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SECTION 106 OF THE SECONDARY MORTGAGE MARKET ENHANCEMENT ACT OF 1984 AND THE NEED FOR OVERRIDING STATE LEGISLATION

I. Introduction

On October 3, 1984, the Secondary Mortgage Market Enhancement Act (SMMEA) was signed into law.\(^1\) Title I of this legislation was designed to remove some of the regulatory barriers that previously inhibited the development of a private market for mortgage-backed securities.\(^2\) Section 106 of Title I, which provided for federal regulation, preempted blue sky laws\(^3\) requiring registration of mortgage-backed securities and regulatory statutes affecting investment in mortgage-backed securities by state-chartered financial institutions.\(^4\) Both categories of regulation were perceived by Congress as posing major obstacles to participation by the private sector in the secondary market for home mortgages.\(^5\) Additionally, Congress included provisions in section 106 which reserve a seven year period during which the states may enact legislation overriding either or both of the federal preemptions.\(^6\)
This Note examines whether the states should enact legislation to override the federal preemptions. Initially, this Note provides an overview of the secondary market for home mortgages by examining the factors leading to the enactment of SMMEA. It then examines the scope and rationale behind the section 106 preemptions. While it was believed the situation required preemption of state laws, the existence of the override provisions indicates that Congress felt that the states should be given an opportunity to reevaluate their laws. Finally, this Note juxtaposes the policies and objectives underlying state legal investment and blue sky laws with the section 106 preemptions. Based on that analysis, this Note concludes that the enactment of override legislation is required to protect potential mortgage-backed security investors from fraud and from speculative securities and to preserve the fiscal welfare of state-chartered financial institutions.

II. Overview of the Secondary Market for Residential Mortgages

Traditionally, thrift institutions were the primary source of long term credit for residential mortgages. Serving as financial inter-
mediaries,¹⁵ thrifts thrived on the spread between long-term interest rates earned on mortgages, which they originated and kept in their portfolios, and short-term rates paid to depositors.¹⁶ Recently, however, the demand for new mortgages has outpaced the limited resources of the thrift industry.¹⁷ In addition, the late 1970's saw thrifts undergo a severe crisis due to the deregulation of interest rate ceilings on short-term deposits and unusually high short-term rates.¹⁸ These developments made it unprofitable for thrifts to continue to offer long-term, fixed-rate residential mortgages to home-buyers in the absence of a market where such loans could be liquidated immediately.¹⁹ Moreover, they underscored the importance

in the residential mortgage market can be attributed to their comparative advantage over other mortgage lenders, as well as the legal restrictions to which such institutions are subjected. The advantage held by thrifts over other lenders is that they are essentially local institutions. T. Mayer, J. Duesenberry & R. Aliber, Money, Banking & the Economy 106 (1981) [hereinafter cited as Mayer, Duesenberry & Aliber]. This enables their personnel to keep abreast of changes in the local real estate market and thus provide a more customized service for their clients. With respect to the legal restrictions, legal investment laws have traditionally limited the type of investments thrifts can make to real estate, U.S. government securities and cash. Id.

¹⁵. Financial intermediaries, in addition to clearing payments, obtain the funds of savers in exchange for their own liabilities (such as entries in a passbook), in order to make loans to others. Id. at 106; see also Horvitz & Ward, supra note 13, at 15-18.


¹⁸. See E. Bowden & J. Holbert, Revolution In Banking 57-94 (2d ed. 1984) for a discussion of the effects of deregulation of the banking system. Deregulation of interest rate ceilings brought about the end to a longstanding advantage that thrifts enjoyed over commercial banks in terms of the amount of interest such institutions could offer to depositors. Consequently, the ensuing competition among financial institutions to attract depositors greatly increased the cost of such funds. The thrift industry was particularly disadvantaged by the large percentage of its assets that were tied up in long-term fixed-rate residential mortgages at rates substantially below the cost of new funds. Id.

¹⁹. H.R. Rep. No. 994, 98th Cong., 2d Sess. 7, reprinted in 1984 U.S. Code Cong. & Ad. News 2827, 2828-29; N.Y. Times, Jan. 22, 1984, § 3 (Bus.), at 1, col 1. The significance of the mortgage-backed security (MBS) market is that it enables mortgage lenders to convert debt instruments into fungible and highly marketable investment assets. This reduces the risk of long-term lending and ultimately, the cost of credit to the consumer. Moreover, the lender may prefer to liquidate even the higher yielding loans in his portfolio because the origination fees which he receives under contract may be more attractive than speculative profits from any future interest rate spread. Lance, Balancing Private and Public Initiatives in the Mortgage-Backed Security Market, 18 REAL PROP. PROB. & TR. J. 426, 427 (1983) [hereinafter cited as Lance].
of securing alternative sources of capital to fuel the increasing demand for residential mortgage credit. The result has been the emergence of a strong secondary market for residential mortgages.

By definition, "[the secondary mortgage market for home mortgages is a network of primary mortgage lenders who sell loans they have originated, and investors who buy loans or securities backed by groups of loans.]" The dual goals of the secondary market are to equalize credit availability throughout the country, and, more importantly, to provide a link between the capital and mortgage markets through sales of mortgages in the form of securities that attract nontraditional mortgage investors.

The mortgage-backed security, the financial instrument created by the secondary market to lure capital to the housing market, is an undivided interest in a collateralized pool of mortgage loans. A mortgage-backed security is created when a mortgage lender sells his mortgages to a pool sponsor who assigns them to a

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22. THE MONEY ENCYCLOPEDIA, supra note 7, at 553.

23. Id. The original objective of the secondary market was "to redistribute the available mortgage money by transferring funds from the capital-surplus to capital-deficit areas. . . . The secondary market accomplished this role through its purchases of mortgages in the newer, faster-growing regions of the country [such as the south and southwest] and sales of mortgages in the older, slower regions [such as the northeast]." Id.

24. Id. In the past, financial institutions such as life insurance companies avoided direct investment in residential mortgages. Brick, supra note 14, at 44. There were three major reasons for their lack of participation: (1) the administrative costs of investing in mortgages is high due to the cumbersome nature of the instrument; (2) the administrative costs in relation to the return on the investment are disproportionately high compared to other investments like corporate bonds; and (3) large institutions are not easily accessible to the mortgage market because they are highly centralized. Id. at 44-45.


26. A sponsor serves as a conduit between mortgage lenders and investors. The sponsor assembles pools of mortgage loans that it purchases from lenders and packages them in the form of securities which are sold to investors. The PMBS market has grown to such proportions that a number of conduit firms have been established whose activities consist solely of sponsoring PMBS offerings. Marcis, More Thrift
trustee.\textsuperscript{27} Certificates\textsuperscript{28} are sold to investors who ultimately receive payments generated by the mortgage pool.\textsuperscript{29} The originating lender,\textsuperscript{30} who continues to service the underlying mortgages in the pool, collects monthly payments and prepayments and, after deducting a service fee, forwards the proceeds to the trustee who disburses them to all certificate holders.\textsuperscript{31}

In addition to this "pass-through" security,\textsuperscript{32} the secondary market has initiated the use of the mortgage-backed bond\textsuperscript{33} and the mortgage pay-through bond.\textsuperscript{34} In contrast to the pass-through, which constitutes a sale of the issuer's assets,\textsuperscript{35} the mortgage-backed bond is a general

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\item 27. A trustee's responsibilities include retaining the actual mortgage documents and overseeing the collection and disbursement of monthly principal and interest payments. Wall St. J., Feb. 4, 1985, at 1, col. 1.
\item 29. Id.
\item 30. In a single-lender issue, the mortgages in a pool are purchased from one lender. MADISON & DWYER, supra note 25, § 2.02[7][d]. In a multi-lender issue, the mortgages in the pool are purchased from more than one originating lender. Id.
\item 31. Id. Brick, supra note 14, at 45. The fact that a "pass-through" entitles a certificate holder to his pro-rata share of all principal, interest and prepayments on the underlying mortgages in the pool is particularly troublesome to the investor who is concerned with predictability in terms of when and in what amounts his payments will be received. In response to this pitfall, the market has developed what is known as a "fully modified pass-through" which guarantees a certificate holder a specific rate of return that is predetermined at the time of the original sale. MADISON & DWYER, supra note 25, § 2.02[7][d]. Also available is the "partially modified pass-through" which constitutes a partial guarantee of a specific rate of return. Id.
\item 32. Marcis, supra note 28, at 60 (instrument called "pass-through" because mortgage payments are passed through to certificate holders). See supra notes 25-31 and accompanying text for discussion of the structure and mechanics of the "pass-through" security.
\item 33. A mortgage-backed bond (MBB) is a debt obligation of the mortgage lender that is collateralized by mortgage loans. Brick, supra note 14, at 48. The issuer retains ownership of the loans and must rely upon the market value of the collateral to meet its debt service requirements, rather than on the collateral cash flow. MADISON & DWYER, supra note 25, § 2.02[7][d]; Adams, The Thrifts Seek Capital With Mortgage-Backed Bonds, 6 REAL EST. REV. 38, 39 (1976) [hereinafter cited as Adams].
\item 34. The mortgage pay-through bond (MPB) is a debt obligation of the lender, collateralized by mortgage loans, but its debt service requirements are met with the collateral's cash flow. MADISON & DWYER, supra note 25, § 2.02[7][d]; Brick, supra note 14, at 49.
\item 35. Marcis, supra note 26, at 61 (sale of pass-throughs appears on issuer's balance sheet as reduction in mortgages and increase in cash).
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debt obligation of the issuer collateralized by a pool of mortgages or other mortgage-backed securities. The mortgage-backed bond resembles a corporate bond in that it pays semi-annual interest and carries specific maturity dates. The mortgage pay-through bond is similar to a pass-through bond in that its debt service requirements are met by the cash flow paid through to investors out of the pledged mortgage collateral. Like the mortgage-backed bond, however, the mortgage pay-through bond is a debt obligation of the issuer, not a sale of assets. While the structure of the mortgage-backed bond and the mortgage pay-through bond are distinct from that of the pass-through certificate, their role in the secondary market is identical.

The secondary market for home mortgages is dominated by three government-sponsored agencies: the Government National Mortgage

36. Because the MBB is reflected as indebtedness on the issuer's balance sheet, the financial strength of the issuer and the quality and quantity of the collateral are important from an investor's perspective. Typically, an issuer will be required to maintain a minimum collateral value, for example 150% of the outstanding principal on the bonds. Brick, supra note 14, at 48. Consequently, the issuer must also replace any prepaid or foreclosed mortgage loans to maintain the required collateral value. MADISON & DWYER, supra note 25, § 2.02[7][d].

37. Adams, supra note 33, at 39. The MBB is unlike the corporate bond, however, in that it is secured by a pledge of mortgage assets whereas the corporate bond generally is secured by a pledge of any of a number of different types of corporate property, such as inventory or accounts receivable, as well as real property. GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 163-223 (4th ed. 1962).

38. Brick, supra note 14, at 49.

39. Id. The important distinction between the mortgage pay-through bond and the pass-through is that the issuer need not sell his low yielding mortgages at a capital loss. Rather, such loans can be used to form part of the MPB pool provided that the extra risk is offset with additional collateral or mortgage insurance. Id. at 51.

The popular collateralized mortgage obligation (CMO) is a form of MPB. Id. at 50. A typical CMO offering is divided into three classes. While each class of bonds receives monthly interest payments based on the coupon rate, all monthly principal payments are made to the class one bondholders until the face amount of the bond is satisfied. Id. At such time, the class two bondholders begin to receive mortgage principal payments and prepayments, and so on. Id. The offering may be set up so that the class one bondholders are completely paid off after five years; the class two bondholders, after twelve years; the class three bondholders, after 20 years, CMO's reduce some of the uncertainty surrounding the actual term of security. Id.

40. Kanner, supra note 21, at 348 (all mortgage related securities have proven attractive to nontraditional mortgage investors).

41. Brownstein & Lore, supra note 20, at 14 (agencies created by Congress to develop secondary market for residential mortgages to expand and equalize credit on national basis by means of purchase and sale of whole mortgage loans).
Association (GNMA); the Federal National Mortgage Association (FNMA); and the Federal Home Loan Mortgage Corporation (FHLMC). Combined, these agencies command more than ninety-five percent of the market, with the remainder attributable to a few private issuers. GNMA, the largest participant in the secondary market, is part of the Housing and Urban Development Department (HUD) and contributes to the secondary market through its guarantee of certificates supported by Federal Housing Administration (FHA) insured and Veterans Administration (VA) guaranteed mort-

42. The Government National Mortgage Association (GNMA) was created by Congress in 1968 under Title I of the National Housing Act. 12 U.S.C. § 1717(a)(2)(A) (1968). It is a government corporation whose traditional role has been to support the government's housing objectives by aiding that part of the housing market for which conventional financing is not readily available. THE MONEY ENCYCLOPEDIA, supra note 7, at 555. For a detailed discussion of GNMA's role in the secondary market, see Ganis, All About the GNMA MBS Market, 4 REAL EST. REV. 55 (1974) [hereinafter cited as Ganis].

43. The Federal National Mortgage Association (FNMA) was created by Congress in 1943 as a government corporation and in 1954 it became a mixed ownership entity. National Housing Act, Pub. L. No. 73-479, Title III, 48 Stat. 1246, 1252 (1934). In 1968, under Title III of the National Housing Act, FNMA was partitioned into GNMA and FNMA and the latter was awarded to the private shareholders. 12 U.S.C. § 1717 (1968). FNMA also provides assistance to federal housing programs through secondary market support. THE MONEY ENCYCLOPEDIA, supra note 7, at 553. See generally Murray, Fannie Mae Goes Shopping for Conventional Mortgages, 1 REAL EST. REV. 54 (1971) (discussion of evolution of FNMA's role in secondary market).

44. The Federal Home Loan Mortgage Corporation (FHLMC) was created by Congress in 1970 under Title III of the Emergency Home Finance Act. 12 U.S.C. § 1451 (1970). FHLMC is owned by the Federal Home Loan Banks and its board of directors is comprised of members of the Federal Home Loan Bank Board, serving in a separate capacity. THE MONEY ENCYCLOPEDIA, supra note 7, at 553. In addition to its secondary market activities, FHLMC is authorized to issue long-term and short-term debt obligations and may access lines of credit. Id.

45. H.R. REP. No. 994, 98th Cong., 2d Sess. 14, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2827, 2835. At the end of 1983, outstanding MBS's from the three government agencies totaled $243 billion, the equivalent of 20% of all outstanding residential mortgage debt. Id. The private issuers, on the other hand, accounted for only $10 billion of the currently outstanding MBS's. Id. Moreover, it is estimated that approximately $72 billion in residential mortgages were financed by securities in 1983. Id. at 2835-36. Of these, the government agencies accounted for $70 billion, or 97%, while private issuers made up the remaining $2 billion. Id.

46. See supra note 42.

47. The Federal Housing Administration and the Veterans Administration are federal agencies that provide mortgage insurance. G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 11.2 (1979) [hereinafter cited as OSBORNE, NELSON & WHITMAN]. The Federal Housing Administration was established in 1934 by the National Housing Act (12 U.S.C. § 1701-42 (1934)) and currently is a part
gages.\textsuperscript{48} GNMA's guaranty, which is backed by the full faith and credit of the United States for timely repayment of all principal and interest,\textsuperscript{49} effectively removes all risk of default.\textsuperscript{50}

FHLMC and FNMA are both federally-chartered institutions.\textsuperscript{51} FHLMC is owned by the twelve Federal Home Loan Banks\textsuperscript{52} and purchases only conventional mortgages from thrifts that are members of a Federal Home Loan Bank.\textsuperscript{53} FNMA is privately owned and purchases both conventional and FHA insured and VA guaranteed mortgages.\textsuperscript{44} While both FNMA and FHLMC issue securities bearing their own guarantees, unlike the GNMA certificates, they are not backed by the full faith and credit of the United States.\textsuperscript{55} Nevertheless,
FNMA and FHLMC have benefitted substantially from their association with the federal government in terms of market acceptance, regulatory exemptions, and ability to raise funds for operations.

The private sector's participation in the secondary market, on the other hand, is still in its infancy because private issuers have been unable to compete with the government agencies due to tax, securities, and investment regulations that were promulgated without mortgage-backed securities in mind. Moreover, since private mortgage-backed securities are backed by pools of primarily conventional mortgages and depend largely upon private insurance companies to indemnify investors, they entail a higher level of risk than their federal agency counterparts.

The secondary market for home mortgages already has wrought enormous changes in the way housing is financed. For example, in 1983, $89 billion worth of mortgage-backed securities were issued, accounting for roughly forty-seven percent of all home loans originated during the year. Furthermore, it has been estimated that $1.6 trillion will be needed to finance the demands for housing credit over the next ten years, and more than $4 trillion will be required to reach the end of the century. In light of these astronomical capital requirements, the federal agencies will be forced to expand their current activities if they are to continue their dominant role in the secondary market. Even if the federal agencies assume an enhanced secondary market role, they will not be able to satisfy the credit demands of the future without help from the private
sector.\textsuperscript{67} If the private sector does not begin to play a more active role in the secondary market by attracting new investors and fresh capital, there will be insufficient funds to fuel the burgeoning residential mortgage market.\textsuperscript{68}

III. The Secondary Mortgage Market Enhancement Act

The myriad concerns about the future of the housing industry provided the impetus for the enactment of SMMEA.\textsuperscript{69} The notion behind SMMEA is that private mortgage-backed securities should not be viewed as competing with government mortgage-backed securities. Rather, they should be regulated as an investment vehicle competing with other commonly pooled, privately sponsored investments such as mutual funds.\textsuperscript{70}

SMMEA consists of two separate titles: Title I, "Securities Laws Amendments,"\textsuperscript{71} and Title II, "Secondary Mortgage Market Programs."\textsuperscript{72} Title II's amendments to the FNMA and FHLMC charters grant new powers to each entity and attempt to clarify the role of each in the secondary market.\textsuperscript{73} Title I seeks "to increase the flow

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\item \textsuperscript{67} Older, \textit{supra} note 16, at 5.
\item \textsuperscript{70} Madison & Dwyer, \textit{supra} note 25, § 2.02[7][d]; Lance, \textit{supra} note 19, at 426.
\item \textsuperscript{73} S. Rep. No. 293, 98th Cong., 1st Sess. 3-4, 10-15, \textit{reprinted in} 1984 U.S. Code Cong. & Ad. News 2809, 2811-13, 2818-23. Congress believed that in order to narrow the gap between government agencies and the private sector, a portion of the market should be set aside for the latter. \textit{Id.} To this end, Congress did not expand FNMA's and FHLMC's authority to purchase mortgages above a previously determined maximum value (which is presently $114,000, but is adjusted annually). \textit{Id.} Congress reasoned that the federal agencies were set up to assist middle- and low-income homebuyers and, therefore, that these groups should continue to benefit from the agencies activities. Thus, the amendments effected by Title II are intended to solidify the role of the federal agencies as secondary market champions for governmental housing policies. \textit{Id.}
\item Perhaps the most significant amendment to the FNMA and FHLMC charters is the provision which allows the agencies to purchase second mortgages for both single-family and multi-family properties. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 203, 98 Stat. 1689, 1693. With respect to the second mortgages on one- to four- family residences, the Secondary Mortgage
of funds to housing by facilitating participation by the private sector in the secondary market for mortgages. Thus, Title I contains the more significant provisions in terms of removing some of the regulatory barriers that previously impeded the development of a private mortgage-backed security market.

Title I's provisions have the following effect on existing law: (1) sections 102, 103, and 104 relax the margin requirements previously imposed by the Securities Exchange Act of 1934 to facilitate the forward trading and delivery that occurs with mortgage securities; 

Market Enhancement Act limits their value to one half of the limit on first lien mortgages. Id. at 1694. Limitations are also placed on the value of second mortgages on properties with five or more dwelling units which are purchased by the agencies. Id.

Additionally, Title II contains provisions which: authorize FHLMC to purchase manufactured-home loans on principal residences, regardless of whether they are considered personal or real property under state law (§ 202); authorize FHLMC to purchase loans insured by state agencies (§ 204); remove current loan-to-value ratios imposed by both FHLMC and FNMA for one- to four-family residences (§ 205); prohibit FHLMC from guaranteeing securities backed by mortgages not purchased by FHLMC (§ 210); increase the size of the FNMA board of directors from fifteen to eighteen members, five of whom will be appointed annually by the President of the United States (§ 207); limit to forty-five days, with a fifteen-day extension, the time within which the Secretary of Housing and Urban Development must respond to FNMA requests for approval of corporate activities (§ 209). Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689, 1692-1698.

77. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, §§ 102, 103, 104, 98 Stat. 1689, 1690-91. The need to enhance the marginability of PMBS's was due to the unique nature of the secondary mortgage market. The secondary market typically requires a four- to six- month settlement period whereas corporate securities are generally issued for only a one-week settlement. H.R. REP. No. 994, 98th Cong., 2nd Sess. 12-13, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2827, 2829-31. The reason for this distinction in the case of the MBS is that mortgages in a pool are not originated until a commitment to purchase the securities that are backing them has been made. Since most rules regarding settlement periods, extension of credit and broker-dealer relationships were developed with an eye toward corporate-debt securities, and government MBS's are exempted from such rules, an adjustment was needed to accommodate private MBS issuers. Thus, §§ 102, 103, and 104 allow for the development of forward trading markets for mortgage-related securities by amending §§ 7, 8(a) and 11(d)(1) of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78g, 78h(a), 78k(d)(1)). Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, §§ 102-104, 98 Stat. 1689, 1690-91. The Secondary Mortgage Market Enhancement Act provides that forward trading of mortgage related securities for up to one hundred and eighty days does
(2) section 105 removes restrictions on investment in private mortgage-backed securities by federally-chartered depository institutions, savings and loan associations and credit unions previously subject to regulatory limitations; and (3) section 106 preempts state legal investment laws and blue sky laws which previously limited investment in private mortgage-backed securities by state-chartered financial institutions and required registration under the various state securities statutes. Additionally, section 101 amends the Securities Exchange Act of 1934 to include a definition of the term "mortgage related security." Unless a mortgage-backed security qualifies under the

not constitute an extension of credit for purposes of these sections. H.R. Rep. No. 994, 98th Cong., 2nd Sess. 12-13, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2827, 2833-34. This relaxation of margin requirements is qualified by the fact that the Federal Reserve Board may establish rules which limit or condition the exception granted under the Secondary Mortgage Market Enhancement Act when such rules would be in the best interest of investors or the general public. Id.

78. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 105, 98 Stat. 1689, 1691. Preceding, federal savings and loan associations had no explicit authority to purchase PMBS's and federal credit unions were simply not permitted to invest in PMBS's at all. S. Rep. No. 293, 98th Cong., 1st Sess. 6, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2808, 2814. Because of the need to attract new sources of credit to the housing industry, however, Congress believed that these federally supervised financial institutions should have the authority to invest in PMBS's. See id. Congress reasoned that such authority would pose only limited risks to the financial welfare of federal savings and loan associations and credit unions because it perceived PMBS's as not being inherently risky investments. See id. Moreover, Congress insured that the appropriate authorities would be able to provide regulations affecting the size and denomination of the authorized purchases should they turn out to be necessary. Specifically, § 105(a) of the Secondary Mortgage Market Enhancement Act amends the Home Owners Loan Act of 1933 (12 U.S.C.A. § 1464(c)(1) (West 1980 & Supp. 1984)) to permit federally chartered thrifts to invest in those PMBS's described in § 101 subject to those conditions imposed by the Federal Home Loan Bank Board. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689, 1691. Additionally, § 105(b) amends the Federal Credit Union Act (12 U.S.C.A. § 1757 (West 1980 & Supp. 1984)) in order to grant federal credit unions the same authority to invest in PMBS's, as regulated by the National Credit Union Administration. See S. Rep. No. 293, 98th Cong., 1st Sess. 6, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2808, 2814; H.R. Rep. No. 994, 98th Cong., 2d Sess. 13, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2827, 2834.


80. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, § 101, 98 Stat. 1689, 1689-90. A mortgage related security is a security which is rated in one of the two highest categories by a nationally recognized statistical rating organization. Such securities may include securities that are backed by first lien mortgages on a single parcel of real estate, including stock allocated to residences
section 101 definition, it is not eligible for the liberalized margin requirements under sections 102, 103, and 104 or the preemptions under section 106.\textsuperscript{81}

Section 106, "The Preemption of State Law," is perhaps the most heralded provision of Title I of SMMEA and, arguably, the most important.\textsuperscript{82} While preemption is a drastic measure, Congress did not employ it to prevent the states from providing investor protection with respect to private mortgage-backed securities.\textsuperscript{83} Accordingly, section 106 allows the states seven years in which to enact new requirements which specifically override, limit or differ from the federal preemptions.\textsuperscript{84} In effect, Congress has informed the states that they should reexamine their blue sky and investment laws in light of the new market for private mortgage-backed securities.\textsuperscript{85}

IV. The Section 106(a) Preemption and the Need for Overriding Legislation

Section 106(a) preempts state legal investment laws to allow state-chartered and regulated financial institutions, insurance companies, pension funds, trustees, and other regulated entities to invest in mortgage related securities, exempt mortgage-backed securities or securities issued or guaranteed by FNMA or FHLMC to the same


\textsuperscript{83} H.R. REP. No. 994, 98th Cong., 2d Sess. 13, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2827, 2834 (purpose of preemption is recognition that most blue sky and legal investment laws were enacted before MBS's existed and that such laws artificially restrain market).


extent that state laws would authorize such entities to hold or invest in government obligations. However, investment in mortgage related securities, exempt mortgage-backed securities or securities issued or guaranteed by FNMA or FHLMC are considered to be obligations issued by the United States for purposes of state laws limiting the purchase, holding or investment in such obligations.

The rationale underlying the section 106(a) preemption is that the majority of state laws regulating legal investments were enacted prior to the advent of private mortgage-backed securities. Since many of these investment statutes set forth lists of permissible investments for each entity being regulated, the absence of private mortgage-backed securities from such statutes was thought to limit demand for such instruments artificially without regard for the soundness of the investment. Thus, Congress did not rule out the prospect of investment regulation but merely called the states' attention to the fact that most legal investment statutes were enacted without private mortgage-backed securities in mind.

A. State Legal Investment Regulation

All fifty states have statutes setting forth permissible investments for the financial institutions they charter and regulate. Entities that
are generally governed by state investment laws include insurance companies,\textsuperscript{92} pension funds,\textsuperscript{93} state-chartered savings and loan associations\textsuperscript{94} and mutual savings banks\textsuperscript{95} and other state-chartered financial intermediaries.\textsuperscript{96} The principal objective of legal investment regulation is to preserve the financial welfare of entities that serve
a quasi-public function.\textsuperscript{97} The operation of the insurance industry, for example, entails broad participation by the general public.\textsuperscript{98} Individuals purchase insurance to minimize the fortuitous risks of life and to allow for the safe accumulation of wealth for the future.\textsuperscript{99} Policyholders, however, generally do not regard their premiums as investments like stocks and bonds that are subject to risk of loss.\textsuperscript{100} Nonetheless, the manner in which an insurance company invests its capital assets or reserves, which are primarily built upon the premiums of policyholders, affects its solvency.\textsuperscript{101} The same can be said for deposits at savings banks and contributions to pension funds.\textsuperscript{102}

As a means of insuring the solvency of state-chartered and regulated financial institutions, legal investment laws typically utilize both quantitative and qualitative standards to safeguard investors.\textsuperscript{103} For example, many statutes require diversification of investment,\textsuperscript{104} which can be achieved by limiting the percentage of an entity's assets that can be invested in each type of investment or by limiting the size of any one investment.\textsuperscript{105} Another common requirement addresses the quality of the investment. In this regard, a statute may forbid the purchase of a particular corporate stock unless a dividend has been paid recently or the security has been assigned.
a highly favorable evaluation by a recognized rating organization.106 Both diversification and quality standards serve to reduce the inherent risk factors that investing entails.107

An examination of the section 106 preemption in light of the principles underlying state legal investment laws highlights the need for the states to enact legislation that overrides the federal preemption before the seven year limitation period expires. Although it would be beneficial to observe the effect of the preemption on the market before enacting such legislation, certain factors, including the nature of a private mortgage-backed security,108 the type of private mortgage-backed security investor envisioned by SMMEA,109 and the reliance which SMMEA places on the rating organizations,110 can be regarded as posing a potential threat to the beneficiaries of state legal investment laws.

1. The Nature of the Private Mortgage-Backed Security

By requiring the states to treat private mortgage-backed securities that fall within the ambit of SMMEA as the equivalent of United

106. See, e.g., ARIZ. REV. STAT. ANN. § 20-553 (Supp. 1984) (insurer may only invest in bonds, notes or other evidences of indebtedness secured by first mortgages or deeds of trust or leasehold estates of greater than two years or more on improved property located in United States and no such loan shall be made or acquired except after appraisal by qualified appraiser); N.J. STAT. ANN. § 17B:20-1(d) (West 1985). The New Jersey Statute prohibits an insurance company from purchasing corporate stock of any class unless (1) such corporation has paid cash dividends on such class of stock during each of the past 5 years preceding the time of purchase or (2) such corporation shall have earned during the period of such 5 years an aggregate sum available for dividends upon such stock which would have been sufficient, after all fixed charges and obligations, to pay dividends upon all shares of such class of stock outstanding during such period averaging 4% per annum computed upon the par value (or in the case of stock having no par value, upon the stated capital in respect thereof) of such stock.

107. MAYER, DUESENBERRY & ALIBER, supra note 14, at 26. The notion behind diversification is that if an investor holds assets in his portfolio that are affected in opposite directions by a given future event, the risks in the portfolio will be reduced. Id. In effect, diversification renders the assets in a portfolio less risky in the aggregate than if each component were taken separately. For example, if an investor holds stock from one company that is likely to gain from inflation, and stock from another company that is likely to decline in value in response to the same event, his portfolio is less risky than if he held only one of these two assets. Id. at 26.

108. See infra notes 111-44 and accompanying text.

109. See infra notes 145-56 and accompanying text.

110. See infra notes 157-78 and accompanying text.
States' obligations for the purpose of investment regulation, Congress has overlooked certain characteristics of these instruments which make them potentially risky investments. The foundation of the private mortgage-backed security is the mortgage itself. Groups of mortgages are assembled to form pools from which certificates are issued or, in the case of private mortgage-backed bonds, the pools provide collateral for borrowing. In both cases, mortgages pose many risks which affect the behavior of the mortgage pool and ultimately influence the quality of the security. The most significant of these risks include loss from damage or destruction to the property and loss from default by the mortgagor. In addition, it is possible that a mortgagor will be delinquent in making his monthly payments.

In light of the risks associated with investing in mortgages, regulatory statutes traditionally have recognized the distinction between United States' obligations and mortgages as safe investments. Under the typical investment statute, the entity being regulated has broader authority to invest in United States' obligations because they are backed by the full faith and credit of the federal government. In contrast, greater limitations are imposed on investments in conven-

111. See supra notes 25-40 and accompanying text for discussion of the structure of the MBS, MBB, and MPB.
112. See supra notes 25-31 and accompanying text for a discussion of the creation and structure of the MBS.
113. See supra notes 35-37 and accompanying text for a discussion of the creation and structure of the MBB.
114. See generally Budd & Wasserman, The Yankee Mac Mortgage Pass-Through Program: A Source of Ideas for Insurance Companies, 15 Conn. L. Rev. 385, 400-02 (1983) (discussion of types of loss to be insured against in mortgage pool and kinds of insurance issuer must purchase to insure against such losses) [hereinafter cited as Budd & Wasserman]; Kanner, supra note 21, at 346 (insurance on mortgage securities has four components: (1) primary mortgage insurance; (2) pool insurance; (3) hazard insurance; and (4) coverage on performance by master servicer).
115. See Budd & Wasserman, supra note 114, at 400-402.
116. Id.
117. See, e.g., N.J. Stat. Ann. § 17B:20-1 (West 1985) (unlimited authority to invest in United States' obligations; aggregate mortgage investments may not exceed 50% of insurer's assets and single mortgage investment may not exceed 2% of insurer's assets); N.Y. Ins. Law § 1405(a)(3) (McKinney 1984) (unlimited authority to invest in United States' obligations; investment in any single mortgage limited to the greater of $30,000 or 2% of admitted assets).
tional mortgages. A statute may require that the loans be first lien mortgages or that the loans be limited to a specified percentage of the mortgaged property's appraised value. Private mortgage-backed securities are indeed distinct from the mortgages themselves. In fact, they may be a safer investment due to the protection afforded by insurance and by the diversity of loans in a mortgage pool. However, since private mortgage-backed securities are built upon the mortgage, an instrument that has been viewed traditionally as inherently risky, it would be imprudent to impose on private mortgage-backed securities the same regulatory constraints as those imposed on United States' obligations.

Moreover, while it is possible to mitigate the risk of investing in private mortgage-backed securities through the use of insurance on the mortgage pool as well as on the individual mortgages in the pool, the possibility of insurance fraud and/or insolvency makes private mortgage-backed securities a riskier investment than United States' obligations. In addition, the many entities and levels of

119. See infra notes 120-21 and accompanying text for the types of limitations imposed by statutes regulating investment in mortgages.

120. See, e.g., ARIZ. REV. STAT. ANN. § 20-553 (Supp. 1984-1985) (insurer may only invest in bonds notes or other evidences of indebtedness which are secured by first lien mortgages on improved property and no such loan shall be made or acquired except after appraisal by qualified appraiser); GA. CODE ANN. § 33-11-25 (1982) (insurer may only invest in bonds, notes, or other evidences of indebtedness which are secured by first lien mortgages upon improved or income producing property in U.S. or Canada).

121. See, e.g., GA. CODE ANN. § 33-11-25 (1982) (loan on single family residential dwelling not to exceed 80% of property value; loan on all other properties not to exceed 75% of property value); R.I. GEN. LAWS § 19-9-8 (1956) (loans on residential property not to exceed 80% of appraised property value unless for improved real estate in residential neighborhood, designed for habitation by not more than four families, not more than 50 miles from lending institution, and approved by two officers).

122. See Moody's Corporate Credit Report, supra note 50, at 5.

123. See supra notes 114-116 and accompanying text for discussion of the risks associated with mortgage investment.


125. Id. See also Budd & Wasserman, supra note 114, at 400-02 for a discussion of the types of insurance used in connection with the "Yankee Mac" pass-through program.

The reason why individual mortgage insurance and pool insurance are so critical in the case of pass-through securities is that such securities are not general obligations of the issuer. See Marcis, supra note 26, at 109. Rather, they represent the individual obligations of the mortgagors whose loans make up the pool. Id. Thus, the investor must rely on insurance for protection against loss of interest or principal. Id.

126. For a discussion of the Bank of America incident, which allegedly involved insurance fraud and insolvency, see infra notes 128-41 and accompanying text.
administration involved in marketing private mortgage-back securities present many opportunities for fraud. A recent incident involving the Bank of America (BOA), the nation’s second largest commercial bank, is illustrative. The bank, which acted as the trustee and escrow agent for a private mortgage-backed securities offering, essentially was forced to repurchase almost $100 million of worthless securities from approximately twenty-five thrifts that allegedly were defrauded into purchasing them. Specifically, the owner of the properties underlying the securities obtained an inflated appraisal upon which he and the issuer documented a false loan.

127. For a discussion of the Bank of America incident, which allegedly involved a fraudulent sale of PMBS’s, see infra note 128 and the accompanying text.


129. A bank’s obligation as trustee and escrow agent is to retain the actual mortgage documents and oversee the collection and disbursement of monthly principal and interest payments. Nationwide Pattern Being Found In Huge Losses on Bad Mortgages, N.Y. Times, Feb. 25, 1985, at 1, col. 1. Moreover, as trustee, a bank should safeguard the interests of investors and inform them if problems begin to arise. Id. As an escrow agent, a bank holds assets as a neutral party. Id.

The Bank of America (BOA) was not the only bank involved in the BOA incident. Apparently, Wells Fargo Bank, another major commercial bank located on the West Coast, also acted as trustee and escrow agent, but for a smaller part of the offering. Bond Buyer, Feb. 11, 1985, at 1, col. 1.

130. The thrifts that purchased the securities are located primarily on the East Coast. Wall St. J., Feb. 4, 1985, at 1, col. 1. While approximately 25 thrifts were involved in the BOA incident, it has been reported that dozens of such institutions are attempting to recoup their investments in similar PMBS schemes. N.Y. Times, Feb. 25, 1985, at 1, col. 1.

131. Wall St. J., Feb. 4, 1985, at 1, col. 1. BOA originally reported that only $37 million worth of securities had to be repurchased. Id. Shortly after this original claim, the total was revised upward by $58 million to $95 million. N.Y. Times, Feb. 6, 1985, at D8, col. 1.

132. There is currently a growing concern in the real estate industry about faulty appraisals. See Wall St. J., Feb. 13, 1985, at 33, col. 1. The spotlight has shifted toward appraisers as a result of declining property values. Id. An inflated appraisal, in conjunction with a deflating market, could have serious implications for a mortgage insurer; should the mortgagor default, the insurer would be forced to pay the insured according to the falsely inflated value. Nevertheless, the number of faulty appraisals may be on the rise as a crowded profession seeks to accommodate the sellers and lenders who are their prime customers. Id.

133. Wall St. J., Feb. 4, 1985, at 1, col. 1. The owner of the properties involved in the BOA incident is West Pac Corp., a California based outfit which is controlled by Kent B. Rogers, a convicted felon whose case is currently on appeal. Id. The properties behind the securities are located in Texas and California. West Pac was supposed to use its share of the proceeds from the sale of the securities to refurbish the properties and convert them into co-ops but never did. Id.
The issuer then packaged certificates based on the phony loan which were subsequently sold to the thrifts through an affiliated brokerage firm.\textsuperscript{134} To make the securities more marketable, they were either insured or covered by surety bonds.\textsuperscript{135} The company that guaranteed most of the private mortgage-backed securities sold to the thrifts, however, was virtually insolvent at the time of the sale.\textsuperscript{136} Thus, when the property owner defaulted on his monthly payment—which was inevitable since the loan was based on a false appraisal—and the issuer filed a claim with the insurance company, it could not pay.\textsuperscript{137} Apparently, the bank’s decision to repurchase the worthless private mortgage-backed securities was motivated by its embarrassment at having been involved in the scheme.\textsuperscript{138} In a similar situation,
however, the investors probably would have been forced to absorb the loss.\footnote{139} 

Fraud related to private mortgage-backed securities has not been limited to this particular incident.\footnote{140} Insurance regulators in California, where the BOA incident originated, are currently investigating the activities of a number of insurance companies that have also guaranteed hundreds of millions of dollars in private mortgage-backed securities.\footnote{141} These inquiries have unearthed other potentially precarious situations in which small undercapitalized companies guaranteed large issues of private mortgage-backed securities backed by loans based on inflated property appraisals.\footnote{142} As the private sector expands its participation in the secondary mortgage market, there will be an increasing demand for mortgage insurance to protect bad loans that do not carry government guarantees.\footnote{143} State insurance regulators, whose task it is to monitor the activities of mortgage insurance companies within their jurisdictions, will be unable to prevent every fraudulent scheme from occurring.\footnote{144} Subjecting po-

\footnote{139} In fact, the Wells Fargo bank has refused to reimburse four thrifts in connection with another PMBS incident in which it acted as trustee and BOA acted as escrow agent. Like the BOA incident, this involves a defaulted loan based on an inflated appraisal and an insurance company that has failed to pay the claim. N.Y. Times, Feb. 25, 1985, at 1, col. 1; Bond Buyer, Feb. 11, 1985, at 1, col. 1.

\footnote{140} N.Y. Times, Feb. 25, 1985, at 1, col. 1; Wall St. J., Feb. 4, 1985, at 1, col. 1. It has been reported that dozens of institutions have already purchased bad mortgage investments and are looking to be reimbursed. N.Y. Times, Feb. 25, 1985, at 1, col. 1. Many of these incidents had their genesis on the West Coast and involved some of the same parties connected with the BOA incident. \textit{Id.} The reason why fraud has been so pervasive in connection with PMBS's may be that the process by which mortgages are converted into securities insulates the investor from his purchase and forces him to rely on the judgment of others as to its soundness. In a sense, the investor is issuing a mortgage loan "without meeting the borrowers, inspecting the properties or having appraisals made." \textit{Id.}

\footnote{141} Wall St. J., Feb. 4, 1985, at 1, col. 1. The Glacier General Assurance Company, which has been actively insuring mortgages in California, was recently ordered to cease and desist from selling mortgage insurance in that state. Wall St. J., Feb. 11, 1985, at 46, col. 1. Glacier allegedly guaranteed approximately $21 million worth of loans which are delinquent and based on inflated appraisals. \textit{Id.}; see also Wall St. J., Feb. 4, 1985, at 1, col. 1. Glacier General is currently the subject of a grand jury investigation in Los Angeles for its role in the BOA incident as well as its other activities in the state. Wall St. J., Feb. 4, 1985, at 1, col. 1.


\footnote{143} Wall St. J., Feb. 4, 1985 at 1, col. 1.

\footnote{144} See, e.g., \textit{Id.} (insurance regulators involved in BOA incident were slow in perceiving fraud and insolvency of Pacific American).
potential private mortgage-backed securities investors to more stringent investment regulations than those mandated by the federal preemption would minimize the risk of fraud associated with the purchase of private mortgage-backed securities.

2. The Private Mortgage-Backed Security Investor

Private mortgage-backed securities are marketed primarily to large institutional investors\(^\text{145}\) to whom the policies underlying the investment statutes apply with equal force.\(^\text{146}\) The insurance companies and thrifts that Congress intended to reach with the section 106(a) preemption are "affected with a public interest"\(^\text{147}\) regardless of their sizes. In fact, the larger the entity being regulated, the greater a state's interest in preserving its financial health since the entity's failure would have a disastrous effect on individual policyholders who are likely to be unsophisticated consumers as well as on the overall economy.\(^\text{148}\)

One specific reason for questioning the wisdom of exempting even the more sophisticated institutional investors from regulations governing investment in private mortgage-backed securities concerns the effects of deregulation of the banking system on the thrift industry.\(^\text{149}\) Deregulation has intensified competition among thrifts for high yielding loans to help pay the high interest rates needed to attract depositors.\(^\text{150}\) The result has been a limited supply of assets in a high demand economic environment.\(^\text{151}\) In this respect, private mortgage-backed securities are an ideal investment for a thrift because they offer high yields without the cost and overhead of underwriting mortgages.\(^\text{152}\) Consequently, thrifts are already among the leading purchasers of private mortgage-backed securities\(^\text{153}\) especially in the

\(^{145}\) See Madison & Dwyer, supra note 25, § 2.02[7][d] (major MBS investors, ranked in descending order, are thrifts, private and public pension funds, commercial banks and insurance companies).

\(^{146}\) See Mayer, Duesenberry & Aliber, supra note 14, at 31. Banks and other financial intermediaries create a major part of the money supply. Id. It is thus necessary to prevent such institutions from taking too many risks because a wave of failures could destroy a large portion of the money supply, result in a loss of public confidence, and ultimately lead to a depression. Id.

\(^{147}\) See Center & Heins, supra note 97, at 15.

\(^{148}\) See Mayer, Duesenberry & Aliber, supra note 14, at 31.

\(^{149}\) Wall St. J., Feb. 4, 1985, at 1, col. 1.

\(^{150}\) Id.

\(^{151}\) See supra note 19.

\(^{152}\) Wall St. J., Feb. 4, 1985, at 1, col. 1.

\(^{153}\) See Madison & Dwyer, supra note 25, § 2.02[7][d] (savings and loan associations leading purchasers of mortgage-backed securities as of June, 1983).
Northeast where loan demand is lagging far behind healthy deposit growth. The problem with the thrifts investing in such large quantities of private mortgage-backed securities is that they might succumb to the temptation to purchase securities that, because of a hasty examination, turn out to be worthless. In fact, it has been suggested that the thrifts involved in the BOA incident were enticed by this very trap.

3. The Rating Agencies

Perhaps the most troubling aspect of the section 106(a) preemption is its reliance on the rating agencies as substitutes for the regulatory constraints provided by investment statutes. A security does not qualify for the section 106(a) preemption unless it is a "mortgage related securit[y]," which must be "rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization." According to the rating definitions issued by Standard & Poor's, the leading rating agency evaluating mortgage-backed securities, the two highest rating categories are "AAA" and "AA." In essence, these top rating categories are an opinion by the rating organization that the potential of the security being rated to pay interest and repay principal is extremely strong. In this respect, the "AAA" rating differs from the lower "AA" rating only to a small degree.

Despite their pronouncements as to the safety of a "AAA" or "AA" investment rating, the rating agencies do not provide investor

155. Id.
156. Id.
158. Id. at 1689.
159. Rating agencies are "[o]rganizations which provide the service of evaluating the relative creditworthiness of Issues and assigning Ratings to them, such as Moody's Investors Service, Inc., Standard & Poor's Corporation, and Fitch's Investors Service," J. PENDERGAST & D. FRANKLIN, GLOSSARY OF PUBLIC FINANCE TERMINOLOGY 27 (1984) [hereinafter cited as PENDERGAST & FRANKLIN]. Ratings are "[l]etter and number symbols used by Rating Agencies to express their evaluation of the relative creditworthiness of an Issue." Id.
160. Id. at 38. "Debt rated AAA has the highest rating assigned by Standard & Poor's. Capacity to pay interest and repay principal is extremely strong. Debt rated AA has a very strong capacity to pay interest and repay principal and differs from the higher rated issues only in small degree." Id.
161. Id.
162. Id.
protection that is the equivalent of an investment statute. On a general level, the agencies' primary goal is not investor protection. Rather, the main purpose of securities ratings is to provide a uniform evaluation of a particular product so that an investor can make an informed decision based, in part, on the rating that has evaluated the credit risks. Furthermore, the agencies do not guarantee the accuracy of their ratings and, therefore, they urge investors to conduct their own analyses of any issuer whose securities they consider purchasing. The investor also must bear in mind that the rating agency customarily receives a fee from the issuer of the securities it evaluates. In light of the rating agencies' function, it would be anomalous to assign to them the responsibility of investor protection especially since they are not accountable to the general public.

Specifically, there are a number of concerns about the process employed by the rating agencies which focus attention on the need for legislation overriding the federal preemption. Foremost is the idea that the organizations do not subscribe to any uniform approach to rating private mortgage-backed securities and are free to alter


164. See, e.g., Moody's Corporate Credit Report, supra note 50, at 2.

165. Id.; see also Pendergast & Franklin, supra note 159, at 42 ("[a]s ratings are designed exclusively for the purpose of grading bonds according to their investment qualities, they should not be used alone as a basis for investment operations").

166. See, e.g., Moody's Corporate Credit Report, supra note 50, at 2; see also Pendergast & Franklin, supra note 159, at 40 (Standard & Poor's customarily receives fee from issuer).

167. See supra notes 159-66 and accompanying text for discussion of the function of rating agencies and purpose of ratings.


169. A comparison between the approach used by Standard & Poor's and that used by Moody's illustrates a significant divergence in their methods. Standard & Poor's claims to utilize a "four step" process that is composed of the following steps: (1) assessing the legal infrastructure of the issue; (2) identifying the potential areas of loss exposure; (3) assessing whether the amount of loss protection provided to cover the risks is adequate; and (4) evaluating the creditworthiness of the entities providing the loss protection. D. Tibbals, Rating Approach in Standard & Poor's Criteria for Rating Mortgage Securities 3 (Feb. 13, 1984) (presented at seminars
their methods whenever they deem it necessary.\textsuperscript{170}

Furthermore, under any of the mortgage pool analyses employed by the agencies that rate private mortgage-backed securities,\textsuperscript{171} an investment grade rating always can be attained provided there is an adequate trade-off between certain desirable characteristics of the mortgage pool and the amount of loss coverage on the pool.\textsuperscript{172} Therefore, the process by which the rating agencies determine how much loss coverage is necessary for a particular pool is probably the most crucial aspect of rating private mortgage-backed securities.\textsuperscript{173} In this regard, however, many of the characteristics of mortgages are not quantifiable in terms of their effect on the mortgage pool.\textsuperscript{174} Consequently, the rating agencies generally have utilized a normative approach to deriving their loss assumptions.\textsuperscript{175} That is, they have

\textsuperscript{170} PENDERGAST \& FRANKLIN, supra note 159, at 38.

\textsuperscript{171} Standard \& Poor's Corporation and Moody's Investor Service are currently the only agencies that rate PMBS's. For discussion of their approach to rating PMBS's, see MOODY'S CORPORATE CREDIT REPORT, supra note 50, and Tibbals, supra note 169.

\textsuperscript{172} See generally MOODY'S CORPORATE CREDIT REPORT, supra note 50, at 29-31 (guidelines for cash flow over-collateralization and pool insurance coverage). Both of the aforementioned charts specify the amount of additional overcollateralization or insurance that is necessary to obtain an investment grade rating in the presence of various risk characteristics.

\textsuperscript{173} Tibbals, supra note 169, at 4. In analyzing credit risk, Standard \& Poor's makes two key assumptions: (1) the percentage of loans in the pool that will go into foreclosure, and (2) the average loss that will be realized on these loans. \textit{Id.} "The amount of loss coverage needed is simply the product of these two assumptions." \textit{Id.}

\textsuperscript{174} Assumptions regarding foreclosure frequency and loss severity are made based on specific characteristics of the pool. In the case of a "prime pool," which has the lowest risk characteristics, these assumptions can be made with a fair degree of certainty. \textit{Id.} at 5. For a non-prime pool, however, there is less empirical data available on how certain important characteristics will effect loss assumptions. \textit{Id.} at 6-7. In this respect, Standard \& Poor's points out that the following characteristics have the most influence on their loss assumptions: lien status; types of secured property; loan-to-value ratios; loan rate and payment terms; geographic location of secured properties; purpose of loan; loan size; and number of loans. \textit{Id.}

\textsuperscript{175} Tibbals, supra note 169, at 7.
arrived at their conclusions as to how much loss coverage is necessary on a particular pool based on their perceptions of the risks rather than on the evidence of specific empirical data.\textsuperscript{176} As the market matures and the behavior of mortgage pools becomes more readily ascertainable, the rating agencies undoubtedly will incorporate additional empirical data into their rating processes.\textsuperscript{177} However, many of the variables that affect the behavior of mortgage pools are simply not amenable to empirical analysis.\textsuperscript{178}

V. Section 106(c) and the Need for Overriding Legislation

Section 106(c) preempts blue sky laws in order to exempt, to the same extent as United States obligations, mortgage related securities or exempt mortgage-backed securities from state laws requiring registration or qualification of securities or real estate.\textsuperscript{179} Congress did not intend this provision to affect state anti-fraud statutes or any other state regulations governing the operations of dealers and underwriters of exempt mortgage-backed securities or mortgage related securities.\textsuperscript{180}

The section 106(c) preemption is a result of the Congressional belief that state securities law registration requirements were duplicative of those mandated by the Securities Exchange Commission (SEC) under federal securities law\textsuperscript{181} thus imposing additional and unnecessary costs on the marketing of mortgage-backed securities.\textsuperscript{182} The enactment of the 106(c) preemption also may have been motivated by the desire to match the existing exemptions for securities issued or guaranteed by GNMA, FNMA and FHLMC.\textsuperscript{183}

\begin{itemize}
  \item \textsuperscript{176} Id.
  \item \textsuperscript{177} Id.
  \item \textsuperscript{178} Id.
  \item \textsuperscript{181} Registration of securities under federal law is governed by the Securities Act of 1933. 15 U.S.C. §§ 77a-77aa. The underlying policy of registration under the federal scheme is one of full disclosure; the registrant must reveal to the investing public complete and truthful information about the offering as well as the issuer. \textit{See infra} note 198 and accompanying text.
\end{itemize}
A. Blue Sky Laws

The first blue sky laws were enacted during the early twentieth century before securities regulation existed on a federal level.184 Their immediate popularity reflected the public's fear that trading in merchandise as intricate as securities would give rise to countless opportunities for dishonesty.185 The purpose of blue sky laws is to protect the investing public from fraud and from highly speculative offerings.186 Thus, blue sky laws generally impose regulations on all types of investment schemes.187

To date, virtually every state has some form of blue sky legislation.188 Moreover, in 1956, a Uniform State Securities
Act\textsuperscript{189} was promulgated which has since been adopted substantially by most states.\textsuperscript{190} Although no two state statutes are wholly identical,\textsuperscript{191} all are comprised of at least one of three distinct types of regulatory devices.\textsuperscript{192} These include: (1) anti-fraud provisions;\textsuperscript{193} (2) provisions requiring registration or licensing of certain persons engaging in the securities business;\textsuperscript{194} and (3) provisions requiring the registration and licensing of securities.\textsuperscript{195} Each of these regulatory devices embodies a different philosophical approach to the same end—protecting the investing public.\textsuperscript{196}


189. The Uniform Securities Act was drafted by Professor Louis Loss of Harvard Law School and his associate Edward M. Cowett. Uniform Securities Act (1958). They undertook the drafting of the Act at the prompting of the National Conference of Commissioners on Uniform State Laws. SOWARDS & HIRSCH, supra note 3, § 1.03, at 1-11.

190. The states which have coordinated their securities laws with the Uniform Securities Act include: Alabama, Alaska, Arkansas, Colorado, Delaware, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. SOWARDS & HIRSCH, supra note 3, § 1.03 n.25, at 1-14.

191. LOSS & COWETT, supra note 184, at 18.

192. Id. at 19. The states generally have not treated these provisions as being mutually exclusive. Instead, they have determined that combinations of two or three of these provisions provide the best investor protection. See SOWARDS & HIRSCH, supra note 3, pt. 2, § 7.01, at 7-3, 7-4.

193. Loss & Cowett, supra note 184, at 19. The anti-fraud provisions provide the administrator with an opportunity to issue public warnings, to investigate fraudulent activities, to take injunctive or other measures to stop them and ultimately to punish them. Id.

194. Loss & Cowett, supra note 184, at 19. Registration of brokers, dealers and investment advisors is aimed at preventing fraudulent and unqualified persons from participating in the securities business, at supervising their activities once registration has taken place and at revoking their registration should they fall below the statutory standards. Id.

195. See infra notes 198-202 for a discussion of the policy behind registration of securities under the blue sky laws.

196. Loss & Cowett, supra note 184, at 19.
The section 106(c) preemption purports to affect only those provisions in blue sky laws requiring registration and qualification of securities. Registration of securities offerings under blue sky laws is similar to registration under the federal structure in that full disclosure of all relevant and material facts is required. The state registration process, however, also may impose substantive standards concerning the securities to be issued, the issuer, or other characteristics of the offering. Should the registrant fail to comply with these so-called merit standards, the state administrator has the option to refuse an application for registration. The rationale behind merit regulation is that the "man in the street" does not have the expertise to evaluate a complicated prospectus and to determine whether an investment is a sound one.

The section 106(c) preemption specifically provides that exempt mortgage-backed securities or mortgage-related securities should be treated as the equivalent of United States' obligations for the purpose of registration under state securities laws. This essentially amounts


198. Goodkind, Blue Sky Law: Is There Merit in Merit Requirements?, 1976 Wis. L. Rev. pt. 1, at 79, 80 [hereinafter cited as Goodkind]. Full disclosure requires that the issuer divulge to the investing public complete and truthful information about the securities being offered. See Sowards & Hirsch, supra note 3, § 1.02, at 1-7, 1-8. Upon full disclosure, the issuer is entitled to register the securities, regardless of how speculative they may be. See id. at 1-8. The notion behind full disclosure is that an investor who hopes to achieve a greater return has the right to place his money in a highly speculative offering provided that the nature of the enterprise has been fully revealed. Id. The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa, is a typical example of a disclosure oriented statute. See Sowards & Hirsch, supra note 3, § 1.02, at 1-7, 1-8.

199. See Sowards & Hirsch supra note 3, pt. 2, § 7.01, at 7-2, 7-3.

200. The administrator generally is an agency or official, such as the attorney general, that oversees the daily operation of the blue sky law and renders the policy decisions that must often be made. See Loss & Cowett, supra note 184, at 46.

201. Sowards & Hirsch, supra note 3, pt. 2, § 7.01, at 7-2, 7-3.


to a complete exemption for such securities because the Uniform Securities Act and other relevant statutes include United States' obligations on their lists of exempt securities. The rationale behind this broad exemption may be that private mortgage-backed securities


There are essentially two categories of exemptions: exempt securities and exempt transactions. Sowards & Hirsch supra note 3, pt. 1, § 4.01. The effect of an exemption is not to remove a security or transaction from the purview of the statute; it merely provides relief from the formal registration requirements as to that security or that transaction. Id.

An example of an exempt transaction is § 402(b)(8) of the Uniform Securities Act which exempts

any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity . . . .

Uniform Securities Act § 402(b)(8) (1958). The rationale behind this exemption is that the purchasers enumerated in the provision generally are thought to be so sophisticated and knowledgeable of the securities market that they do not require the protection of the blue sky laws. Sowards & Hirsch, supra note 3, pt. 1, § 5.
are primarily purchased by institutional investors, and since it is generally assumed that such investors are sufficiently sophisticated and have adequate expertise in evaluating securities, they will not require the protection afforded by the blue sky laws.\textsuperscript{205} However, for the same reasons that the preemption of state investment laws affecting investment in private mortgage-backed securities should not remain in effect,\textsuperscript{206} the states should enact blue sky legislation overriding the section 106(c) preemption.\textsuperscript{207} The need for such regulation is particularly urgent to protect the small private mortgage-backed security investor.\textsuperscript{208} In both areas, the ultimate risk rests on the small unsophisticated investor, either directly in the case of a small investor who purchases private mortgage-backed securities or indirectly in the case of an individual who invests his funds with some financial intermediary.\textsuperscript{209}

The enactment of blue sky legislation overriding the federal preemption would expose private mortgage-backed securities issuers to the civil and criminal sanctions that are available under many state provisions.\textsuperscript{210} Moreover, the state administrator would have the


\textsuperscript{206.} See supra notes 111-78 and accompanying text for a discussion of the factors which led to the conclusion that the states should enact overriding legislation replacing the § 106(a) preemption.

\textsuperscript{207.} See infra notes 222-38 and accompanying text for discussion of proposed blue sky legislation to override the § 106(c) preemption.

\textsuperscript{208.} Although they are marketed primarily to institutional investors, PMBS's, as well as government agency MBS's, are presently available in amounts as little as $1,000. Such securities will be purchased by individual investors, those who are most in need of the protection under the blue sky laws. See, e.g., N.Y. Times, Feb. 13, 1985, at D21, col. 1; Dreyfus, Just Passing Through, MONEY, Apr. 1984, at 101.

\textsuperscript{209.} Registration of securities under the blue sky laws is to protect consumers from purchasing worthless securities. See supra notes 197-202 and accompanying text. Investment regulation, on the other hand, is designed to preserve the fiscal welfare of state-chartered financial institutions, primarily for the benefit of consumers who utilize the services of these regulated entities. See supra notes 97-102.

\textsuperscript{210.} Section 410(a) of the Uniform Securities Act provides that a vendor is strictly liable for the offer or sale of unregistered securities. Uniform Securities Act § 410(a) (1958). Only seven states have adopted the specific Uniform Act provisions. ALASKA STAT. §45.55.220(a)(1) (1980); ARK. STAT. ANN. § 67-1256(a)(1) (1980); COLO. REV. STAT. § 11-51-125(1) (Supp. 1984); CONN. GEN. STAT. ANN. § 36-498 (West 1958 & Supp. 1984); OKLA. STAT. ANN. tit. 71, § 408(a) (West Supp. 1984-1985); W. VA. CODE § 32-4-410(a) (1982); WYO STAT. ANN. § 17-4-
opportunity to consider an offering of securities prior to solicitation and to bar from registration those securities that do not meet the


The Uniform Securities Act additionally provides for civil actions by the purchaser against a vendor who acts as broker-dealer, investment advisor or agent without registering (§ 201(a)); representations that registration constitutes approval by the administrator of any person, security or transaction (§ 403(b)); fails to file with the administrator any advertising or sales literature that he may require (§ 403); sells securities without submitting a prospectus to purchasers in accordance with the sales of the administrator (§ 304(d)); fails to comply with escrow conditions that the administrator may order in connection with securities sold to promoters at a price less than the public offering price or sold for consideration other than cash (§ 305(g)); or fails to comply with the form of sales contract for the sale of securities as required by the administrator (§ 305(h)). Uniform Securities Act (1958).

statute’s merit standards. Registration probably would have a deterrent effect on those contemplating fraudulent schemes to market


211. See supra notes 199-202 and accompanying text for a discussion of the role of merit standards in the registration of securities under blue sky laws.

Under the Uniform Act, the state administrator retains broad regulatory powers. Sowards & Hirsch supra note 3, pt. 2, § 10.01, at 10-1, 10-2. In general, the administrator may “make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of [the] act . . . .” Uniform Securities Act § 412 (1958). The only real limitation on the power of the state administrator is that a rule, order or form may not be adopted, amended or rescinded unless he determines that such action is necessary and appropriate for the protection of investors or the public interest and consistent with the purposes fairly intended by the policy and provisions of the Act. Uniform Securities Act § 412(b) (1958).

questionable private mortgage-backed securities as well as controlling the quality of private mortgage-backed securities that are available on the market.

VI. Recommendations

A. Legal Investment Regulation

The states should enact legislation overriding the preemption of their legal investment laws by section 106(a) of the SMMEA. Procedurally, section 106(b) provides a seven year period during which the states may enact such legislation, and it further requires that a statute overriding the section 106(a) preemption must refer specifically to the federal preemption in order to be effective.

In drafting legislation that overrides the federal preemption, the states should impose investment limitations on private mortgage-backed securities similar to those governing investment in residential mortgages, which incorporate both quantitative and qualitative


In other jurisdictions, the administrator relies on his broad grant of authority to make such "orders as are necessary to carry out the provisions of [the] act . . ." Uniform Securities Act § 412(a) (1958).

212. See SOWARDS & HIRSCH supra note 3, pt. 1, § 1.02, at 1-9.


214. See supra notes 120-21 for examples of statutes that regulate investment in mortgages by various state-chartered financial institutions.
standards to protect investors.\textsuperscript{215} A diversified investment portfolio reduces the risk that an institution will fail due to a concentration of its assets in any one holding that turns out to be bad or worthless.\textsuperscript{216} To achieve diversification, an institution should be limited to investing only a specified percentage of its assets in private mortgage-backed securities as well as in any one pool. To prevent investment in highly speculative instruments, there should be a minimum quality standard\textsuperscript{217} which requires mortgages in an underlying pool to be first lien mortgages on residential property and limits the amount of each loan to a certain percentage of the appraised value of the property.\textsuperscript{218} Pool insurance\textsuperscript{219} also should be required or in the case of mortgage-backed bonds a specified level of overcollateralization.

A further consideration in drafting legal investment regulation is the nature of the industry that will be affected. The life insurance industry, for example, has traditionally been subject to more stringent regulatory constraints then most other institutional investors probably because of its quasi-public function.\textsuperscript{220}

The following is a sample statute regulating the investment in private mortgage-backed securities by a state chartered life insurance company:

(a) A life insurance company authorized to transact insurance within this state may invest in, purchase, or hold a mortgage participation, pass-through, conventional pass through, trust certificate,
or other similar security which represents an undivided, beneficial interest in a pool of loans provided:

(i) that such loans are secured by first lien mortgages upon fee simple, unencumbered real property which is improved with a residential building or condominium unit or buildings designed for occupation by not more than four persons;

(ii) that the loans in such pool shall not exceed eighty percent of the appraised value of the real estate mortgaged; and

(iii) that such pool is insured by an insurer authorized to transact mortgage guarantee insurance in this state in accordance with the rules and regulations as may be promulgated by the commissioner after due notice and hearing.

(b) No insurance company shall, pursuant to this subsection, invest more than five percent of its total admitted assets in any mortgage pool, nor shall its total investments, pursuant to this subsection, exceed more than twenty five percent of its admitted assets.

(c) This subsection is specifically intended to replace section 106(a) of the Secondary Mortgage Market Enhancement Act.\textsuperscript{221}

B. Blue Sky Legislation

The states should enact legislation overriding the preemption of their blue sky laws by section 106(c) of SMMEA. To this end, section 106(c) is procedurally akin to section 106(b) in that it also reserves a seven year period during which the states may enact such legislation.\textsuperscript{222} Additionally, any statute purporting to require registration of private mortgage-backed securities under the blue sky laws must “specifically refer” to section 106(c) to be effective.\textsuperscript{223}

The best vehicle to replace the federal preemption is amendment of the Uniform Securities Act which has been adopted by a majority of the states.\textsuperscript{224} The amendment also would provide states with existing statutes an opportunity to examine the new provisions and to revise their existing regulatory scheme.

\textsuperscript{221} This proposed statute is modeled after a Georgia statute governing insurance company investment in pass-through securities (GA. CODE ANN. § 33-11-25.1 (Supp. 1984)) and a New Jersey statute governing insurance company investment in mortgages (N.J. STAT. ANN. § 17B:20-1(c) (West 1984)).


\textsuperscript{223} Id.

\textsuperscript{224} See supra note 190 for a survey of the states that have substantially adopted the Uniform Securities Act.
The proposed amendment should bring the private mortgage-backed securities affected by the federal preemption within the purview of the Uniform Securities Act registration provisions which provide for three different types of registration: notification, coordination and qualification. Notification, the simplest method, is generally reserved for the highest quality issues of corporate securities. Registration by coordination is a method that is frequently used when the securities are also being registered under the Securities Act of 1933. To register by coordination, the registrant must provide the administrator with the information that has been filed with the SEC. The registration is effective when the administrator has been notified that the federal registration is effective. Finally, registration by qualification is used primarily in connection with an original offering of securities. Registration by qualification is effective only pursuant to a formal order by the administrator. To obtain such

225. Sowards & Hirsch, *supra* note 3, pt. 2, § 7.01[1]. Those states that have adopted the Uniform Securities Act utilize one or more or any combination of these types of registration. *Id.*


229. Sowards & Hirsch, *supra* note 3, pt. 2, § 7.01[1], at 7-4 to -8. Registration by notification is limited to those companies which: (a) have been in continuous operation for at least five years; (b) have not defaulted in payment of principal, interest or dividends of any security during the preceeding three years; and (c) have had average earnings of no less than 5% on its common shares. Uniform Securities Act § 302(a)(1) (1958).

A notification statement must contain the following information concerning the issuer or any of its subsidiaries: name, address, form of organization, state in which organized, character of business, description of stock options and certain financial data. Uniform Securities Act § 302(b) (1958).

Registration by notification takes effect immediately on the second full business day after filing or before that if the administrator so decides, provided that no stop order is in effect. Uniform Securities Act § 302(c) (1958).

230. See Sowards & Hirsch, *supra* note 3, pt. 2, § 7.01, at 7-8 to -11. The notion behind registration by coordination is that it avoids duplication since the information required by federal and state agencies for the of registration is essentially the same.

231. *Id.*

an order, the registrant must supply the administrator with an application accompanied by the extensive list of information and documents required by the statute.233

In drafting an amendment to the Uniform Securities Act, it is important for Congress to recognize that SMMEA encompasses both private mortgage-backed securities that are subject to registration under the federal securities law and some that are not.234 Therefore, those private mortgage-backed securities that are subject to registration on a federal level because they do not qualify for the section 4(5) exemption to the Securities Exchange Act of 1934 should


233. See Sowards & Hirsch, supra note 3, pt. 2, § 7.01[1], at 7-11 to 7-16. Section 304(b) of the Uniform Securities Act contains seventeen subsections that list the information and documents that must accompany each application. The categories are: (1) the issuer and any subsidiaries; (2) directors and officers; (3) the aggregate remuneration of directors and officers; (4) ten percent stockholders; (5) promoters; (6) sellers other than issuers; (7) capitalization; (8) securities offered, price, and underwriting data; (9) use of proceeds; (10) options; (11) material contracts and litigation; (12) sales literature; (13) specimen of security, articles of incorporation, by-laws and trust indentures; (14) opinion of counsel; (15) statements of consent by experts; (16) financial statements; and (17) other information required by the administrator. Uniform Securities Act § 304(b)(1)-(17) (1958).

234. The § 106 preemptions are available to either mortgage related securities or securities that are exempt from registration pursuant to § 4(5) of the Securities Act of 1933. 15 U.S.C. § 77d(5). The § 4(5) exemption is limited to first mortgages on real estate and participation interests in mortgages backed by whole loans originated by depository institutions that are supervised and examined by Federal and State authorities, and mortgage lenders approved by the Department of Housing and Urban Development (HUD) that sell only to such depository institutions, provided they are sold in minimum amounts of $250,000 and payment is made within 60 days of the date of sale.

be required to register using the coordination method set forth in section 303 of the Uniform Securities Act.\textsuperscript{235} And those private mortgage-backed securities that are exempt under section 4(5) should be registered by qualification pursuant to section 304 of the Uniform Securities Act.\textsuperscript{236} To accomplish this objective, the following amendments should be enacted:

\textsection{303-a.} Any securities which are mortgage related securities (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c (a)(41)) and for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering may be registered by coordination. This provision is specifically intended to replace section 106(c) of the Secondary Mortgage Market Enhancement Act.

\textsection{304-a.} Any securities that are offered and sold pursuant to section 4(5) of the Securities Act of 1933 may be registered by qualification. This provision is specifically intended to replace section 106(c) of the Secondary Mortgage Market Enhancement Act.

For those securities that are registered by qualification, a list of documents and information needed by the administrator to evaluate the offering also should be made a part of the amendment. In addition to the items already required under section 304(b) of the Uniform Act, the list should include the following: detailed information about the participants in the transaction, including the mortgage underwriters for the loans in the pool, the servicer, the escrow agent, the issuer, and the insurer; and an explanation of the structure of the offering including a description of the mortgages in the pool.\textsuperscript{237}

\section{VII. Conclusion}

Enhanced participation by the private sector is vital to the continued viability of the secondary market for home mortgages. Private

\textsuperscript{235} Uniform Securities Act \textsection{303} (1958). See \textit{supra} notes 231-32 and accompanying text for a discussion of registration by coordination under the Uniform Securities Act.

\textsuperscript{236} Uniform Securities Act \textsection{304} (1958). See \textit{supra} notes 233-34 and accompanying text for a discussion of registration by qualification under the Uniform Securities Act.

\textsuperscript{237} Section 304(b)(17) provides for “such additional information as the [administrator] requires by rule or order.” Uniform Securities Act \textsection{304(b)(17)} (1958). Thus, each administrator is given the authority to promulgate rules requiring the registrant to submit information not set forth in \textsection{304(b)(1)-(16)}. Uniform Securities Act (1958). Rather than amend the Act to provide for additional information, each state may prefer to issue its own rules governing the type of information that should be submitted by the registrant in connection with a PMBS offering.
mortgage-backed securities are an attractive means of linking non-traditional investors with the "capital hungry" mortgage market. The Secondary Mortgage Market Enhancement Act was designed to eliminate some of the regulatory barriers which impeded the development of a private mortgage-backed securities market. Section 106 of SMMEA preempted state legal investment laws and blue sky laws affecting private mortgage-backed securities. In preempting these state laws, Congress specifically reserved to the states the power to override the section 106 preemptions within seven years from the date of enactment of SMMEA. The override provisions in section 106 reflect Congress' belief that the blue sky laws and legal investment laws serve a valid purpose but that the statutes need to be remodeled in light of the private sector's participation in the secondary market for home mortgages. An examination of the section 106 preemptions in light of the policies and goals underlying the blue sky and state legal investment laws indicates that the states should enact legislation in both fields overriding the federal preemptions. Such legislation is necessary to protect investors from fraud and highly speculative securities and to preserve the financial welfare of state-chartered investment institutions.

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238. Madison & Dwyer, supra note 25, § 2.02[d].