable solution here. The arguments in this Comment highlighting the notion that there is nothing inherently nefarious with material conflicts of interest if proper disclosure accompanies them render it difficult to justify information barriers, which are an extreme implementation.[215] Furthermore, information barriers prevent many of the legitimate purposes that transactions affected by material conflicts can serve, discussed in this Comment.[216] Finally, it would be remiss to fail to mention that there is some debate as to the effectiveness of information barriers when put in place.[217] Thus, a disclosure requirement is a more effective and streamlined way to deal with this problem

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212. *See* Homer Kripke, *Fifty Years of Securities Regulation in Search of a Purpose*, 21 SAN DIEGO L. REV. 257, 261 (1984) (explaining that mandatory disclosure serves the purpose of helping investors decide whether to buy, sell, or hold securities).

213. *See supra* Part V.D.

214. *See Id.*

215. *See supra* Part VI.A.

216. *See supra* Part V.A.

217. *See, e.g.*, H. Nejat Seyhun, Symposium, *Insider Trading and the Effectiveness of Chinese Walls in Securities Firms*, 4 J.L. ECON. & POL'Y 369, 386 (2008) (presenting "evidence that suggests Chinese walls are porous . . . .").

2. Relying on Federal Case Law is Inadequate Without Increased Disclosure Requirements

Although current law considers a conflict of interest to be "material" and requires disclosure in instances where it exists, there are many instances where firms use boilerplate language to warn about the possibility of such a conflict existing later.[218] Similarly, this law is incomplete because it deals mostly with disclosing conflicts as they occur.[219] And while the *Czuczko* opinion, discussed at Part V.C *supra*, makes clear that disclosure of a potential conflict when an actual conflict is already present constitutes an actionable misstatement of material fact, it still fails to address the situation where a conflict legitimately develops after the sale of the security.[220] Furthermore, the decision remains unpublished and has not been cited by any federal courts to date.[221] Thus, relying on this case law and waiting for, or depending on, it to develop is counterintuitive and unlikely to provide any near term solutions. At the same time, it is unlikely to fully address the problem at hand.

3. Establishment of a Fiduciary Duty Is Cumbersome

Establishing a fiduciary duty for any party with a material conflict of interest could also be a method of requiring disclosure of conflicts of interest and reducing information asymmetry. Such an obligation would be modeled on the fiduciary duty that already exists in the insider trading context between holders of material non-public information and the shareholders owning the effected securities.[222] Accomplishing this would require a statutory or regulatory addition that expressly called for a fiduciary duty to attach once a structurer or seller of a security decides to engage in activity that creates a material conflict of interest between it and the long investors. This, however, would be a cumbersome and ill-suited approach, especially in light of the more streamlined recommendation made *infra*.

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218. *See supra* Part V.
219. *Id.*
220. *See supra* Part V.C.
221. *See supra* note 179.
222. *See supra* note 199.

Fiduciary duties that come from the insider trading context are judicial constructs to cope with the fraud element of Rule 10b-5.[223] As such, they are less suited for use in the context of material conflicts of interest. First, fiduciary duties require much work by the courts to figure out when such duties actually attach.[224] Second, breach of fiduciary duties only implicates Rule 10b-5 and not the other disclosure provisions of the securities laws.[225] Third, a mere breach of fiduciary duty is probably not enough to attach liability under Rule 10b-5 because deception, omission or misrepresentation must also occur.[226] As such they leave investors with less causes of action than the alternative of adding a disclosure requirement or exemption to the existing statutes. Furthermore, it seems incongruous to provide investors and the SEC with causes of action as remedies that relate only to fraud when a large part of the issue is simple lack of disclosure by the party having the conflict of interest.[227] Third, a fiduciary duty addition to existing statutes or regulations would likely not reflect the fact that Section 621 only makes its prohibition for one year after the sale of the security in question.[228] Therefore, beyond that timeframe, this addition would actually be more restrictive than Section 621, which limits itself to only one year.[229]

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223. *See* Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore*, 54 AM. J. COMP. L. 123, 127 (2006) ("The 'fraud' requirement in Rule 10b-5 is . . . constituted by fiduciaries dealing with the beneficiaries without full and proper disclosure.").

224. *See* Thomas Lee Hazen, *Are Existing Stock Broker Standards Sufficient? Principles, Rules, and Fiduciary Duties*, 2010 COLUM. BUS. L. REV. 710, 724-25 (2010) ("Standards within fiduciary relationships are flexible, and courts can apply them as they see fit in individual circumstances. As a result, it is difficult to make meaningful generalizations describing fiduciary relationships, considering the diversity of contexts in which they can arise.").

225. *See* Loke, *supra* note 223, at 127 (explaining that 10b-5's fraud requirement, which is unique among securities laws, stems from fiduciary duties).

226. *See* United States v. O'Hagan, 521 U.S. 642, 654-55 (1997).

227. Rule 10b-5 implicates fraud. *See* 17 C.F.R. § 240.10b-5(a) (2009). On the other hand, other securities laws, like Section 11 of the 1933 Act, do not implicate fraud. *See* 15 U.S.C. § 77k(a) (2006).

228. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1631-32 (2010) (to be codified at 15 U.S.C. § 77z-2a).

229. *Id.*

4. Adding a Disclosure Exemption to The SEC's Rule Implementing Section 621 is the Most Effective Resolution

The best possible solution would be to add a disclosure exemption to Section 621's general prohibition that effectively requires structurers and sellers of asset-backed securities to disclose their short positions on such products and give investors access to all relevant underlying information they have regarding the products. In effect, this is a disclosure requirement because Section 621's prohibition on material conflicts of interest is left in place unless the disclosure exemption is met. Disclosure in this form would be the most favorable solution because it informs investors without unnecessarily restricting their purchasing ability. It is consistent with the goals of the securities laws.[230] It keeps structurers or sellers and buyers on equal footing while allowing the market to price the affected securities accordingly.[231] It recognizes and respects that informed parties often have reasonable yet different outlooks on certain investments regardless of who structured the investments as well as divergent needs in terms of the risks they decide to take.[232] The implementation of a disclosure exemption could be achieved in two different ways. First, Section 621 could be amended to include a disclosure exemption. Second, SEC Rule 127B[233], the SEC's rule regulating Section 621, could be implemented with a disclosure exemption.[234]

Amending Section 621 to include a disclosure exemption is unfavorable because it requires more action on Congress's part.[235] To amend Section 621, now that it has been passed into law, would require Congress to pass an additional law.[236] This seems like a step backwards and markedly more difficult than adding such an exemption to the SEC Rule implementing Section 621, as described below. First, the SEC would probably have to put its rule making on hold while Congress

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230. *See supra* Part V.A.
231. *See supra* Part VI.A.ii.
232. *Id.*
233. *See* SEC Proposed Rule 127B, *supra* note 14.
234. *See infra* note 239.
235. *See* 82 C.J.S. *Statutes* § 288 (2011).
236. *See id.* ("An amendment to an existing statute is no less an act of the legislative authority than a new, stand-alone statute.") (citing Jones v. R.R. Donnelley & Sons Co., 541 U.S. 369 (2004)).

revisited Section 621.[237] Second, Congress would have to have to agree on proper language and garner enough votes to pass the amendment.[238]

Adding a disclosure exemption to SEC Rule 127B is within the SEC's authority and presents the most streamlined and effective process for a solution. Under Section 28 of the Securities Act, the SEC has the authority to create this exemption.[239] Indeed, in proposing Rule 127B, the SEC mentioned this authority in its discussion of a possible disclosure exemption.[240] SEC Commissioner Troy A. Paredes noted his concern about the proposed rule's lack of a role for disclosure, noting that a role for disclosure would be consistent with the overall philosophy of the securities laws and preventing the limitation of investor's choices.[241] Having the agency that is in the process of studying disclosure in this context, has ample experience drafting securities-related rules and regulations, and will enforce the rule upon implementation provides an advantage in terms of streamlining the process of adding the disclosure exemption and making sure it is drafted

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237. It seems axiomatic that a regulatory body would not waste its resources drafting regulations for a statute that could be substantially altered. *Cf.* Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385,1426-28 (1992) (explaining that fear of judicial or congressional review may dissuade agency decision makers from expending resources on drafting regulations they feel will be disturbed in the review process).

238. *See* 82 C.J.S. *Statutes* § 288.

239. *See* 15 U.S.C. § 77z-3 (2006) ("The [SEC], by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.").

240. *See* SEC Proposed Rule 127B, *supra* note 14, at 95-96.

241. *See* Troy A. Paredes, Comm'r SEC, Statement at Open Meeting to Propose Rule Amendments to Prohibit Conflicts of Interest in Certain Securitizations (Sept. 19, 2011) ("I am concerned that, as proposed, Rule 127B does not incorporate a role for disclosure. When a transaction or structure is banned, investors may find themselves forced to forego investment opportunities that they might welcome if given the opportunity to make an informed choice. One way to keep from sacrificing investor choice in the context of this rulemaking could be to allow for proper disclosure to redress what might otherwise be treated as a prohibited material conflict of interest. Indeed, the tradition of the federal securities laws is one of disclosure whereby investors are allowed to make investment decisions as they see fit with the benefit of the information provided to them.").

appropriately.[242] Finally, because disclosure is only as effective as its timeliness, as recognized by the SEC,[243] such an exemption should contain guidance on the timeliness of disclosure and a clawback provision for cases when the conflict occurs after the sale of the security to the buyer.[244]

C. PROPOSED DISCLOSURE EXEMPTION IN SEC RULE 127B

The current draft of SEC Rule 127B is printed below.[245] In bold is this Comment's proposed disclosure exemption and a clawback provision accompanying it. The disclosure exemption requires disclosure of both the material conflict of interest and raw data underlying the security in question. It covers situations where the covered party has an actual material conflict of interest and where such a party intends to enter into any transaction where it would develop a material conflict of interest. The clawback provision allows purchasers a right to rescission of the affected security upon the development of a material conflict on the part of any of the covered parties.

§ 230.127B CONFLICTS OF INTEREST RELATING TO CERTAIN SECURITIZATIONS

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

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242. *See generally* Glen Staszeski, *Political Reasons, Deliberative Democracy, and Administrative Law*, 97 IOWA L. REV. 849, 901 (2012).

243. *See* SEC Proposed Rule 127B, *supra* note 14, at 90 n.131 ("[W]e note that disclosure that is made subsequent to an [asset-backed security] transaction would not be appropriate in managing conflicts of interests because an investor would have already made an investment decision regarding whether or not to purchase the [asset-backed security].").

244. *Id.*

245. *Id.*

conflict of interest with respect to any investor in a transaction arising out of such activity.

(b) *Excepted activity.* The following activities shall not be prohibited by paragraph (a) of this section:

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

(2) *Liquidity commitment.* Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security; or

(3) *Bona fide market-making.* Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

(4) *Disclosure of Material Conflicts of Interest and Underlying Information*. Purchases or sales of asset-backed securities where the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity discloses (1) its material conflict of interest or intent to enter into a transaction that would create a material conflict of interest; and (2) all raw information that it possesses about the underlying assets.

(i) *Clawback provision.* Where the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity enters into any transaction that would create a material conflict of interest, that entity must disclose that material conflict of interest and all raw information that it possesses about the underlying assets or offer the buyer rescission of the affected security. Additionally, even if disclosure is made in accordance with this provision, all buying parties in this circumstance are entitled to rescission of the security upon their election.