

CRITICISMS OF COLLATERALIZED DEBT OBLIGATIONS IN THE WAKE
OF THE GOLDMAN SACHS SCANDAL

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I. Introduction

Following a string of downturns and scandals in the past several years, CDOs have become a household phrase. In 2008, primary issuances froze as the CDO market collapsed.¹ It was worth over \$2 trillion at its peak.² On April 16, 2010, the SEC launched a \$1 billion lawsuit against Goldman Sachs over allegedly fraudulent disclosure statements in its synthetic CDO originations.³ The suit was high-dollar, high-profile and unprecedented.⁴ Shortly afterward, on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) was signed into law, promising massive financial overhaul.⁵

Discourse exploded in the wake of the Goldman suit. Critics blamed CDOs for inflating the housing bubble and helping to bring about the recession,⁶ credit rating agencies for inflating CDO

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¹ Jody Shenn, *CDO Market Is Almost Frozen, JPMorgan, Merrill Say*, BLOOMBERG, Feb. 5, 2008,

² *Id.*

³ Gregory Corcoran, *SEC v. Goldman: The News Release + the Complaint*, WSJ DEAL JOURNAL BLOG, Apr. 16, 2010, <http://blogs.wsj.com/deals/2010/04/16/goldman-v-sec-the-news-release/>

⁴ David S. Morgan, *Spitzer: SEC Likely to Win Against Goldman*, CBS NEWS, Apr. 20, 2010,.

⁵ Matthew G. Lamoreaux, *Obama Signs Dodd-Frank Reform Bill*, J. OF ACCOUNTANCY, July 21, 2010, <http://www.journalofaccountancy.com/Web/20103125.htm>.

⁶ See, e.g., Joe Nocera, *A Wall Street Invention Let the Crisis Mutate*, N.Y. TIMES, Apr. 16, 2010. <http://www.nytimes.com/2010/04/17/business/17nocera.html>

ratings,⁷ and originators and short sellers, like Goldman Sachs and Paulson, for marketing synthetic CDOs that were expected to fail.⁸ Unfortunately, despite the large volume of discourse, few mainstream commentators discussed CDOs with a high degree of technical clarity. In fact, numerous mainstream newspaper articles simply referred to CDOs as “complex,” offering few technical details about their structure or function.⁹

This article will begin by offering the first detailed definition of CDOs to appear in a law review article.¹⁰ A solid grasp of the various types of CDOs and how they are originated is essential to understand further topics, such as common criticisms against CDOs, the Goldman case and whether the Dodd-Frank Act’s measures are effective. First, I will differentiate between the two basic classes of CDOs: cash and synthetic. For each of these two classes, I will make further distinctions between arbitrage and balance sheet CDOs, as well as cash flow and market value CDOs. In addition, I will provide a basic overview of how CDOs are rated and sold to investors.

Next, I will discuss the most common criticisms of CDOs. In essence, this section will focus on what went wrong. First, critics argue that originators were incentivized to churn low-quality mortgages into CDOs, which helped create the housing bubble.¹¹ In

⁷ See, e.g., Robert Oak, *Credit Ratings Agencies Complicit in Global Financial Casino Gambling Hall Dupe*, ECONOMIC POPULIST, Apr. 23, 2010.

⁸ See, e.g., Mark Trumbull, *Goldman Sachs vs. SEC: “Vampire Squid” or “Doing God’s Work”?*, CHRISTIAN SCIENCE MONITOR, Apr. 21, 2010, <http://www.csmonitor.com/Money/2010/0421/Goldman-Sachs-vs.-SEC-Vampire-squid-or-doing-God-s-work> (observing, with humor, that one critic described Goldman Sachs as “a great vampire squid wrapped around the face of humanity”).

⁹ See, e.g., Aline van Duyn, *More Turmoil Looms in CDO Market*, FINANCIAL TIMES, June 21, 2010.

¹⁰ A previous article of mine summarized current developments in CDO regulation and contained a partial definition of CDOs and their structure, but my discussion was limited. Neal Deckant, Recent Development, *Reforms of Collateralized Debt Obligations: Enforcement, Accounting and Regulatory Proposals*, 29 ANN. REV. BANKING & FIN. L. 79 (2009). In my research, I was surprised at how difficult it was to find a clear, concise, technical overview of the various types of CDOs.

¹¹ See, e.g., Ryan Chittum, *Audit Notes: Yes, There Was a Housing Bubble; Magnetar; Facebook*, COLUM. JOURNALISM REV., Apr. 21, 2010, <http://>

other words, by selling securitized mortgages to investors, originators could remove low-quality mortgages from their balance sheets and earn an origination fee in the process.¹² Second, critics argue that credit rating agencies had a fundamental conflict of interest, which incentivized inflated ratings.¹³ Third, critics argue that some investment firms improperly used synthetic CDOs to create risky, over-leveraged “bets,” instead of using the instruments to hedge legitimate risk.¹⁴ Fourth, critics argue that some originators did not adequately disclose important details, such as whether an independent third-party selected the portfolio.¹⁵ This criticism is especially salient in light of the Goldman Sachs scandal.¹⁶

The SEC’s case against Goldman Sachs will provide an effective case study of each of these criticisms. Not only is the Goldman case high-profile and high-dollar, but the criticisms against CDOs are highly relevant to the fact set. I will discuss the facts of the case, detailing how each criticism appears. In other words, I will provide an explanation of what “went wrong” with Goldman, and I will tie it into the prior discussion of common criticisms of CDOs.

www.cjr.org/the_audit/housing_bubble_magnetar_facebook.php (concluding that CDOs played a significant role in the housing bubble).

¹² C.W. Griffin, *Mortgage Crisis Starts with CDOs*, AHWATUKEE FOOTHILL NEWS, Dec. 15, 2009, http://www.ahwatukee.com/commentary/article_b58cb55a-f885-5e56-ac41-716d05f5280b.html. When many sources discuss “origination fees,” the term is used in a broad sense to not only mean transaction fees but also fees to act as the servicer, fees to set up a trust account, and brokerage fees in selling the SPV interests. Each of these services may offer lucrative business. The originator decides which of these services it will provide, and which it will contract to an outside party. For a discussion of the various benefits that originators and outside contractors may provide for an SPV, such as escrow agents, trustees, custodians, and servicers, see generally Tamar Frankel & Mark Fagan, LAW AND THE FINANCIAL SYSTEM 45-67 (2009).

¹³ See generally Tamar Frankel & Mark Fagan, LAW AND THE FINANCIAL SYSTEM 167-72 (providing a general discussion of the various credit rating agency conflicts of interest).

¹⁴ Nocera, *supra* note 6.

¹⁵ See, e.g. Felix Salmon, *Deutsche Bank and CDO Disclosure*, REUTERS, Apr. 26, 2010, <http://blogs.reuters.com/felix-salmon/2010/04/26/deutsche-bank-and-cdo-disclosure/> (highlighting some possible questions and conflicts that may arise from inadequate disclosure).

¹⁶ As will be discussed later, the Goldman Sachs scandal is centered on allegedly inadequate disclosure statements.

Finally, I will examine various corrective measures, such as SEC rules and key provisions of the Dodd-Frank Act. These measures were introduced around the time of the Goldman Sachs scandal. They were designed to correct specific problems with CDOs and securitization. If implemented properly, they may go a long way towards restoring investor confidence.

II. Definitions and History

In short, a CDO is a basket of assets or income streams that are pooled together, split into subordinated repayment rights (“tranches”), rated by a credit rating agency and sold to investors.¹⁷ The assets may consist of cash assets, such as bonds, loans, preferred securities, mortgages, or even tranches of other CDOs.¹⁸ When a CDO is created from a cash asset, it is called a cash CDO.¹⁹ Alternatively, a CDO may be created from income streams that result from a pool of credit default swaps, a type of derivative.²⁰ When a CDO is created from credit default swaps (“CDSs”) instead of cash assets, it is called a synthetic CDO.²¹ There are other distinctions and classifications, but cash CDOs and synthetic CDOs are the two fundamental classes.

The first cash CDO was issued in the late 1980s, when investment banks like Morgan Stanley wished to securitize pools of assets.²² Regular issuance of cash CDOs began in 1995, and Moody’s

¹⁷ See generally Sivan Mahadevan et al., MORGAN STANLEY STRUCTURED CREDIT INSIGHTS (3d ed. 2007). I rely heavily on this book in the definitional section. In my research, Mahadevan’s book is unparalleled in offering a detailed, technical overview of CDO structuring, issuance, and rating. While this information is available in other sources, Mahadevan’s book is the best consolidated source.

¹⁸ *Id.* at 12. When CDOs are created from tranches of other CDOs, they are colloquially dubbed “CDO-squared.” Nonetheless, if the underlying assets are cash assets, this is still a cash CDO. This structure may be repeated recursively—CDOs can be created from CDO tranches, which are created from CDO tranches. Such a holding is called a “CDOⁿ.”

¹⁹ *Id.*

²⁰ *Id.* at 28-29.

²¹ *Id.*

²² *Id.* at 6.

created a ratings model for CDOs in 1996.²³ Around 2007, near the market's peak, \$500 billion in cash CDOs were originated annually.²⁴

In comparison, synthetic CDOs were created quite later, in 1997.²⁵ At the time, synthetic CDOs were a much smaller portion of the market than cash CDOs, but they were an equally important section.²⁶ For example, one could have profited from the collapse of the housing bubble by taking short positions on synthetic CDOs that contained subprime mortgage credit risk as the underlying obligation.²⁷ This practice is hotly controversial.²⁸ As will be explained later in this article, Paulson & Co. sparked the Goldman Sachs scandal by taking short positions on synthetic CDOs created from a collection of CDSs based on subprime mortgages. Indeed, the downturn in the housing market drove synthetic CDO issuances in the past few years.²⁹ In 2007, near the CDO market's peak, synthetic transactions were valued at over \$1.5 trillion annually.³⁰

A. Cash CDOs

1. Origination and Structuring

To create a cash CDO, an originator begins with a given basket of assets, such as loans, bonds, preferred securities, mortgages, or holdings in other CDOs.³¹ The originator then incorporates a special purpose vehicle ("SPV") and transfers these assets to the SPV.³² The SPV is then divided into subordinated repayment rights, called tranches.³³ Each tranche corresponds to a given subordination in repayment, with a corresponding yield to cover the

²³ *Id.*

²⁴ *Id.* at 1.

²⁵ *Id.* at 6.

²⁶ *Id.* at 13.

²⁷ See, e.g., Marisa Taylor, *Paulson and Co. Made a \$3.7 Billion Profit on Collapse of the Subprime Mortgage Market*, Apr. 18, 2010, <http://rainbowwarrior2005.wordpress.com/2010/04/18/paulson-co-made-a-3-7-billion-profit-on-collapse-of-subprime-mortgage-market/> (explaining that Paulson made \$3.7 billion from "betting against" the housing market).

²⁸ See, e.g., *id.*

²⁹ Mahadevan, *supra* note 17, at 1.

³⁰ *Id.*

³¹ *Id.* at 12.

³² *Id.* at 14.

³³ *Id.* at 3.

risk of default.³⁴ For example, senior tranches are paid first.³⁵ Since they have the lowest risk, they are assigned the lowest yield.³⁶ On the other hand, junior tranches are paid last.³⁷ Accordingly, junior tranches have the highest risk and therefore offer the highest rates of return.³⁸ When choosing a CDO, investors must not only pick a CDO that contains underlying assets that they are comfortable with, but they must also pick the right tranche, taking into account risk of default and expected return.

To mitigate the difficulty in choosing the correct tranche, credit rating agencies rate each tranche before they are sold.³⁹ In theory, this allows investors to quickly assess the risks of each tranche before deciding on the proper expected return. In practice, CDOs are notoriously difficult and costly to rate.⁴⁰ And, as will be discussed, credit rating agencies have a fundamental conflict of interest.⁴¹ They are relied upon for accurate ratings, but there is an incentive to issue inflated ratings to earn repeat business.⁴² Despite these issues, the credit rating is an essential step in CDO origination. After the ratings are assigned, the tranches are sold to investors.

2. Source of the Assets: Balance Sheet and Arbitrage CDOs

A further distinction of cash CDOs may be made between balance sheet and arbitrage CDOs. This distinction examines where the assets came from—either the originator already had the assets on its balance sheets, or it acquired the assets with the intent of creating

³⁴ *I'm Shocked, Shocked to Find that Subprime is in this CDO!*, <http://accruedint.blogspot.com/2007/03/im-shocked-shocked-to-find-that.html> (Mar. 9, 2007) (explaining the process of subordination in CDO tranches).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ Lisbeth Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 VT. L. REV. 592-93 (2009).

⁴⁰ *See generally* Frankel & Fagan, *supra* note 13, at 149-51 (discussing the various difficulties in rating securitizations).

⁴¹ *See generally id.* at 167-72 (providing a broad discussion of the various conflicts of interest credit rating agencies have).

⁴² *See generally* Freeman, *supra* note 39, at 592-93 (explaining why many CDOs received artificially high credit ratings).

a CDO. If the originator creates the CDO using cash assets already on its balance sheets, it is a balance sheet CDO.⁴³ The originator usually sells assets that it already owns to the SPV for cash in a “true sale.”⁴⁴ The originator is repaid from the proceeds of the initial sale of the tranches plus an origination fee. Since the SPV retains the same assets throughout its life, there is typically little management after the initial sale.⁴⁵ As will be discussed later, because the originator removes the assets from its balance sheets and earns an origination fee, balance sheet CDOs incentivize originators to pool together bearish assets, remove them from their balance sheets, get a credit rating agency to put a high rating on it and sell it to investors.⁴⁶ However, there are variations on this system. The originator may choose to retain an equity interest in order to overcollateralize or bolster investor confidence, meaning that the assets may remain on its balance sheets.⁴⁷ Nonetheless, if the CDO’s assets were originally owned by the originator and came from its balance sheets, it is a balance sheet CDO.

⁴³ Tamara Patton, *Going to Market: Understanding Market Value CDOs*, TD SECURITIES, July 2000, <http://www.securitization.net/knowledge/transactions/tcdco.asp> (explaining the difference between balance sheet and market value CDOs).

⁴⁴ Rosaleen Marzi, *Legal Considerations for CDO Transactions*, THE SECURITIZATION CONDUIT, Mar. 22, 2002, <http://www.thefreelibrary.com/legal+considerations+for+CDO+Transactions-a0137012486> (observing that the major credit rating agencies require a legal opinion letter of a “true sale” in many types of securitizations). A true sale is not required when an originator, such as an FDIC-insured bank, is not subject to the Bankruptcy Code. But the credit rating agencies still require assurance that the rights of the investors will not be prejudiced upon the event of a bankruptcy. A legal opinion letter to this effect is usually necessary. Frankel & Fagan, *supra* note 13, at 153.

⁴⁵ Mahadevan, *supra* note 17, at 16.

⁴⁶ Masazumi Hattori & Kazuhiko Ohashi, *Incentives to Issue Low-Quality Securitized Products in the OTD Business Model*, BANK OF JAPAN: INSTITUTE FOR MONETARY AND ECONOMIC STUDIES, Discussion Paper No. 2009-E-26, Nov. 29, <http://www.imes.boj.or.jp/english/publication/edps/2009/09-E-26.pdf> (“In the presence of asymmetric information between the lender and investors regarding the credit quality of potential borrowers, overvaluation from the lender’s perspective can occur for low-quality securitized products, which inefficiently induces the lender not to screen borrowers and hence to issue the securitized products of low credit quality.”).

⁴⁷ Mahadevan, *supra* note 17, at 16, 19.

In an arbitrage CDO, the originator actively seeks to acquire assets with the intention of creating a CDO, whereby it can profit from the spread between the funding costs and the asset's returns.⁴⁸ That is, the originator seeks to acquire assets that it may package and resell as a CDO. The incentive for the originator is realization of origination and management fees in the acquisition of assets, as well as the trading, monitoring and sale of the tranches.⁴⁹

In 1998, fifty-two percent of cash CDOs were arbitrage and forty-eight percent were balance sheet, but by 2006, the percentage of arbitrage CDOs rose to ninety-three percent.⁵⁰ This means that near the market's peak in 2006-08, the vast majority of originators actively sought to acquire assets with the sole intent to resell them as CDOs, instead of using assets it already owned.

3. Source of the Funds: Cash Flow and Market Value CDOs

A final distinction of cash CDOs may be made between cash flow CDOs and market value CDOs. This distinction examines the source of the funds—either the assets contain sufficient income streams or the manager must monitor the market value of the assets. In a cash flow CDO, the assets have a cash flow such that they are expected to satisfy repayment obligations of all the tranches.⁵¹ That is, if the assets have an income stream that satisfies all the tranche repayment obligations, little management is required. The SPV buys and holds most assets, and the manager only needs to divide up the incoming payments.

In market value CDOs, the assets are such that they may not necessarily have sufficient income streams to satisfy the tranches.⁵² Instead, the manager actively values the underlying assets' market value, using mark-to-market accounting.⁵³ The manager must periodically sell off and acquire assets to satisfy cash flow to the tranches.⁵⁴

⁴⁸ Patton, *supra* note 43.

⁴⁹ Mahadevan, *supra* note 17, at 16.

⁵⁰ *Id.* at 17.

⁵¹ Patton, *supra* note 43.

⁵² Mahadevan, *supra* note 17, at 17.

⁵³ *Id.*

⁵⁴ Patton, *supra* note 43.

If all these distinctions seem confusing, note that a CDO is a contractual relationship and these terms are intended to explain the most common variations. At its core, a cash CDO is simply a collection of assets that are pooled, divided into subordination rights, rated and sold to investors. The distinction between balance sheet and arbitrage CDOs explains where the assets come from, and the distinction between cash flow and arbitrage CDOs explains where the funding to the tranches comes from. While these distinctions among types of cash CDOs can be somewhat academic, the difference between cash and synthetic CDOs is more fundamental.

B. Synthetic CDOs

1. Origination and Structuring

Unlike cash CDOs, synthetic CDOs only have one underlying type of obligation: credit default swaps (“CDSs”).⁵⁵ By way of introduction, CDSs are a type of derivative traditionally used to hedge credit risk.⁵⁶ A party taking a short position pays periodic sums to a party taking a long position to protect against credit default on certain assets.⁵⁷ In return, if a credit default does occur on that asset, the party with the long position must cover the cost of the default by paying the party in the short position.⁵⁸ Like paying an insurance premium, the short party makes periodic payments to the long party, but if a trigger occurs in the event of a credit default, the long party must cover the cost.⁵⁹ The short parties make periodic payments in order to protect themselves from a collection of credit risks, while the long parties receive incoming payments for assuming credit risk.⁶⁰

⁵⁵ Frankel & Fagan, *supra* note 13, at 194.

⁵⁶ Credit Default Swap, INVESTOPEDIA, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Nov. 4, 2010).

⁵⁷ A Beginner’s Guide to Credit Default Swaps, <http://richnewman.wordpress.com/2007/12/09/a-beginners-guide-to-credit-default-swaps/> (Dec. 9, 2007, 18:21 EST).

⁵⁸ Mahadevan, *supra* note 17, at 29.

⁵⁹ *How Does a Credit Default Swap Work?*, Accrued Interest, Apr. 22, 2007, <http://accruedint.blogspot.com/2007/04/how-does-credit-default-swap-cds-work.html> (“A CDS is a lot like an insurance policy . . . if there is a default, the buyer is essentially made whole because s/he gets par for the bonds.”).

⁶⁰ Mahadevan, *supra* note 17, at 29.

Similar to cash CDOs, synthetic CDOs are created by transferring a basket of CDSs to an SPV.⁶¹ The only difference is that cash CDOs are comprised of assets, while synthetic CDOs are comprised of CDSs. All the short parties make periodic payments to the SPV, which then disburses the income to the long parties.⁶² If one of the credit events triggers (e.g. a default occurs), then the parties taking long positions must pay a percentage of the default.⁶³ Again, subordination rights are established. Senior parties receive payment first and bear the lowest percentage amount of loss in the event of a default, and junior parties receive payment last and bear the largest percentage amount of loss.⁶⁴

Once subordination rights are structured, a credit rating agency assigns a rating to each tranche, and the long and short positions are marketed to parties.⁶⁵ Like cash CDOs, ratings are difficult and costly to establish.⁶⁶

2. Funded and Unfunded Synthetic CDOs

In the event of a large default, the long parties may not be able to cover the amount of the default. Because of this possibility, some synthetic CDOs are funded. Funded CDOs mean that upon assuming the credit risk, parties taking long positions must contribute cash up front to an escrow fund maintained by the CDO manager.⁶⁷ If a default occurs and the parties in long positions are unable to cover, the fund may be used to ensure payment to the parties holding short positions.⁶⁸ Funding also disincentivizes parties from over-leveraging long positions. In an unfunded CDO, a distressed party could be tempted to over-leverage long positions, since long positions require

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 36.

⁶⁶ All of the difficulties of rating cash CDOs are present in synthetic CDOs, namely a large pool of underlying assets and the uncertain effect of subordination. For a discussion of general difficulties in rating securitizations, see generally Frankel & Fagan, *supra* note 13, at 149-51.

⁶⁷ Mahadevan, *supra* note 17, at 35.

⁶⁸ *Id.*

no upfront cash and receive regular income.⁶⁹ The problem comes when there is a default.

3. Source of the CDSs: Balance Sheet and Arbitrage Synthetic CDOs

Similar to cash CDOs, a distinction may be made between balance sheet and arbitrage synthetic CDOs. In a balance sheet CDO, the originator creates credit default swaps using its own assets and liabilities. The originator often takes a short position in order to offload credit risks onto parties in long positions, while retaining ownership of the assets.⁷⁰ By contrast, in an arbitrage CDO, the originator uses third-party credit risks to create the CDSs.⁷¹ In this way, the distinction between balance sheet and arbitrage CDOs is just a way to differentiate between whether the assets were initially on the originator's balance sheets or whether they came from a third source.⁷²

4. Derivatives: The Underlying Obligation in Synthetic CDOs

To be clear, the underlying obligations in synthetic CDOs (credit default swaps) are derivatives.⁷³ Unlike the cash assets found in cash CDOs, they are not intended to be a growth-enhancing investment.⁷⁴ CDSs involve "parties" and "counterparties" taking long and short positions, instead of "investors" purchasing a portion

⁶⁹ Felix Salmon, *The Silver Lining to Synthetic CDOs*, REUTERS, Apr. 11, 2010, <http://blogs.reuters.com/felix-salmon/2010/04/11/the-silver-lining-to-synthetic-cdos/> ("[S]ynthetic CDOs did make it much easier for banks, in particular, to take on enormous amounts of highly-leveraged exposure to the subprime market, by holding on to unfunded super-senior tranches.")

⁷⁰ Mahadevan, *supra* note 17, at 32.

⁷¹ *Id.* at 33.

⁷² *Id.* at 32-33.

⁷³ Frankel & Fagan, *supra* note 13, at 194.

⁷⁴ For a great introductory discussion on the nature of derivatives and their uses in hedging, *see generally* Kenneth A. Froot, David S. Scharfstein & Jeremy C. Stein, *A Framework for Risk Management*, HARV. BUS. REV., Nov.-Dec. 1994; Robert M. McLaughlin, OVER-THE-COUNTER DERIVATIVE PRODUCTS: A GUIDE TO BUSINESS AND LEGAL RISK MANAGEMENT AND DOCUMENTATION 70 (1998).

of an income stream.⁷⁵ With derivatives, one party's gain is the counterparty's loss, and the net present value of a position is intended to be zero.⁷⁶ In other words, the price of the payments from the short party is, theoretically, priced at the probability of default multiplied by the magnitude of the default. Positions in CDSs and synthetic CDOs may be highly effective in hedging volatility, instead of creating long-term growth.⁷⁷ In practice, certain parties have attempted to use synthetic CDOs to create long-term growth which is a source of criticism of CDOs that I will address in the next section.⁷⁸

III. The Most Common Criticisms Against CDOs

CDOs have been heavily criticized in the past several years. The CDO market, worth over \$2 trillion, collapsed from 2007 to 2008.⁷⁹ Commentators also criticized the role CDOs played in creating the housing bubble, the subprime crisis and helping to bring about the recession.⁸⁰ These issues became even more poignant after the Goldman Sachs scandal surfaced and talks about financial reform began in earnest.⁸¹

A. The Role CDOs Played in the Housing Bubble, Subprime Crisis and Recession Due to Churning Low-Quality Mortgages

One of the greatest sources of criticisms against CDOs stems from the role they played in bringing about the current U.S. financial crisis.⁸² First, critics claim that CDOs artificially inflated housing

⁷⁵ Robert M. McLaughlin, *OVER-THE-COUNTER DERIVATIVE PRODUCTS: A GUIDE TO BUSINESS AND LEGAL RISK MANAGEMENT AND DOCUMENTATION* 68-70 (1998).

⁷⁶ *Id.*

⁷⁷ See generally Froot, *supra* note 74; McLaughlin, *supra* note 75 (arguing that derivatives should be used mainly to hedge volatility, not create growth).

⁷⁸ See Taylor, *supra* note 27.

⁷⁹ Shenn, *supra* note 1.

⁸⁰ Griffin, *supra* note 12.

⁸¹ Please note that the sources presented in this section are not intended to be exhaustive, but illustrative of the most common criticisms.

⁸² Some sources criticize the process of "securitization" instead of CDOs, specifically. The differing terminology is irrelevant. Mortgages (and other assets) are securitized through an SPV and sold as an interest in a CDO.

prices through churning, which helped create a housing bubble.⁸³ Second, critics point to the ways in which CDOs incentivized subprime lending.⁸⁴ Third, critics note that the massive losses and write-downs from CDOs may have played a major role in bringing about the credit crisis and recession.⁸⁵

1. Background on Housing Prices

Median home values surged from the late 1990's to 2006.⁸⁶ The U.S. Census provides data on new home sales from 1963 to the present, which is a rough estimation of the overall health of the housing market.

Year	Median Price	Change
1990	122,900	2.42%
1991	120,000	-2.36%
1992	121,500	1.25%
1993	126,500	4.12%
1994	130,000	2.77%
1995	133,900	3.00%
1996	140,000	4.56%
1997	146,000	4.29%
1998	152,500	4.45%
1999	161,000	5.57%
2000	169,000	4.97%

⁸³ See, e.g., Chittum, *supra* note 11.

⁸⁴ See generally Hattori & Ohashi, *supra* note 46.

⁸⁵ See, e.g., William Galston, *Shocking Revelations on Wall Street (And Obama's Tone-Deaf Response)*, NEW REPUBLIC, Sept. 28, 2010, <http://www.tnr.com/blog/william-galston/77985/wall-street-obama-financial-crisis> (“[T]he CDO collapse . . . sparked the Great Recession.”); Radi Khasawneh, *Hope, Optimism and CDOs*, FINANCIAL NEWS, Oct. 27, 2010, <http://www.efinancialnews.com/story/2010-10-07/cdo-market-optimism> (“CDOs, of course, were the villains of the financial crisis. The vehicles of debt, which was backed by a dizzying array of other debt, exploded in such spectacular fashion in 2007—triggering meltdown at many an institution.”).

⁸⁶ *Median and Average Sales Prices of New Homes Sold in the United States*, CENSUS, <http://www.census.gov/const/uspriceann.pdf> [hereinafter “Census”].

2001	175,200	3.67%
2002	187,600	7.08%
2003	195,000	3.94%
2004	221,000	13.33%
2005	240,900	9.00%
2006	246,500	2.32%
2007	247,900	0.57%
2008	232,100	-6.37%
2009	216,700	-6.64%

The data reveals that new house prices increased roughly four to five percent per year, from 1996 to 2005.⁸⁷ There are some outlier years, but prices began their hike around 1996.⁸⁸ Values then leveled around 2006-07⁸⁹ and fell about six percent in 2008 and 2009.⁹⁰

Recall that regular issuance of mortgage-backed cash CDOs began in 1995 and halted in 2007-08.⁹¹ It is no coincidence that the boom in securitizations through cash CDOs roughly corresponds to the rise and fall of the housing bubble. Indeed, the use of CDOs to securitize mortgages is often cited as a reason why the housing bubble and subprime crisis occurred.⁹²

2. Churning Mortgages and the Housing Bubble

To understand the role CDOs played in creating the housing bubble and subprime crisis, one must first consider how banks loaned money to buyers prior to the popularization of cash CDOs. Traditionally, banks gave buyers a loan that was collateralized by the value of the home and typically required a 20% down payment and rigorous credit check.⁹³ The banks would hold the mortgage on their

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ Mahadevan, *supra* note 17, at 6; Shenn, *supra* note 1.

⁹² *See, e.g.,* Griffin, *supra* note 12. (“The housing bubble could never have occurred without mortgage-backed, collectivized debt obligations (CDOs).”).

⁹³ *Id.*

books, collecting income streams over the course of many years.⁹⁴ The banks would be the only party exposed to the risk of default.⁹⁵ This risk incentivized banks to lend quality mortgages to credit-worthy individuals, so that each mortgage would be an investment that could remain on the bank's balance sheets for decades.

Critics argue that CDOs eliminated the incentive for banks to originate quality mortgages.⁹⁶ Instead of holding mortgages on its balance sheets, a bank could securitize pools of mortgages through CDOs and resell them to investors, acting as a CDO originator instead of an investor in a mortgage.⁹⁷

As long as the originating bank is able to successfully sell interests in mortgage-backed CDOs, this process entails little to no risk because the investors in the CDO realize the loss, not the originating bank.⁹⁸ The bank also earns origination and transaction fees for providing initial lending for the mortgage and creating the CDO.⁹⁹ With securitization through CDOs, banks are incentivized to originate as many mortgages as possible, regardless of their quality.¹⁰⁰

Many critics blame the banks. The consensus of these critics is that “[t]he housing bubble could never have occurred without mortgage-backed, collectivized debt obligations (CDOs). This practice of bundling mortgages into large debt packages and selling them to pension funds and other investors promoted reckless gambling in a formerly safe, sound market.”¹⁰¹ More pointedly, one commentator writes that “mortgage lenders became obsessed with fast bucks from initial fees. Insulated from risk, they abandoned all pretense at sane credit criteria.”¹⁰² Another commentator writes that CDOs “encourage[d] subprime originators in the Inland Empire to

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ See generally Hattori & Ohashi, *supra* note 46.

⁹⁹ See general *id.*

¹⁰⁰ See generally *id.*

¹⁰¹ Griffin, *supra* note 12. Note that a “collectivized debt obligation” is a less common name for a CDO, but it is referring to the same thing as a “collateralized debt obligation.”

¹⁰² Felix Salmon, *The Silver Lining to Synthetic CDOs*, REUTERS, Apr. 11, 2010, <http://blogs.reuters.com/felix-salmon/2010/04/11/the-silver-lining-to-synthetic-cdos/>.

give \$600,000 mortgages to itinerant strawberry pickers, just to keep their channels full.”¹⁰³

As credit became available to more and more buyers, regardless of their creditworthiness, the larger pool of buyers consistently increased housing demand from 1996-2006.¹⁰⁴ As demand increased, price increased. This is one popular explanation of the housing bubble.

3. The Subprime Crisis

With housing prices artificially inflated through CDOs, plus an abundance of low-quality mortgages across the market, the financial industry was a powder keg ready to explode. Mortgage lenders did “not represent the borrowers . . . [i]nstead, they [were] more like independent salespeople . . .” who sought origination fees by repacking pools of dubious mortgages into CDOs and selling them to investors.¹⁰⁵

Subprime mortgages were the spark that ignited the crisis. As might be expected, the first series of mortgages that defaulted were the ones lent to borrowers lacking a quality credit history, the subprime mortgages.¹⁰⁶ In January 2007, during the start of the country’s economic problems, over fourteen percent of subprime mortgages were over sixty days delinquent.¹⁰⁷

After the bubble began to collapse, home values plummeted. Values of new homes were roughly level in 2007 but fell over six percent in both 2008 and 2009.¹⁰⁸ “[M]ortgages were bundled together and sold to investors as collateralized debt obligations (CDOs) When the higher risk underlying mortgages started to default, investors were left with properties that were quickly losing value.”¹⁰⁹ For many homes, the value of the house was worth less

¹⁰³ *Id.*

¹⁰⁴ *Cf.* CENSUS, *supra* note 86.

¹⁰⁵ Alistair Barr, *Subprime Crisis Shines Light on Mortgage Brokers*, MARKETWATCH, Apr. 10, 2007, <http://www.marketwatch.com/story/subprime-crisis-shines-spotlight-on-mortgage-broker-practices>.

¹⁰⁶ *See id.*

¹⁰⁷ *Id.*

¹⁰⁸ CENSUS, *supra* note 87.

¹⁰⁹ *Subprime Meltdown*, Investopedia, <http://www.investopedia.com/terms/s/subprime-meltdown.asp>.

than the outstanding mortgage.¹¹⁰ That is, the mortgage was undercollateralized; if a buyer were to default, the mortgage holder may not be able to recoup the amount of the default by reselling the property.

Even worse, in many cases, buyers were incentivized to purposefully default.¹¹¹ If a homeowner's mortgage was worth more than the actual value of the home, the owner could decide to "cut his losses" and walk away, instead of continuing to pay an above-market price for his home.¹¹² "If their payments are rising and the houses are worth less than they owe, they'll just walk away," said Bill Wheaton, director of MIT's Center for Real Estate.¹¹³ And again, each foreclosure meant realization of losses by the mortgage holder.

4. Recession

As financial firms realized massive losses and write-downs due to the bursting of the housing bubble and the subprime crisis, the U.S. economy slid into a recession. While the exact cause of the recession is still debated, popular sentiment holds that the CDO driven subprime crisis was, at the very least, a significant contributing factor.¹¹⁴ In conclusion, critics blame CDOs for helping to bring about the housing bubble, subprime crisis and recession. It is yet unclear whether this was a one-time catastrophe, or whether securitization will continue to pose serious risks to the financial system.

¹¹⁰ Chris Arnold, *Economists Brace for Worsening Subprime Crisis*, NPR, Aug. 7, 2007, <http://www.npr.org/templates/story/story.php?storyId=12561184>.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ See *Financial Crisis of 2007-2010*, WIKIPEDIA, http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932010 ("The CDO in particular enabled financial institutions to obtain investor funds to finance subprime and other lending, extending or increasing the housing bubble and generating large fees."). I am aware that it is taboo to cite Wikipedia. I use this source merely to show that popular opinion draws a strong link between the housing bubble and the current U.S. financial crisis not to prove a factual point. Even so, this Wikipedia article is well-written and well-researched.

B. Inflated Ratings and Credit Rating Agency Conflicts of Interest

An important step in originating a CDO is for a credit rating agency to assign a rating to each tranche.¹¹⁵ It is extremely difficult for an individual investor to gauge the risk of default on a given tranche, since determining a credit rating is time-consuming, costly and requires a great deal of expertise.¹¹⁶ In theory, a reliable credit rating reduces information costs, since it allows an investor to gauge the risk that a tranche will default.¹¹⁷

But after the onset of financial problems in 2007, credit rating agencies began to downgrade ratings on scores of CDO tranches.¹¹⁸ Downgrades hurt the market value of firms holding CDOs, resulting in further write-downs. “We will see additional forced selling of CDOs when downgrades eventually occur,” said a UBS AG analyst.¹¹⁹

In short, the downgrades indicate that the credit ratings were inflated. Inflated credit ratings have been a major source of criticism against CDOs.¹²⁰ Worse yet, the reason behind the inflated ratings is due to a fundamental conflict of interest that originators have with credit rating agencies.¹²¹

As discussed, securitization caused banks and mortgage lenders to shift from being investors to being CDO originators.¹²²

¹¹⁵ Frankel & Fagan, *supra* note 13, at 148.

¹¹⁶ *See generally id.* at 149-51 (discussing the rating process).

¹¹⁷ *Id.* at 162.

¹¹⁸ *See, e.g.,* Darrell Hassler, *Fitch, S&P Warns Investors About Subprime Mortgage CDOs, Bonds*, BLOOMBERG, June 22, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFmS14SrROTQ>.

¹¹⁹ *Id.*

¹²⁰ For example, in April 2010, the Senate Committee on Homeland Security and Government Affairs held hearings regarding the role that inflated ratings played in bringing about the recession. These hearings included the way that inflated ratings negatively affected the CDO market. Press Release, Senate Committee on Homeland Security and Government Affairs, Senate Subcommittee Holds Third Hearing on Wall Street and the Financial Crisis: The Role of Credit Rating Agencies (Apr. 22, 2010) (http://hsgac.senate.gov/public/index.cfm?FuseAction=Press.MajorityNews&ContentRecord_id=2778a107-5056-8059-7625-aa17151c8b72).

¹²¹ Frankel & Fagan, *supra* note 13, at 171 (discussing the basic conflict of interest in the “issuer-pays” model.).

¹²² Griffin, *supra* note 12.

Instead of holding a mortgage on their books, lenders would pool mortgages together and resell them as a CDO, earning origination fees in the process.¹²³ But banks and lenders knew that their CDOs needed positive ratings to stay in the origination business.¹²⁴ Indeed, credit rating agencies were keenly aware of the importance of a positive credit rating.¹²⁵

Unfortunately, credit rating agencies faced a fundamental conflict of interest.¹²⁶ Simply put, originators paid credit rating agencies high fees to rate their instruments.¹²⁷ Some credit rating agencies earned over fifty percent of their revenues from securities.¹²⁸ All parties involved knew the necessity of high ratings, and credit rating agencies knew that assigning high ratings would mean return business. To this end, credit rating agencies actually advised originators on ways to obtain high ratings.¹²⁹

This conflict of interest is a source of significant criticism. Fortunately, the Dodd-Frank Act and new SEC rules contain measures that bring greater accountability to credit rating agencies and maintain their independence, which I discuss later. It remains to be seen whether these measures will fully correct this conflict of interest.

C. Betting With Synthetic CDOs, Instead of Hedging Legitimate Risk

Another major source of criticism is that financial institutions took risky “bets” in synthetic CDOs, a type of derivative. That is, instead of using derivatives to hedge volatility, these institutions took positions in synthetic CDOs with the intention of

¹²³ *Id.*

¹²⁴ See Frankel & Fagan, *supra* note 13, at 163 (noting that the major credit rating agencies counseled issuers on how to structure their securitizations in order to maximize ratings.).

¹²⁵ *Id.*

¹²⁶ *Id.* at 171.

¹²⁷ Freeman, *supra* note 39, at 601.

¹²⁸ *Id.* at 602.

¹²⁹ *Id.* (rating agencies are now actively engaged with the investment banks in determining the proper structures to maximize ratings...”).

earning long-term growth.¹³⁰ Some firms made money, but many others lost considerable sums when their derivative bets went sour.¹³¹

Simply put, derivatives are not intended to be a growth-enhancing investment.¹³² Unlike investments in assets, derivatives are contracts that involve “parties” and “counterparties,” and one party’s gain corresponds to another party’s loss.¹³³ For example, in synthetic CDOs, the income earned by the long position is intended to be set at the risk of credit default multiplied by the magnitude of the default.¹³⁴ In theory, given a sufficiently large pool of CDSs, the amount the short position pays to the long position exactly equals the sum total of credit defaults that the long position pays to the short position.¹³⁵ “[T]he objective in designing [a swap] is to ensure that at the outset the net present value (“NPV”) of all exchanges of the payments to be made by both sides will equal zero.”¹³⁶

In practice, because valuing positions in synthetic CDOs involves forward-looking projections of credit risk, it is impossible to know the value of a position with certainty. Some managers, such as Paulson of the Goldman Sachs scandal, apparently believed that certain positions were undervalued.¹³⁷ Because he took significant short positions in synthetic CDOs backed by subprime mortgage risk, Paulson apparently believed that the risk of mortgage default was actually higher than the rating agencies anticipated. Paulson turned out to be correct, and he profited.¹³⁸ But given the nature of derivatives, for every party like Paulson that profits, there is a counterparty that loses.¹³⁹

¹³⁰ Nocera, *supra* note 6 (“Once synthetic C.D.O.’s became popular, Wall Street no longer needed to feed the beast with new subprime loans. It could make an infinite number of bets on the bonds that already existed.”).

¹³¹ See, e.g., Taylor, *supra* note 27.

¹³² See McLaughlin, *supra* note 75, at 68.

¹³³ *Id.* at 68, 70.

¹³⁴ *Id.* at 71.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ It is impossible to know that Paulson *actually* believed that the risk of default in subprime mortgages were underestimated, but that appears to be the case since he heavily leveraged his fund in short positions of synthetic CDOs backed by subprime mortgage risk.

¹³⁸ See Taylor, *supra* note 27 (“[P]aulson & Co., made a \$3.7 billion profit by betting against the housing market.”).

¹³⁹ See McLaughlin, *supra* note 75, at 70.

Many managers made “bets,” believing that certain positions were undervalued, and many were wrong. Some critics believe that such bets are an inappropriate use of derivatives. In *A Framework for Risk Management*, Professors Kenneth A. Froot, David Scharfstein and Jeremy Stein advance guidelines for effective derivative use.¹⁴⁰ Because derivatives are intended to be zero-NPV, where one party’s gain is another party’s loss, they recommend that companies put excess cash into growth-enhancing investments.¹⁴¹ In turn, growth-enhancing investments will increase future cash flows and bring profits to shareholders.¹⁴² They argue that companies should stick to this core model, whether or not the companies participate in financial services.¹⁴³ However, for almost every conceivable company, volatility and risk may threaten cash flows and impair the company’s ability to make growth-enhancing investments.¹⁴⁴ Fortunately, when used properly, derivatives can allow a company to hedge cash flow risk, allowing it to continue its investments.¹⁴⁵ “The role of risk management is to ensure that a company has the cash available to make value-enhancing investments.”¹⁴⁶ If derivatives are used to hedge risk, they can help bring regularity and certainty to a company’s cash flow, which may be used for investment and growth.

But risk actually increases if a company uses derivatives with the intent of creating growth. Several major companies lost considerable sums with inappropriate derivative bets.¹⁴⁷ If one takes an unnecessary large position in a derivative, it will, in fact, increase cash flow risk.¹⁴⁸ Derivatives will only decrease cash flow volatility and risk when they hedge by trading the risk of a massive loss for regular “insurance” payments.¹⁴⁹ When a company violates these principles, it puts itself at a risk of loss. Many companies took risky bets, believing it could quickly generate cash, and lost equity. For this reason, in its complaint against Goldman Sachs, the SEC

¹⁴⁰ Froot, *supra* note 74.

¹⁴¹ *Id.* at 91-94.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 94.

¹⁴⁷ *Id.* at 91-92 (including Proctor & Gamble and Metallegscheft).

¹⁴⁸ *Cf.* Froot, *supra* note 74, at 91-94.

¹⁴⁹ *Id.*

concluded that, “[s]ynthetic CDOs . . . contributed to the recent financial crisis by magnifying losses . . .”¹⁵⁰

D. Fair Value Accounting

Yet another source of criticism against CDOs was the harmful effect of fair value (mark-to-market) accounting. Basically, if a fund wants to have GAAP compliant accounting statements, then it must value its CDO holdings at fair value, per Statement of Financial Accounting Standards No. 157.¹⁵¹ In short, this means that the book value of the fund’s holdings is determined using the market price of the CDO.¹⁵²

Unfortunately, difficulties rapidly surface when one attempts to determine market price of a CDO holding.¹⁵³ First, bids may vary considerably.¹⁵⁴ Given the complexity and highly individualized nature of CDOs, parties may not agree on a bid price.¹⁵⁵ Second, if the market is illiquid, it may be difficult to actually obtain a bid, or limited bids may not accurately reflect the value of the CDO.¹⁵⁶ Arriving at a price is difficult in itself, and this difficulty may result in misleading financial statements.

Moreover, fair value accounting may have incentivized firms to sell their holdings at fire sale rates as the market collapsed in 2007. Suppose that a firm has a CDO holding worth \$100. If similar holdings are actively traded for \$100, then the firm must report the holding’s book value at \$100. But when the CDO market was distressed, similar holdings may have been sold at only \$60.¹⁵⁷ Here,

¹⁵⁰ Securities and Exchange Commission v. Goldman Sachs & Co., Complaint, <http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf> [hereinafter “SEC v. Goldman Sachs complaint”], at 1.

¹⁵¹ Mark McQueen, *Accountants Failed Investors With “Fair Value” Accounting*, SEEKING ALPHA, Aug. 7, 2007, <http://seekingalpha.com/article/43688-accountants-failing-investors-with-fair-value-accounting>.

¹⁵² *Fair Value*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fairvalue.asp>.

¹⁵³ McQueen, *supra* note 151.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ Eric B. Poer, “Inactive” Market Presents Challenges for Fair Value Accounting, BANKING DAILY, Feb. 12, 2009 (“Amid the 2008 credit crisis, these financial instruments became highly illiquid because their complex nature made it extremely difficult to determine both the underlying value as

the nature of the firm's holding did not change, but the firm must report a forty percent loss due to the nature of the market.¹⁵⁸ Now suppose that the market is expected to get worse. The firm is incentivized to sell the holding at only \$60, because a further decline in the market will result in further losses on its book value.¹⁵⁹ In doing so, the firm actually realizes a forty percent loss on its investment.¹⁶⁰ Ironically, had the firm simply held the CDO to maturity, it is quite possible that no actual losses would have been realized.¹⁶¹ Yet, fair value accounting creates a perverse incentive for firms to unload assets at fire sale prices in a distressed market, realizing actual losses, in order to prevent losses on the book value of equity.¹⁶² Fair value accounting may not be appropriate in distressed markets. These issues became especially salient when the CDO market collapsed.

E. Inadequate Disclosure During Issuance

A final criticism is that CDO originators, particularly those issuing synthetic CDOs, gave investors inadequate disclosure and warnings about various risks.¹⁶³ This issue remains controversial, as it is the primary point of the Goldman Sachs scandal.¹⁶⁴

Goldman Sachs, the originator of synthetic CDOs, neglected to tell parties taking long positions that a prominent hedge fund manager, Paulson, handpicked mortgages he believed would fail, with the intent of taking a short position.¹⁶⁵ Did Goldman Sachs have the duty to inform its customers of the identity of the party taking a short position? Is it relevant that the short party was a prominent hedge fund manager? How relevant is it that Paulson handpicked the underlying mortgages? Must an originator always tell its customers who arranged the underlying assets, or is it only important if it the

well as the accompanying risk. Those companies forced by circumstances, such as bankruptcy and capital requirements, to sell these instruments received only pennies on the dollar.”)

¹⁵⁸ *Id.*

¹⁵⁹ *Cf. id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Cf. Id.*

¹⁶³ *See, e.g., SEC v. Goldman Sachs complaint, supra note 150.*

¹⁶⁴ *See generally id.*

¹⁶⁵ *See generally id.*

party is taking a short position? There are more questions than answers. This issue will be discussed after the full set of facts of the Goldman Sachs scandal are introduced in the next section.

IV. *SEC v. Goldman Sachs: A Case Study*

On April 16, 2010, the SEC launched a billion-dollar civil suit against Goldman Sachs for engaging in allegedly fraudulent practices in synthetic CDO origination.¹⁶⁶ At the time, Goldman Sachs had a pristine record. The suit was high-profile and hotly controversial.¹⁶⁷

Some commentators welcomed the suit as the start of a new era, bringing greater honesty and integrity to capital markets.¹⁶⁸ However, other commentators accused the SEC of furthering Congress's Democratic policy agenda considering the suit was filed just as Congress began discussing Dodd-Frank financial reform in earnest.¹⁶⁹ The vote to bring suit against Goldman was 3-2, split across party lines.¹⁷⁰

In any event, Securities and Exchange Commission v. Goldman Sachs & Co. ("the Goldman Sachs case") highlights many of the previously discussed criticisms against CDOs. Reviewing the facts of the case will serve as an effective case study and summary of public criticisms against CDOs.

A. Background Facts

The SEC brought a Rule 10b-5 and Section 17(a) fraud suit against Goldman Sachs for material misstatements and omissions in

¹⁶⁶ *Id.* at 22.

¹⁶⁷ Morgan, *supra* note 4.

¹⁶⁸ See, e.g., Ian Fraser, *SEC vs. Goldman Sachs Suggests Changed Days for Wall Street*, QFINANCE, Apr. 23, 2010, <http://www.qfinance.com/blogs/ian-fraser/2010/04/23/sec-vs-goldman-sachs-suggests-changed-days-for-wall-street>.

¹⁶⁹ See, e.g., Jack McHugh, *SEC v. Goldman Sachs; Timing and Methods are Curious*, THE BIG PICTURE, Apr. 19, 2010, <http://www.ritholtz.com/blog/2010/04/sec-v-goldman-sachs-timing-and-methods-are-curious/>.

¹⁷⁰ Jesse Westbrook, *SEC Said to Vote 3-2 to Sue Goldman Sachs Over CDOs*, BUSINESSWEEK, Apr. 19, 2010, <http://www.businessweek.com/news/2010-04-19/sec-said-to-vote-3-2-to-sue-goldman-sachs-over-cdo-disclosures.html>.

originating synthetic CDOs.¹⁷¹ The SEC argues that Goldman Sachs materially mislead investors when it marketed the underlying portfolio of a synthetic CDO as being chosen by a neutral third-party when, in fact, a prominent hedge fund made the selections, intending to take short positions.¹⁷² The short party profited while the long parties realized the loss.¹⁷³

Paulson & Co., a prominent hedge fund managed by billionaire investor John Paulson, was the short party.¹⁷⁴ The fund's strategy was to take short positions on credit default swaps where the underlying obligation consisted of subprime mortgages.¹⁷⁵ Paulson likely believed that credit rating agencies underestimated the credit risk of subprime mortgages as consequently that the short position was undervalued.¹⁷⁶ Seeking to profit when the mortgages defaulted, Paulson contacted Goldman Sachs to originate subprime mortgage-based CDOs with his fund taking a short position.¹⁷⁷

In 2004-05, Goldman Sachs began originating synthetic CDOs based on subprime mortgages, which it called "ABACUS."¹⁷⁸ In 2007, Paulson approached Goldman Sachs to originate a synthetic CDO in which he would take the short position.¹⁷⁹ Goldman Sachs, then, planned to market long positions to its customers.¹⁸⁰

However, according to the SEC's complaint, Goldman Sachs knew that its customers would not enter into a long position if they knew that a prominent hedge fund in a short position had picked the underlying assets.¹⁸¹ For this reason, Goldman Sachs hired ACA Management, LLC ("ACA") to act as the collateral manager.¹⁸² However, ACA was only the manager on paper. In practice, Paulson handpicked a list of 123 low-grade mortgages he believed would

¹⁷¹ SEC v. Goldman Sachs complaint, *supra* note 150, at 3.

¹⁷² *Id.* at 11-15.

¹⁷³ Taylor, *supra* note 27.

¹⁷⁴ *Id.* at 5.

¹⁷⁵ *Id.*

¹⁷⁶ It is impossible to know what Paulson *actually* believed, but the very fact that he took significant short positions sends a market signal that he believed they were undervalued.

¹⁷⁷ *Id.* at 6.

¹⁷⁸ *Id.* at 4.

¹⁷⁹ *Id.* at 6.

¹⁸⁰ *Id.* at 7.

¹⁸¹ *Id.*

¹⁸² *Id.* at 7-8.

default and forwarded the list to Goldman Sachs.¹⁸³ Goldman Sachs then forwarded the list to ACA, stating that it wished to create the synthetic CDO with those mortgages.¹⁸⁴ ACA ultimately approved ninety of the original 123 to create the synthetic CDO.¹⁸⁵

According to the SEC's complaint, Goldman Sachs did not disclose to investors that Paulson had personally selected the original list of 123 acceptable mortgages.¹⁸⁶ In fact, Goldman Sachs led ACA to believe that Paulson was taking a long position.¹⁸⁷ Goldman Sachs knew that ACA would have been reluctant to approve the mortgages if it knew that Paulson had handpicked them with the intent of taking a short position.¹⁸⁸ The SEC alleges that Goldman Sachs purposefully misled ACA into believing that Paulson was taking a long position, in order for ACA to pick from the list of pre-approved mortgages without objection.

Additionally, Goldman Sachs did not mention Paulson's role in the selection process when it marketed the long positions, and the disclosure documents made no mention of it.¹⁸⁹ Fabrice Tourre, the Goldman Sachs employee who marketed the long positions, took an almost cavalier attitude. He wrote to customers that the portfolio was "selected by ACA," while internal communications stated that it was "selected by ACA/Paulson."¹⁹⁰ Given that Goldman Sachs and Tourre believed that its customers would not take long positions if they knew about Paulson's role, the SEC accused both Goldman Sachs and Tourre of fraud.¹⁹¹ Paulson was not a party to the suit.¹⁹²

¹⁸³ *Id.* at 9.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* at 11.

¹⁸⁶ *Id.* at 2.

¹⁸⁷ *Id.* at 13 ("GS&Co also misled ACA into believing that Paulson was investing in the equity of ABACUS 2007-AC1 and therefore shared a long interest with CDO investors.").

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 11.

¹⁹⁰ *Id.* at 17.

¹⁹¹ *See id.* at 1-2.

¹⁹² *See generally id.*

B. How Criticisms of CDOs Apply to the Facts of the Case

The facts of the Goldman case are particularly insightful when one recalls the previously discussed criticisms against CDOs. In fact, almost every criticism appears in the fact set.

First, Paulson and Goldman had an almost uncanny awareness of the housing bubble and upcoming subprime crisis. The complaint states that, “Paulson came to believe that synthetic CDOs whose reference assets consisted of certain Triple B-rated mid-and-subprime RMBS would experience significant losses and, under certain circumstances, even the more senior AAA-rated tranches of these so-called ‘mezzanine’ CDOs would become worthless.”¹⁹³ Similarly, Tourre stated in private emails that there was “[m]ore and more leverage in the system, [t]he whole building is about to collapse anytime now . . .” and that “the cdo biz is dead we don’t have a lot of time left.”¹⁹⁴ Paulson and Goldman Sachs appeared to have been keenly aware of the dire state of synthetic CDOs backed by subprime mortgages.

By entering into short positions of synthetic CDOs backed by subprime mortgages, Paulson signaled that he believed that the credit risks of subprime mortgages were underestimated and that scores of subprime mortgages were likely to default. It is unclear how, exactly, Paulson was aware of the imminent bursting of the housing bubble. Given his considerable skill and expertise with CDOs, perhaps he was aware of the role they played in churning mortgages and fueling subprime lending.

Second, Paulson may have expressed knowledge of the credit rating agencies’ conflict of interest. He wrote that, “It is true that the market is not pricing the subprime RMBS wipeout scenario. In my opinion this situation is due to the fact that rating agencies, CDO managers and underwriters have all the incentives to keep the game going . . .”¹⁹⁵ This is a telling comment. It reveals that Paulson knew origination and transaction fees incentivized originators to continue churning CDOs. More significantly, the comment may also reveal that Paulson knew that rating agencies earned significant revenue from CDO valuations, especially from big customers like

¹⁹³ *Id.* at 6.

¹⁹⁴ *Id.* at 7.

¹⁹⁵ *Id.* at 6.

Goldman Sachs, so they were incentivized to inflate ratings in order to earn return business.

Inflated ratings were critically important to Paulson's strategy. If the credit ratings corresponded to the actual risk of default, then the short position would have been fairly priced, and Paulson would likely break even. In order for the short positions to be undervalued, the ratings would need to be inflated. Ultimately, Paulson was correct. By October 2007, eighty-three percent of the mortgages were downgraded, and the rest were on negative watch.¹⁹⁶ Knowledge of the credit rating agencies' conflict of interest may have been a large motivator for Paulson to arrange the deal.

Interestingly, Paulson may have exploited Goldman Sachs' conflict of interest as well. At the time, Paulson was a billionaire investor, ran a prominent hedge fund and his fund paid Goldman Sachs \$15 million to originate the ABACUS CDOs.¹⁹⁷ Goldman Sachs may have been induced to draft potentially fraudulent disclosure statements in order to keep Paulson as a customer. Professor Elizabeth Nowicki notes that, "This appears to be a straightforward case of a privileged client asking Goldman to help the client make a ton of money, and Goldman agreeing while simultaneously failing to make the appropriate disclosure . . ."¹⁹⁸ This explanation is plausible and highly compelling.

Third, parties exposed themselves to unnecessary risk by making "bets" with their derivative positions instead of legitimate hedging. That is, Goldman Sachs's customers were not hedging risk in the ABACUS CDOs. Given the nature of derivatives, a gain by one party exactly corresponded to losses by the counterparty.¹⁹⁹ Interests in the CDO were designed to be zero-NPV, and the price of each position was intended to correspond to its level of risk.²⁰⁰ Paulson had reason to believe that the short positions were underpriced, since he apparently knew that the level of risk was underestimated. Nonetheless, he made a bet. He won the bet, but the counterparties in the long position lost. Had the counterparties stuck

¹⁹⁶ *Id.* at 3.

¹⁹⁷ *Id.*

¹⁹⁸ David Wessell, *A Narrative for the Crisis Emerges in Allegations*, WALL ST. J., Apr. 17, 2010, http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052702304180804575188441300375102.html.

¹⁹⁹ McLaughlin, *supra* note 75, at 65-71.

²⁰⁰ *Id.* at 68, 70.

with growth-enhancing investments and only used derivatives to hedge legitimate risk, they would not have sustained these losses.

Fourth, Goldman Sachs was accused of inadequate disclosure, as it had neglected to mention Paulson's identity or his role in selecting the underlying assets.²⁰¹ Given the relatively new nature of CDOs, particularly synthetic CDOs, the case raises larger questions about what level of disclosure is actually required. For example, a chief concern in the complaint was that Goldman Sachs did not disclose Paulson's identity as the short party.²⁰² But synthetic CDOs always have long and short parties, given that they are derivatives.²⁰³ It seems unlikely that the parties' identities must always be disclosed to each other. Perhaps, then, it is important that the short party selected the underlying portfolio, given that short party would profit if it defaults. Moreover, the fact that Paulson managed a prominent hedge fund may be relevant. Then again, suppose that Paulson & Co. had been a small, unknown hedge fund. Would its exact identity been relevant? Would the fact that the short party arranged the portfolio still have been relevant? Unfortunately, these questions were left unanswered in the present case. On July 16, 2010, two hours after the Senate passed the Dodd-Frank Act, Goldman Sachs settled with the SEC for \$550 million.²⁰⁴

It is important to note that the SEC did not bring any charges against Paulson.²⁰⁵ The suit involved fraudulent disclosure by the originator, Goldman Sachs. The practice of short selling itself was never under attack. This distinction has escaped some journalists and commentators, who misinterpreted the suit as an attack on profiting through the act of short selling.²⁰⁶ Short selling is legal and has legitimate uses. First, it sends signals to the market.²⁰⁷ For example,

²⁰¹ See SEC v. Goldman Sachs complaint, *supra* note 150 at 2.

²⁰² *Id.* at 11.

²⁰³ Mahadevan, *supra* note 17, at 28-29.

²⁰⁴ Christine Harper & Joshua Gallu, *Goldman Settlement 'Victory' Ushers Change to Wall Street*, BLOOMBERG, July 16, 2010, <http://www.bloomberg.com/news/2010-07-16/goldman-sachs-settlement-victory-ushers-in-change-may-cost-wall-street.html>.

²⁰⁵ See generally SEC v. Goldman Sachs complaint, *supra* note 150.

²⁰⁶ See, e.g., *Goldman Testifies: "We're Not That Smart." Jerks, Too.*, Apr. 28, 2010, <http://attempter.wordpress.com/2010/04/28/goldman-testifies-were-not-that-smart-jerks-too/>

²⁰⁷ Johnny Tamny, *Another Defense of Short Selling*, REAL CLEAR MARKETS, Dec. 1, 2009, http://www.realclearmarkets.com/articles/2009/12/01/another_defense_of_short_selling_97529.html.

an observer may have noticed that Paulson, a financially sophisticated party, took an unusually large short position in subprime mortgages. The natural conclusion would be that Paulson had reason to believe that short positions were underpriced, meaning that the mortgages were more likely to default than the credit rating indicated. Second, short selling through synthetic CDOs may be used for legitimate hedging.²⁰⁸ Suppose that a bank holds a large collection of subprime mortgages. It is therefore exposed to significant credit risk. The bank could originate a synthetic balance sheet CDO, take a short position and market long positions to customers. This is a cheap and effective way to hedge credit risk. Short selling is a legitimate financial tool. Goldman Sachs, on the other hand, may have committed fraud by leading its customers to believe that a neutral party selected the portfolio, when it was in fact selected by a hedge fund taking a short position.

Ultimately, the Goldman Sachs scandal highlighted a number of serious problems that plagued CDO issuance. As may be expected, these problems prompted a massive legislative response, both in terms of federal statutes and administrative rules.

V. *Corrective Measures*

Around the time of the Goldman Sachs scandal, various measures were introduced to correct some of the problems that led to the collapse of the CDO market. If implemented properly, these measures may restore investor confidence and prompt a new wave of primary issuances.

This section will highlight some of the most salient corrective measures. For several reasons, this discussion is not exhaustive. First, these measures come from a wide variety of sources. Second, many of these measures are not yet fully implemented, so their actual effects on the CDO market are still unknown. Once implemented, it is likely that some issues will be resolved, while new ones will arise. Third, many of these measures are rather far-reaching. They may intend to broadly regulate originators, credit rating agencies, or securitizations in general, but in doing so, they may alter CDO issuance as a secondary effect. Ultimately, the discussion will be speculative, but may serve as a forward-looking analysis of future issues in CDO issuance.

²⁰⁸ Frankel & Fagan, *supra* note 13, at 194.

A. Churning Low-Quality Mortgages: Risk Retention

Title IX, Subtitle D of the Dodd-Frank Act contains measures that broadly affect securitization in general, including CDOs.²⁰⁹ The most significant measure is a risk retention requirement. Basically, originators and securitizers of asset-backed securities must retain a five percent holding in their assets.²¹⁰ The text of Subtitle D expressly states that CDOs are a type of asset-backed security, bringing CDO originators under the risk retention requirement.²¹¹ The rules allow originators and securitizers to split the five percent holding between them, in some manner.²¹² In short, originators and securitizers of CDOs can no longer remove an asset from their balance sheets after they sell it to an SPV—they must retain part of the risk.

Presumably, this requirement is intended to prevent originators from churning low-quality assets. Previously, banks lent mortgages with a view to distribute them under an “originate-to-distribute” model.²¹³ That is, as long as the banks could sell the mortgages in a securitization, there was little incentive to originate quality mortgages. Now, the interests of originators are aligned with those of investors, since they hold part of the assets. Ideally, originators are now incentivized to originate quality mortgages, and investors will be confident that the originator is concerned with the long-term viability of the underlying assets.

However, some difficulties are already apparent. First, it is unclear how originators should maintain this five percent holding in the assets. The statutory text does not specify whether it should be

²⁰⁹ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §§ 941-46, 124 Stat. 1890-98 (2010).

²¹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §941, 124 Stat. 1890-96 (2010).

²¹¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §941(a), 124 Stat. 1890 (2010) (“The term ‘asset-backed security’ means a fixed-income or other security . . . that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including . . . a collateralized debt obligation.”).

²¹² Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §941(b), 124 Stat. 1893 (2010).

²¹³ See Hattori & Ohashi, *supra* note 46.

part of a senior tranche, junior tranche, or equity holding.²¹⁴ If the originator may simply hold a senior tranche, it will be exposed to far less risk than if it were required to hold a junior tranche or equity, which minimizes the effectiveness of the statute. Second, there is some statutory ambiguity in the definition of “securitizer” and “originator.”²¹⁵ These parties may split the five percent holding between them, but it is unclear how this should occur, in practice.²¹⁶ Third, this measure may tighten credit and dampen the economy. If originators must retain a five percent holding, they may only regain up to ninety-five percent of the value of their assets during a securitized sale. Under the prior model, originators could sell assets, regain the full value in cash and lend again. In theory, originators could lend indefinitely. Now, there is a finite end point, since originators must retain an interest in the assets. Indeed, the Dodd-Frank Act requires the Chairman of the Financial Services Oversight Council to prepare a study of the possible macroeconomic effects of the risk retention requirement.²¹⁷ Ultimately, this measure will hopefully align the incentives of originators with those of investors, at the cost of a possible liquidity crunch.

B. Credit Rating Agency Conflicts of Interest: Disclosure, Accountability and Independence

Another set of measures addresses the fundamental conflict of interest of credit rating agencies. That is, originators pay rating agencies to rate their CDO tranches.²¹⁸ Rating agencies also consult with originators on how to properly structure their CDOs to achieve a high rating.²¹⁹ However, the credit rating agencies know that a high rating is necessary to earn repeat business from any given originator. Therefore, rating agencies are incentivized to give inflated high ratings, especially if they can earn lucrative consulting fees in the process.

²¹⁴ Grant E. Buerstetta, *Potential Impact of Dodd-Frank Act on CDO/CLO Transactions*, BLANK ROME LLP, Aug. 2010, <http://www.blankrome.com/index.cfm?contentID=37&itemID=2289>.

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, § 946, 124 Stat. 1898 (2010).

²¹⁸ *See Freeman, supra* note 39, at 602.

²¹⁹ *Id.*

Title IX, Subtitle C of the Dodd-Frank Act aims to bring greater accountability to credit rating agencies and to eliminate conflicts of interest with originators, including CDO originators.²²⁰ In fact, Subtitle C begins with an express acknowledgment that a conflict of interest exists.²²¹ Among other provisions, Subtitle C requires nationally recognized statistical rating organizations (“NRSROs”) to develop internal controls to ensure neutral ratings.²²² Each rating must be accompanied by a certification that the rating was not influenced by outside factors, such as business considerations.²²³ In essence, credit rating agencies will be regulated similarly to accounting firms.²²⁴

In addition, the SEC promulgated new rules in 2009 that require greater disclosure and independence for credit rating agencies.²²⁵ Most notably, credit rating agencies must disclose their rationale for assigning a rating higher than the asset would normally suggest.²²⁶ This requirement may disincentivize inflated ratings. Moreover, credit rating agencies must maintain independence. They may not rate an instrument if they consulted with the originator on how to structure or price the instrument.²²⁷ This requirement may be an attempt to eliminate the conflict of interest. Together with greater accountability in the Dodd-Frank Act, the days of inflated ratings are hopefully over.

²²⁰ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §§ 931-39H, 124 Stat. 1872-90 (2010).

²²¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, § 931(5), 124 Stat. 1872 (2010) (“In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored.”).

²²² Dustin Hall, *Dodd-Frank Wall Street Reform Bill Significantly Modifies the Regulation of Credit Rating Agencies*, BRYAN CAVE, July 2, 2010, <http://www.bankbryancave.com/dodd-frank-wall-street-reform-bill-significantly-modifies-the-regulation-of-credit-rating-agencies/> (“All NRSROs will be required to establish, maintain, enforce, and document an effective internal control structure for determining credit ratings.”).

²²³ *Id.*

²²⁴ *Id.*

²²⁵ Frankel & Fagan, *supra* note 13, at 172.

²²⁶ *Id.*

²²⁷ *Id.*

C. Speculative “Betting” with Derivatives Versus Hedging Legitimate Risk: Disclosure and Transparency

Another issue is that some parties in derivative transactions assume positions with the intent of speculative “betting,” instead of hedging legitimate cash flow volatility.²²⁸ As discussed, derivatives are zero-NPV.²²⁹ They may be useful in hedging cash flow volatility, but when unnecessary positions are taken, they actually increase risk.²³⁰ Unfortunately, this distinction is difficult to regulate. The Dodd-Frank Act does not appear to contain rigid requirements limiting the use of derivatives. Perhaps financial firms must learn to police themselves with effective risk management controls.

One answer may be greater disclosure and transparency. The Dodd-Frank Act establishes the Financial Stability Oversight Council (“FSOC”), which has certain authority to conduct risk assessments for financial companies.²³¹ The Act contains a number of provisions that require reporting to the FSOC, including disclosure of derivative positions.²³² Disclosure to the FSOC of a company’s derivative positions may increase transparency and disincentivize speculation. However, some critics note that these reports are not available to the public.²³³ Nonetheless, disclosure to federal regulators may be a step in the right direction.

D. Fair Value Accounting in an Inactive Market: Suspension of Fair Value Methods Under Certain Circumstances

When the CDO market collapsed, there was concern that fair value accounting worsened the damage. That is, investors in securitizations were induced to sell their holdings at fire sale

²²⁸ See *supra* Part III.c.

²²⁹ See *supra* Part III.c.

²³⁰ See *supra* Part III.c.

²³¹ Bobby Bartlett, *Dodd-Frank: “It Will Finally Bring Transparency to the Kinds of Complex, Risky Transactions that Helped Trigger the Financial Crisis”*, THE CONGLOMERATE, July 22, 2010, <http://www.theconglomerate.org/2010/07/doddfrank-it-will-finally-bring-transparency-to-the-kinds-of-complex-risky-transactions-that-helped-.html>.

²³² *Id.*

²³³ *Id.*

prices.²³⁴ Otherwise, they would be forced to record major losses on their books, due to valuing their holdings at fair value in a depressed market.²³⁵

Fortunately, the Emergency Economic Stabilization Act of 2008, colloquially known as the “bank bailout,” granted the SEC the power to suspend fair value accounting for a company or class of securities if doing so is in the public interest.²³⁶ Moreover, the Act also required the SEC to prepare a report on how fair value accounting contributed to the country’s economic problems.²³⁷ So, in situations where fair value accounting is against the public interest, such as when companies must record losses due to an inactive market, the SEC has authority to suspend it for a class of securities. It remains to be seen whether the SEC will use this new power effectively.

E. Broadening Disclosure During Issuance

The Goldman Sachs scandal left some questions unanswered. During the scandal, there was uncertainty regarding what information Goldman Sachs had to disclose. For example, the scandal never resolved whether Goldman Sachs was actually required to inform investors that Paulson was taking short positions.

Fortunately, the Dodd-Frank Act recently resolved this issue. Title IX, Subtitle D requires the SEC to pass disclosure requirements for asset-backed securities, which include CDOs.²³⁸ First, the SEC must pass rules that require issuers to disclose information sufficient for investors to conduct due diligence, including the degree of risk retention by originators, the degree of compensation for the broker

²³⁴ See Poer, *supra* note 157.

²³⁵ *Id.*

²³⁶ 12 U.S.C.A. § 5237 (West 2010) (“The Securities and Exchange Commission shall . . . suspend, by rule, regulation, or order, the application of Statement Number 157 of the Financial Accounting Standards Board for any issuer . . . if the Commission determines that is necessary or appropriate in the public interest.”).

²³⁷ 12 U.S.C.A. § 5238 (West 2010) (“The Securities and Exchange Commission . . . shall conduct a study on mark-to-market accounting. . . . Such a study shall consider at a minimum . . . the impacts of such accounting on bank failures in 2008.”).

²³⁸ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, §§ 941-46, 124 Stat. 1890-98 (2010). As mentioned, CDOs are expressly defined as asset-backed securities in § 941.

and originator and certain asset-level data.²³⁹ Second, for each security they rate, credit rating agencies must disclose the representations, warranties and enforcement mechanisms available to investors.²⁴⁰ Third, securitizers must clearly disclose all repurchase obligations, if applicable.²⁴¹ Finally, originators that file a registration statement for asset-backed securities must review the underlying assets and disclose the nature of their review.²⁴² These upcoming SEC rules should clarify what information CDO originators must disclose, but some ambiguities likely will remain.

Ultimately, recent rules and regulations address many of the problems that led to the collapse of the primary issuance market and the Goldman Sachs scandal. With so many new rules and regulations, some issues likely will be resolved, while new ones may emerge.

VI. Conclusion

CDOs have an uncertain future. Primary issuances ceased long ago, and there continues to be significant public distrust of unchecked securitization. The housing market is still distressed, and credit is still tight.

The financial landscape will continue to evolve. If CDOs are to regain their status as a viable and trustworthy financial instrument, confidence must be restored. This may be accomplished through effective regulation. To be sure, various statutory measures have been introduced, but it is still too early to determine their ultimate effects. Alternatively, the industry may eventually self-correct by learning from its past mistakes.

²³⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, § 942, 124 Stat. 1896-97 (2010).

²⁴⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, § 943, 124 Stat. 1897 (2010).

²⁴¹ *Id.*

²⁴² Dodd-Frank Wall Street Reform and Consumer Protection Act, Public L. No. 111-203, § 945, 124 Stat. 1898 (2010).