Shining a Light on Shadow Banks

Patrick M. Corrigan[†]

To date, descriptive accounts and reform proposals have framed the problems arising from "shadow banking" as about the risks of lending and maturity transformation by nonbanks operating outside the guardrails of banking law. But shadow banks engage in the business of investing, not lending, and their ownership interests are often held by traditional banking entities. By ignoring the ownership structure and investment activities of shadow banks, the academic literature has overstated the risks that nonbanks pose to financial stability and underestimated the ability of existing regulatory frameworks to address the information and incentive problems posed by shadow banks.

This Article first shows that the innovative design of many securitization vehicles is to give banking entities residual and subordinated economic exposure to securitization vehicles without triggering a legal conclusion that the vehicles are bank "affiliates" or "investment companies." Thus, these securitization vehicles are not regulated under the banking laws or investment company laws. Nevertheless, this Article presents data showing that the traditional banking sector owned, controlled, and backstopped many of the securitization vehicles at the heart of the 2007–2009 financial crisis. Thus, most of these so-called shadow banks were instruments of the traditional banking sector, not bank competitors.

This Article identifies the shadow banks of most concern to ongoing financial stability as entities that would be regulated as investment companies but for an asset-based exemption from regulation under the Investment Company Act—especially when the shadow bank is backstopped by a banking entity. This Article advances a reform proposal that would update the boundary lines between banking entities, regulated investment companies, and unregulated investment companies. The banking laws should add an economic exposure test to the definition of "affiliate" to bring unregulated entities backstopped by banks, and indirectly backstopped by the federal safety net, into the regulatory perimeter. Moreover, the exemptions from the Investment Company Act of 1940 for investment companies that hold only certain types of assets should be narrowed or eliminated altogether. This bottom-up, transactional approach would better regulate risks to investors and the public than the top-down approach in the Dodd-Frank Act that relies on regulators identifying and regulating "systemically important" nonbanks.

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INTRODUCTION

Shadow banks became a primary financial stability concern of regulators and researchers after the 2007–2009 financial crisis because of the belief that they contributed to systemic risk and financial stress.[1] To date, the academic literature has largely framed the problem of shadow banks as about lending and maturity transformation by bank-like entities that operate outside the regulated banking system.[2] This Article shows that most "shadow banks" are actually involved in the business of *investing*. They do not lend or extend credit at all.[3] In many cases, the investment companies that comprise the "shadow banking" sector are instruments of traditional banking entities, not their nonbank competitors.[4] By ignoring the ownership structure and functional activities of securitization

[1] *See, e.g.*, Kathryn Judge, *Information Gaps and Shadow Banking*, 103 VA. L. REV. 411, 414 (2017) (describing "the shadow banking system" as a "third systemically important regime," in addition to the traditional banking system and the capital markets system); Michael S. Barr, Vice Chair for Supervision, Fed. Rsrv. Bd., Statement Before the American Enterprise Institute: Why Bank Capital Matters 7 (Dec. 1, 2022) (transcript available at https://www.federalreserve.gov/newsevents/speech/barr20221201a.htm [https://perma.cc/2QHB-F8PL]) ("We need to worry, a lot, about nonbank risks to financial stability."); Ben S. Bernanke, Chairman, Fed. Rsrv. Bd., Statement Before the Financial Crisis Inquiry Commission 4 (Sept. 2, 2010) (transcript available at https://www.federalreserve.gov/newsevents/testimony/files/bernanke20100902a.pdf [https://perma.cc/8V9N-HM95]) (calling the reliance of "shadow banks" on short-term funding a private sector vulnerability).

[2] FIN. STABILITY BD., SHADOW BANKING: STRENGTHENING OVERSIGHT AND REGULATION 1 (2011); *see also* Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability*, 90 NOTRE DAME L. REV. 1, 1 (2014) (defining shadow banking as "the provision of financial services and products outside of the traditional banking system"); Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity and Systemic Risk*, 64 STAN. L. REV. 657, 659 (2012) (claiming that securitization structures constituted a feature of the "shadow banking system" through which the capital markets provide close substitutes for goods and services historically provided by banks); MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 2 (2016) (defining a shadow bank as "an entity that uses large quantities of short-term debt to fund a portfolio of financial assets and that is not a chartered deposit bank"); Judge, *supra* note 1, at 414 (describing shadow banking as "an intermediation regime that resides in the capital markets while serving many of the economic functions traditionally fulfilled by banks"); Daniel K. Tarullo, Governor, Fed. Rsrv. Bd., Statement Before the Federal Reserve Bank of San Fransico Conference on Challenges in Global Finance: Shadow Banking After the Financial Crisis 1 (June 12, 2012) (transcript available at https://www.federalreserve.gov/newsevents/speech/tarullo20120612a.htm [https://perma.cc/5JV4-CPCR]) (shadow banking is "credit intermediation involving leverage and maturity transformation that is partly or wholly outside the traditional banking system"); Ben S. Bernanke, Chairman, Fed. Rsrv. Bd., Statement Before the Fourteenth Jacques Polak Annual Research Conference: The Crisis as a Classic Financial Panic 4 n.5 (Nov. 8, 2013) (transcript available at https://www.federalreserve.gov/newsevents/speech/bernanke20131108a.htm [https://perma.cc/FP64-UK7E]) ("[S]hadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions . . . ."); Jonathan Macey, *It's All Shadow Banking, Actually*, 31 REV. BANKING & FIN. L. 593, 605 (2012) (describing shadow banks as engaging in the activity of borrowing short-term and lending long-term).

[3] An "investment company," generally, is an entity that pools money from investors and is engaged in the business of investing in securities. *See infra* note 65. In the investment company context, the term "security" sweeps broadly, including most consumer debt. *See infra* note 67.

[4] This Article generally uses the term "bank" as that term is defined in the Bank Holding Company Act of 1956: an insured depository institution or an entity that accepts deposits and makes loans. 12 U.S.C. § 1841(c). The Article uses the term "bank holding company" to mean an entity that controls a bank. 12 U.S.C. § 1841(a)(1).

vehicles, legal scholarship and regulatory reforms have underemphasized the role of traditional banks in the 2007–2009 financial crisis and have overlooked the ability of existing legal frameworks to address financial stability risks. This Article argues that most "shadow banks" ought to be regulated under existing regulatory frameworks as bank affiliates, investment companies, or both.

This Article advances the literature on shadow banks by demonstrating how innovation in securitization transactional design enabled *commercial banking entities* to own, control, and backstop a set of investment companies that have become known as the shadow banking sector without triggering financial regulation under the banking or investment company laws.[5] The analytical focus is on how gaps in the financial regulatory architecture shaped transactional design about the ownership structure of securitization vehicles and how these choices in turn shaped the applicable regulatory scheme and the allocation of risk and reward to investors in securitization vehicles.[6]

This Article first demonstrates that innovations in the ownership structure of securitization vehicles are best explained by regulatory shopping reasons.[7] Securitization vehicles are mere shell companies with no purpose other than to invest in assets and issue securities. The defining innovation of many securitization vehicles—called "variable interest entities" (VIEs) by accountants—is that they do not issue enough equity interests to cover expected losses.[8] By design, these vehicles start their lives under water. Part I.B

This Article adopts the Volcker Rule's convention of using the term "banking entity" to mean, generally, any insured depository institution, any company that controls an insured depository institution, certain foreign bank holding companies, and any affiliate or subsidiary of any of the foregoing. 12 C.F.R. § 248.2(c) (2023).

[5] *See infra* Part II.

[6] This Article complements a wide literature on the role of deregulation in contributing to the financial crisis. *See, e.g.*, Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1689–90 (2011) [hereinafter Omarova, *Unfulfilled Promise*] (examining "the recent history and implementation of . . . section 23A of the Federal Reserve Act."); Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011) (discussing the causes of the 2008 credit crisis); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking*,*"* 63 U. MIA. L. REV. 1041, 1041–42 (2009) [hereinafter Omarova, *Quiet Metamorphosis*] (reviewing the relationship between the Office of the Comptroller, risky derivatives, and the "business of banking"). *See also* the literature on efforts by banks to use securitization to obtain preferable treatment under regulatory capital rules, described *infra* note 10.

[7] While there are various definitions of "shadow banking," there is consensus that this term encompasses securitized financing special purposes entities. *See, e.g.*, RICKS, *supra* note 2, at 83.

[8] *See infra* Parts I.B and II.A. Since 2007, only one major law review has published an article that even discusses VIEs in the context of the financial crisis. William W. Bratton & Adam J. Levitin, *A Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets*, 2020 U. ILL. L. REV. 47. There is literature on credit default swaps and derivatives. *See infra* note 16. There is also a broad literature on securitization transactional design and the financial crisis. *See, e.g.*, William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783 (2013) [hereinafter Bratton & Levitin, *Transactional Genealogy*]; Anna Gelpern & Erik F. Gerding, *Private and Public Ordering in Safe Asset Markets*, 10 BROOK. J. CORP. FIN. & COM. L. 97 (2015); Erik F. Gerding, *Bank Regulation and Securitization: How the Law Improved Transmission Lines Between Real Estate and Banking Crises*, 50 GA. L. REV. 89 (2015); Frank Partnoy, *Shapeshifting Corporations*, 76 U. CHI. L. REV. 261 (2009); Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843 (2016); Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 330 (2017).

shows how these unusual and innovative entity structures enable commercial banks to maintain subordinated and residual economic exposure to securitization vehicles without triggering a legal conclusion that the entity is a bank "affiliate," thus avoiding regulation of the securitization vehicle under the banking laws. This Part also shows how securitization design is limited by the goal of avoiding the vehicle's regulation as an "investment company," a point underappreciated in the academic literature on securitization to date. This regulatory-motivated explanation for the ownership structure of securitization vehicles is consistent with the regulatory arbitrage purpose of VIEs and shell companies in other contexts.[9]

The transactional analysis of VIEs advances regulatory arbitrage explanations of the 2007–2009 financial crisis. To date, that literature has focused on how banking entities used securitization to obtain preferential treatment under capital adequacy rules in the banking laws.[10] The analysis in this Article focuses on *ownership structure* at the entity level as the means of regulatory shopping. It shows how securitization design using shell companies enabled banking entities to avoid virtually all of the rules that apply to bank affiliates *and* investment companies, including affiliate transaction restrictions, prudential supervision, and—in the case of banking entities—involuntary liquidation of assets under the source of strength doctrine, the prompt corrective action doctrine, and involuntary

[9] Two decades ago, Enron pursued this two-step strategy to successfully evade accounting consolidation rules. Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309, 1310 (2002). Venture capital firms use VIE structures to obtain economic exposure to Chinese companies without running afoul of prohibitions on foreign ownership. *See, e.g.*, Samuel Farrell Ziegler, Note, *China's Variable Interest Entity Problem: How Americans Have Illegally Invested Billions in China and How to Fix It*, 84 GEO. WASH. L. REV. 539 (2016); Yue Li, Note, *Variable Interest Entity Risks and Governance*, 48 J. CORP. L. 145 (2022). Special purpose acquisition corporations (SPACs) have used a two-step strategy successfully to help private companies go public while evading the investor protections in the public offering rules of the securities laws. *See* Patrick M. Corrigan, *Do the Securities Laws Actually Protect Investors? Lessons from SPACs*, 101 WASH. U. L. REV. (forthcoming 2024)*; see also* Robert Jackson & John Morely, SPACs As Investment Funds 22–28 (June 14, 2022) (Wharton Initiative on Fin. Pol'y & Regul.), https://wifpr.wharton.upenn.edu/wp-content/uploads/2022/10/Jackson-Morley-SPACs-as-Investment-Funds-2022.07.14.pdf [https://perma.cc/5DC7-DMUX] (applying a proposal to regulate some SPACs as investment companies, similar to this Article's proposal to regulate some securitization vehicles as investment companies). Johnson & Johnson's recent "Texas two-step" strategy that transferred mass tort liabilities to a shell company may also be understood as a means of evading a threshold requirement for obtaining the protection of bankruptcy laws. *In re* LTL Mgmt., LLC, 64 F.4th 84, 109 (3d Cir. 2023) (denying bankruptcy protection to a shell company "'formed,' almost exclusively, 'to manage and defend thousands of talc-related claims'" on grounds that bankruptcy was not filed in good faith).

[10] *E.g.*, JEFFREY FRIEDMAN & WLADIMIR KRAUS, ENGINEERING THE FINANCIAL CRISIS: SYSTEMIC RISK AND THE FAILURE OF REGULATION (2011); Viral V. Acharya, Philipp Schnabl & Gustavo Suarez, *Securitization Without Risk Transfer*, 107 J. FIN. ECON. 515, 521–33 (2013) (presenting evidence consistent with banking entities designing liquidity facilities in ways that obtain favorable capital treatment); Erik F. Gerding, *The Dialectics of Bank Capital: Regulation and Regulatory Capital Arbitrage*, 55 WASHBURN L.J. 357, 367 (2016); *see also* Andrew W. Lo, *Reading About the Financial Crisis: A Twenty-One-Book Review*, 50 J. ECON. LITERATURE 151, 154 (2012) (finding that there is no agreement on the causes of the financial crisis); Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe—From Themselves*, 163 U. PA. L. REV. 1539, 1566 (2015) (arguing that rules requiring securitization sponsors to retain risk in securitization transactions may increase systemic risk).

receivership doctrines.[11] The Article shows how the absence of each of these guardrails exacerbated distress as the 2007–2009 financial crisis unfolded.

Part II applies this analytical framework to reexamine the role of commercial banks in securitization programs during the 2007–2009 financial crisis. Contrary to originate-to-distribute accounts of securitization, the data shows that the traditional banking sector effectively owned, controlled, and backstopped many purportedly third-party securitization programs possessing hundreds of billions of dollars of assets.[12] The financial statements of the four largest U.S. banking organizations show that commercial banking entities reported exposures to loss of around $400 billion to consolidated and unconsolidated VIEs holding securitized assets at the end of the third quarter of 2008.[13] In the consolidated vehicles, the banking entities held a "controlling financial interest."[14] In the unconsolidated vehicles, banking entities held exposures to loss in the aggregate amounting to more than 59% of the total capital stack of these vehicles.[15]

Part II.A.3 provides a more granular transactional analysis, focusing on exposures of banking entities to asset-backed commercial paper conduits. It demonstrates how many of the features of these collective investment vehicles and the activities they undertook would have been prohibited had either the banking laws *or* investment company laws applied. These commercial paper conduits included collateralized debt obligations and structured investment vehicles exposed to some of the most toxic assets at the height of the 2007–2009 financial crisis. These managed investment vehicles used high leverage to magnify returns and invested in some of the same securities as hedge funds that pursued high-risk strategies. They also issued quasi-redeemable securities and created cross-ownership structures—practices identified as contributing to the crash of 1929 and regulated under the Investment Company Act of 1940. Self-reported data from the Federal Reserve Board of Governors (the "Board") indicates that the largest banking entities had committed more than $300 billion of liquidity puts to such asset-backed commercial paper conduits by the third quarter of 2008, effectively guaranteeing most of the conduits' debt.

The analysis advances the academic literature on complex financial instruments in the 2007–2009 financial crisis. That literature has focused on how the instruments issued in connection with securitization vehicles were complex, opaque, and risky.[16] This Article

[11] *See infra* notes 124–39.

[12] Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1182 (2012) ("In their intermediation role, [financial institutions engaged in securitization] do not hold more than a temporary interest in the mortgages they facilitate, so they have incentives different from (and often adverse to) borrowers and investors, the economic principals in mortgage transactions."). *Cf.* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 971 (2009) (claiming that financial conglomerates followed an "originate to not really distribute" strategy by retaining multiple exposures to off-balance sheet securitization vehicles).

[13] *See infra* Tables 1 and 2 and accompanying text.

[14] *See infra* notes 39–42.

[15] *See infra* Table 2.

[16] Judge, *supra* note 2, at 657 (showing how complexity in financial innovation creates information frictions and leads to systemic risk); Omarova, *Quiet Metamorphosis*, *supra* note 6, at 1686–87 (analyzing the legal developments that enabled large U.S. commercial banks to engage in trading and dealing in complex over-

shows how credit default swaps and other complex financial instruments also served as replacements for equity securities that didn't count as "voting securities" under the tests that determine whether an entity is a bank affiliate.[17]

Part III.B creates a typology of shadow banks. It argues that the shadow banks of greatest regulatory concern are unregistered asset-based investment companies. These entities include certain mortgage real estate investment trusts, collateralized loan obligations, and credit funds. The exemptions from regulation under the Investment Company Act on which they rely are asset-based in the sense that they restrict the investment vehicle to holding solely certain types of debt assets. Unlike traditional private equity and hedge funds, these asset-based investment companies are permitted to sell securities to large numbers of dispersed, unsophisticated investors. Weak corporate governance and unsophisticated investors greatly increase the possibility of harm to investors and the possibility that misallocation of capital will contribute to systemic risk.

The shadow banks of greatest concern, however, are the subset of unregistered asset-based investment companies that are sponsored by banking organizations. These entities include bank-sponsored securitization programs and collateralized loan obligations, among others. These entities may raise the governance concerns previously mentioned, but they also provide the shadow banks with a backdoor to the federal safety net for banks, raising all the attendant moral hazard concerns. These are the shadow banks that pose the gravest risk to financial stability moving forward.

Safety, soundness, and systemic risk considerations counsel a reevaluation of the regulatory boundary lines between banking entities, registered investment companies, and unregistered investment companies. The Dodd-Frank Act took a top-down approach to regulating shadow banks by giving regulators authority to identify and regulate certain "systemically important financial institutions."[18] This top-down approach is inadequate. Regulators are unlikely to have the information necessary to identify and deter financial stability risks before it's too late. A better approach is to match regulatory coverage with economic substance by updating existing entity-level, bottom-up regulatory frameworks. The Investment Company Act imposes capital adequacy requirements, restrictions on affiliate transactions, and certain investment restrictions. Banking law imposes similar substantive and prudential regulations on banks and their affiliates. Applying these regulatory frameworks to the shadow banking sector, where justified by economic substance, would apply time-tested, effective regulatory schemes to the complex information and incentives problems posed by shadow banks.[19]

Part III.C tackles the most important question of affiliations between banking entities and unregistered investment funds. The bottom line is that it is bad policy to allow commercial banking entities to backstop investments in unregulated investment companies, providing these unregulated vehicles a backdoor guarantee by the federal safety

the-counter derivatives); Stout, *supra* note 6, at 1 (arguing that the reregulation of certain derivative transactions caused the financial crisis).

[17] *See infra* Part I.B.

[18] Dodd-Frank Wall Street Reform and Consumer Protection Act, §§ 111–12, 12 U.S.C. §§ 5321–22.

[19] *See infra* notes 140–46.

net. The Article argues that the test for determining a bank "affiliate" should include an economic exposure test.[20] Any "financial" company or any other "investment company" in which a banking entity owns or controls more than 25% of the economic exposure to any class of subordinated financial instrument would meet the definition of a bank "affiliate."[21]

Part III.D analyzes the issue of asset-based exemptions to the Investment Company Act. The Article tentatively proposes to eliminate them.[22] These asset-based exemptions were originally intended to exempt small finance companies that directly loaned money to home-buyers and small businesses, but they now cover actively managed collateralized loan obligations holding billions of dollars of unrated debt. Even more modest proposals—such as prohibiting active management or cross-ownership structures as a condition to the exemption from investment company regulation—would greatly enhance the stability of the financial system.

There are important advantages of the proposed regulatory reform compared to other proposals in the academic literature on regulatory architecture and regulatory reform after the 2007–2009 financial crisis. By defining shadow banks as unregistered investment companies, the proposal creates a framework that is familiar and tractable for regulatory analysis. The proposal requires the creation of no new substantive regulations, drawing instead on tested and established regulatory tools. The proposal could be implemented through regulatory action without a need to go to Congress.[23] The proposal does not require regulators to draw any conclusions about the merits of financial innovations. The proposal works by forcing transactional planners to internalize the costs of banking and investment company regulation, rooting out those financial innovations that are valuable only by means of regulatory arbitrage. The proposal is also less burdensome than other prominent financial stability proposals.[24]

Critics will claim that the increased cost of funding from regulating securitization vehicles will outweigh any benefits to investors and the public. True, there are trade-offs

[20] The proposal takes a similar approach as the one advocated by Thiemann and Tröger. *See generally* Matthias Thiemann & Tobias H. Tröger, *Detecting Tail Risks to Preclude Regulatory Arbitrage: The Case for a Normatively Charged Approach to Regulating Shadow Banking*, 11 ACCT. ECON. & L. 233 (2020) ("Our paper proposes to apply regulatory burdens equivalent to prudential banking regulation if the respective transactional structures become only viable through indirect or direct access to (ad hoc) public backstops.").

[21] 15 U.S.C. § 1841(k). A "financial" company means a bank or an entity engaged in activities that are "so closely related to banking as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8). "Investment company" is defined by section 3(a)(1) of the Investment Company Act of 1940. 15 U.S.C. § 80a-3(a)(1).

[22] More precisely, the proposal is to repeal Rule 3a-7 and to increase the conditions for relying on the exemptions in section 3(c)(5). *See infra* Part III.C.

[23] The Securities and Exchange Commission can only repeal Rule 3a-7 under the Investment Company Act with its rulemaking authority. Reform of the exemptions in section 3(c)(5) may have to be addressed by Congress.

[24] *See* Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. (2016) (advancing a safe banking proposal that would split the lending function from the safekeeping function in financial markets); ARTHUR E. WILMARTH, JR., TAMING THE MEGABANKS: WHY WE NEED A NEW GLASS-STEAGALL ACT 335 (making the case for passing a new version of an old law that, among other things, prohibited affiliations between banks and certain securities affiliates); RICKS, *supra* note 2, at 243–47 (proposing to prohibit the issuance of certain short-term debt by nonbanks).

to the proposal, and this is precisely the policy tradeoff that should be at the heart of systemic risk reform debates. However, public harm resulting from the misuse of securitization in the 2007–2009 financial crisis provides a powerful counterweight to this objection. Moreover, I believe that the more faithful policy to the existing legal commitments enshrined in law by Congress is to regulate at least some types of complex securitization vehicles as investment companies and bank affiliates.

Others will attack the proposal on the grounds that it purportedly inhibits the ability of banks to sell their assets. But the proposal imposes no restrictions whatsoever on sales of assets by banks, only their ability to provide large amounts of subordinated financial support to investment companies outside the regulatory perimeter. Still, others will object on the grounds that the proposed reforms will kill the securitized financing industry entirely by depriving it of banking sector backstops. This argument, buttressed by path dependency considerations, has considerable force. But it can be mitigated by an appropriate conformance period and, overall, is not a persuasive justification for maintaining exemptions that distort capital allocation decisions and that pose safety and soundness risks to the banking sector. The burden should apply to proponents of this objection to explain why the social utility of securitization justifies such sweeping regulatory preferences.

I. A Regulatory Shopping Explanation for Securitization Ownership Structure

The heart of the "shadow banking" industry, and the focus of this Part, is securitization.[25] This Part shows that the core transactional innovation of securitization was to replace traditional equity securities with innovative financial instruments called variable interests. It advances one explanation for why market participants replaced equity securities: to avoid regulation as an investment company and, in many cases, as a bank affiliate.

The account here, thus, links the ownership structure of securitization vehicles to regulatory arbitrage explanations of securitization. The regulatory arbitrage account developed here encompasses the well-known arbitrage of capital rules, but it is broader and more comprehensive. It focuses on the *ownership structure* as the locus of regulatory arbitrage and its effects encompass the totality of the rules that ordinarily apply to banks *and* investment companies.[26]

[25] There is consensus that "shadow banking" includes the securitized financing sector. *See, e.g.*, Ricks, *supra* note 2, at 83 (calling an asset-backed commercial paper conduit a "prototypical" shadow bank); *see also* Hossein Nabilou & Alessio M. Pacces, *The Law and Economics of Shadow Banking*, *in* Research Handbook on Shadow Banking: Legal and Regulatory Aspects 7, 13 (Iris H.-Y. Chiu & Iain G. MacNeil eds., 2018) (labeling shadow banks in certain definitions as "non-banks performing bank-like functions").

[26] For a detailed analysis of how the regulatory scheme varies by type of entity, see *infra* Part III.A.

A. Securitization Programs Are Collective Investment Vehicles

The dominant theoretical template for securitization vehicles is that they are a technology for *financing* consumer debt and credit to small businesses.[27] However, securitization vehicles are better understood to fall under another, often overlooked, theoretical template: securitization vehicles are collective investment vehicles in which investors speculate on the value of the underlying assets.

A securitization vehicle is a shell company with no business other than to invest in securities and other assets that generate cash flows.[28] It pools money it receives from investors, invests the money, and pays off investors based on the performance of the investment assets. One hundred percent of the assets owned by a securitization vehicle are investment assets that are held for the purpose of receiving their cash flows. Unlike banks or nonbank finance companies, securitization vehicles do *not* make direct loans to individuals or businesses.

Securitization vehicles have both the assets and organizational structure that distinguish investment funds from ordinary companies.[29] Securitization vehicles have similar assets as investment funds—debt securities and other financial assets. Moreover, securitization vehicles are organized to have no employees or operational resources of their own, relying entirely upon outside investment professionals for advice and management.

Consider a simple example of a mortgage-backed security. In Case F of Accounting Standards Codification (ASC) 810, the Financial Accounting Standards Board describes an example of a residential mortgage-backed security with a two-class waterfall structure in the following way:

> A VIE is created and financed with $100 of 30-year fixed-rate debt securities. The securities are issued in 2 tranches (a $90 senior tranche and a $10 residual tranche). The senior tranche securities are investment grade and are widely dispersed among third-party investors. The residual tranche securities are held by the transferor. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from a transferor. A default on the underlying loans is absorbed first by the residual tranche held by the transferor [of the underlying debt securities].[30]

Figure 1 illustrates this example transaction structure by presenting a simple balance sheet for an asset-backed securities issuer. There are complex variations to securitization

[27] *See supra* note 2 (discussing some of the academic literature related to securitization).

[28] *See, e.g.*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L., BUS. & FIN. 133, 135 (1994) (describing the securitization process as involving a sale of assets representing the rights to future payments to a special purpose vehicle).

[29] *See generally* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014) (discussing the factors distinguishing investment funds from other entities).

[30] CONSOLIDATION (TOPIC 810): AMENDMENTS TO THE CONSOLIDATION ANALYSIS, Fin. Acct. Standards Update No. 2015-02, 810-10-55-160 (FIN. ACCT. STANDARDS BD. 2015).

vehicles on both the asset and liability sides of their balance sheets, but this simple example illustrates the basic structure.[31]

Figure 1. Illustration of Sample Securitization Balance Sheet

Assets	Liabilities
$100 debt instrument	$90 debt
	$10 residual

On the asset side, the securitization vehicle invests in mortgages. On the liability side, the vehicle issues two classes of securities: senior debt and interests in residual cash flows. Figure 1 can be interpreted according to straightforward principles of corporate finance. The residual investors assume first losses up to ten dollars, and the debt investors assume risk beyond that.[32] The risk of losses is concentrated in the residual interest, which makes the debt liability safer by providing a capital buffer. Notice, the residual interests in this example are held by the "transferor"—that is the securitization sponsor and the one that sold the assets to the securitization vehicle in the first place. That's a market standard practice, and more analysis will come on this point in later Parts.

At this point, some accounting background is also necessary to tell the story of securitization, as accounting consolidation concepts drove key regulatory features which, in turn, drove securitization transactional design. Historically, the Financial Accounting Standards Board set forth a consolidation test based on control as evidenced by voting rights.[33] While the test has evolved, control is generally presumed by the holder of a

[31] For example, a securitization vehicle might issue six classes of securities with respective ratings of AAA, AA, A, BBB, BB, and B, as well as a class of securities not rated. *See, e.g.*, HSI Asset Loan Obligation Trust 2007-2, Prospectus Supplement (Form 424B5) S-5 (Oct. 30, 2007). As cash flows generated by the underlying assets enter the securitization, holders of the AAA securities get paid first, then holders of AA securities, then A securities, then BBB securities, and so on. Holders of the unrated securities keep whatever is left after all the senior investors get paid.

[32] The reason that originators or sponsors of the securitized assets retain equity exposure to the securitization vehicle has been explained by adverse selection theory. Retention of the equity tranche by the sponsor acts as a costly signal of the quality of the underlying assets and mitigates an adverse selection problem anticipated by less informed asset-backed securities investors. *See, e.g.*, Gary B. Gorton & George G. Pennacchi, *Banks and Loan Sales: Marketing Nonmarketable Assets*, 35 J. MONETARY ECON. 389 (1995) (using an auto-sales loan study and the relationship between loan sellers and buyers to analyze the premium on equity and sensitivity of loan sales).

[33] *See generally* DELOITTE, ROADMAP: CONSOLIDATION—IDENTIFYING A CONTROLLING FINANCIAL INTEREST 1–5 (November 2022), https://dart.deloitte.com/USDART/pdf/13cdb44e-3f6a-11e6-95db-fda5a02afb67 [https://perma.cc/X2L3-A7PR] (discussing the history and evolution of the consolidation test as it relates to voting rights). While accounting consolidation determinations are complex and development on this topic is still ongoing, I primarily summarize the state of accounting standards before and during the financial crisis for purposes of this Article.

majority voting interest in another entity unless noncontrolling shareholders have substantive participating rights.[34]

The single most important financial innovation event occurred in the late 1990s and early 2000s. At that time, transactional planners realized that they could avoid consolidation of third-party entities by creating structures that did not have voting interests.[35] Thus, an innovative, new type of business entity was born: a thinly capitalized entity that simply did not issue traditional equity securities with voting rights.[36] This is the type of entity that blew up in the Enron accounting scandal.[37] These entities replaced equity securities with complex financial instruments that had a similar economic structure as equity securities but different control rights. Recognizing the growth of the securitization industry, the Financial Accounting Standards Board created a name for this unique entity: the variable interest entity (VIE).[38] By separating economic exposure from voting rights through the mechanism of ex-post guarantees, entities could de-consolidate other entities from their balance sheets without losing any of their economic exposure.

In 2003, the Financial Accounting Standards Board introduced an economic substance test to the question of whether a sponsor had to consolidate a securitization vehicle.[39] This functional consolidation test was designed to combat evasion of the old consolidation rules through VIEs.[40] The relevant accounting interpretation, as revised by FIN 46-R, required a reporting entity to identify a "controlling financial interest" based on which party had the majority of expected risks or rewards of an entity, even if that entity did not have traditional control rights.[41] Reporting entities had to consolidate other entities in which they held a controlling financial influence even if they did not have control over the entity as evidenced

[34] *E.g.*, CONSOLIDATION, Acct. Standards Codification § 810-10 (FIN. ACCT. STANDARDS BD. 2018) (codifying the voting interest entity model of consolidation in which a reporting entity consolidates a legal entity when it has a controlling financial interest in the legal entity through its ownership of voting interests).

[35] DELOITTE, *supra* note 33, at 3.

[36] *Id*.

[37] Bratton & Levitin, *Transactional Genealogy*, *supra* note 8 (describing the role of VIEs in Enron's accounting scandal).

[38] FIN 46-R defines a VIE as an entity that meets one of the following criteria:

> 1. The equity investment at risk is not sufficient [for] the entity to finance its activities without additional subordinated financial support . . . . 2. The equity investors lack . . . [the] characteristics of a controlling financial interest . . . . [Or] 3. The equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

CONSOLIDATION OF VARIABLE INTEREST ENTITIES, Interpretation No. 46 of Acct. Rsch. Bull. No. 51 (FIN. ACCT. STANDARDS BD. 2003). The assets in the VIE create variability—for example, mortgage prepayments or defaults lead to variable cash flows—and the variable interests absorb benefits or losses. Variable interests are contractual rights to *absorb* variability in the cash flows received by the entity.

[39] DELOITTE, *supra* note 33, at 3.

[40] *Id.*

[41] *Id.* The evolution of the VIE concept continues under accounting guidelines, but these nuances are outside the scope of this paper.

by voting rights. Many bank-sponsored securitization vehicles are characterized by this unique and innovative VIE organizational structure.[42]

Importantly, however, securitization transactional design abandoned equity securities in form only, not in economic substance. *Someone* still holds the subordinated and residual risks and benefits of a securitization vehicle, even if these rights are not represented by a traditional equity security. Instead, securitization vehicles contract with third parties for the provision of credit and liquidity enhancements. Leading securitization lawyers sometimes speak of these financial instruments as "*de facto* equity" instruments.[43] The instruments include standby letters of credit; representations and warranties committing the sponsor to repurchase distressed assets from the underlying pool at par value; commitments by loan servicers to guarantee payments to the trust even in the event of a default on underlying mortgage loans; credit default swaps; overcollateralization; spread accounts; and surety bonds.[44] Just like equity securities, credit enhancements sit at or near the bottom of the securitization vehicle's capital stack.[45] Just like equity securities, credit enhancements *concentrate* the risks of the securitized assets and make the more senior debt interests *safer*.[46] Just like the holders of equity securities, the providers of credit enhancements are

[42] *See* Nicola Cetorelli & Stavros Peristiani, *The Role of Banks in Asset Securitization*, 18 ECON. POL'Y REV. 1 (discussing the modern bank and its investment strategies surrounding new securitization assets).

[43] JASON H.P. KRAVITT & CHRISTINE VINCENT, SECURITIZATION OF FINANCIAL ASSETS § 2.01 (3d ed. Supp. 2021) (calling "income notes"—the lowest quality and highest credit risk note in a collateralized debt obligation—the "de facto equity" in collateralized debt obligations).

[44] *See generally id.* § 8.02. Credit default swaps are perhaps the most well-known type of credit enhancement, though their *function* in the context of a securitization deal as a credit enhancement is rarely discussed. While a fairly large literature on the role of credit default swaps in the 2007–2009 financial crisis exists, it has largely been overlooked that these instruments are only one type of a broader class of instruments designed to subordinate some investors to more senior investors in securitization deals. For literature on credit default swaps, see generally sources cited *supra* note 16.

[45] KRAVITT & VINCENT, *supra* note 43, § 8.02.

[46] *Id.* §§ 8.01–8.06. The prudential regulators have long understood this concentration risk. For example, a 1997 supervisory notice from the Board's Division of Banking Supervision and Regulation stated that:

> Partial, first loss recourse obligations retained when selling assets, and the extension of partial credit enhancements (e.g., 10 percent letters of credit) can be a source of concentrated credit risk by exposing institutions to the full amount of expected losses on the protected assets. For instance, the credit risk associated with whole loans or pools of assets that are sold to secondary market investors can often be concentrated within the partial, first loss recourse obligations retained by banking organizations selling and securitizing the assets. In these situations, . . . [institutions] generally retain the same credit risk exposure as if they continued to hold the assets on their balance sheets.

DIV. OF BANKING SUPERVISION & REGUL., BD. OF GOVERNORS OF THE FED. RSRV. SYS., SR 97-21 (SUP), RISK MANAGEMENT AND CAPITAL ADEQUACY OF EXPOSURES ARISING FROM SECONDARY MARKET CREDIT ACTIVITIES (1997); *see also* Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations, 66 Fed. Reg. 59613, 59616 (Nov. 29, 2001) (codified at 12 C.F.R. pts. 3, 208, 225, 325, 567) ("The economic substance of a banking organization's credit risk from providing a direct credit substitute can be identical to its credit risk from retaining recourse on assets it has transferred.").

compensated according to the risk they bear: rights to residual payments to the securitization vehicle or high-yield interest payments.[47]

Consider a simple example from the Office of the Comptroller of the Currency's seminal 1987 approval of a securitization program by a national bank in Interpretive Letter Number 388.[48] Under the proposed securitization program, Security Pacific National Bank would originate mortgages and sell them to a securitization vehicle.[49] The vehicle would issue undivided interests in the cash flows received from mortgage payments. Security Pacific National Bank would service the mortgages for a fee. The bank would also provide a limited guaranty to investors of up to ten percent of the value of the securitized assets. This securitization did not issue any equity securities at all. It only issued debt securities. However, Securities Pacific National Bank was the *de facto* equity holder. Through its limited guaranty, the bank would absorb the first ten percent of credit losses on the securitized assets. Like the residual interests in equity securities, the bank received the residual payments that were left after all the senior debt holders were paid out.

B. Shadow Banks as Bank Affiliates

The question of whether an entity constitutes a bank "affiliate" determines if the bank holding company laws will apply to that entity. Relying on traditional notions of ownership structure, the tests to establish "affiliate" status in various banking laws are pinned down by questions of control, and especially control of voting securities. Economic exposure is *not* a controlling consideration. The key feature of a VIE compared to alternative organizational forms like a limited partnership investment fund is the entity-level regulatory treatment. Limited partnership credit funds with traditional equity securities can replicate the entire economic structure of a securitization program, but they cannot replicate the legal treatment of bank-sponsored VIEs.

1. Affiliate Status Under the Bank Holding Company Act

The three tests under the Bank Holding Company Act that determine whether an entity is a bank "affiliate" all turn on questions about control of the potential affiliate.[50] The tests

[47] OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: ASSET SECURITIZATION 19 (1997) (describing securitization structuring where residual payments from the securitized assets are retained by credit enhancement provider, usually the bank sponsor of the securitization vehicle). In the securitization context, phrases like "excess spread" or overcollateralization are often used instead of the phrase "residual returns." *Id.* at 19 ("[The first loss party] typically receives portfolio cash flow after expenses (which include expected losses) in the form of excess spread.").

[48] Off. Of the Comptroller of the Currency, Interpretive Letter No. 388, Selling Mortgage-Backed Pass-Through Certificates 3, 6 No. 4 OCC Q.J. 41 (June 16, 1987).

[49] *Id.*

[50] The first test looks to whether a bank, or an entity that controls the bank or shares a common controller with a bank, directly or indirectly holds the power to vote 25% of any class of voting securities. 12 U.S.C. § 1841(a)(2); 12 C.F.R. § 225.2(e)(1) (2023). The second test looks to whether any one of these banking entities has the power, in any manner, to control the election of a majority of the directors or trustees of a company. *Id.* The third test is the controlling influence test, described in the text. *Id.*; *see also* Control and Divestiture Proceedings, 85 Fed. Reg. 12398, 12399 (Mar. 2, 2020) (describing the three-prong test for control).

determine whether the entity will be subject to the activity restrictions and other restrictions under bank holding company law, including whether the entity will be consolidated for regulatory capital purposes.[51] More specifically, control determinations are often pinned down by ownership or control of *voting securities*. Given a test based on control determinations and not economic exposure, the lesson is clear for securitization transactional designers: separate economic exposure from control (as control is interpreted under relevant banking laws). Variable interest transaction structures fulfill such a task. Securitization vehicles are structured without voting securities, and a trustee is used in place of a board of directors.

The broadest and most uncertain test for "affiliate" status is the "controlling influence" test. Under the controlling influence test, any banking entity that exerts a "controlling influence" may be deemed a bank "affiliate."[52] However, the Board interprets the controlling influence test according to certain presumptions defined in terms of ownership of voting interests.[53] Among other presumptions, a presumption of non-control arises when a banking entity owns less than five percent of another entity's voting securities, even when the banking entity has significant contractual rights, such as customary protective provisions and the ability to remove fund managers.[54]

Consistent with this analysis, market participants generally structure securitization programs to avoid an outcome in which a banking entity holds more than five percent of a securitization vehicle's voting securities. Securitization vehicles usually don't even issue any voting interests, making these tests largely inapplicable. Banking entities exercise control over securitization vehicles in other ways, such as by retaining the right to vote to remove a general partner or manager of an unconsolidated securitization vehicle for cause, which is not considered to be a "voting securities" for purposes of the control test.[55] Consistent with this purpose, market participants have generally taken the view that securitization vehicles are not "affiliates" for purposes of the Bank Holding Company Act, and the Board has not challenged this interpretation.[56]

[51] *See infra* Part III.A.

[52] The third test, the controlling influence test, is the broadest. This test was established by an amendment in 1970. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760, 1761. The test established control whenever the Board determined, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. *Id.* The Board has stated that "a controlling influence embraces pressures and influences, at times subtle, by which a company may be capable of influencing or controlling the affairs of another company." *Legal Developments: Citizens Incorporated*, 66 FED. RSRV. BULL. 907, 908 (1980). The analysis in the "controlling influence" test is a factually intensive, case-by-case analysis. *Id.* The Board's 2020 rule essentially creates safe harbors in the forms of presumptions that remove much of the prior uncertainty from these tests. *See* sources cited *supra* note 50 (collecting the various Federal Reserve Board rules).

[53] Control and Divestiture Proceedings, 85 Fed. Reg. 12398, 12402 (Mar. 2, 2020) (codified at 12 C.F.R. pts. 225, 238). In general, a presumption of non-control arises if an entity owns less than 5% of the entity's voting securities. *Id.*

[54] *Id.*

[55] *Id.* at 12413.

[56] *See, e.g.*, Saule T. Omarova & Tahyar E. Margaret, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 157–58, 158 n.178

2. *Affiliate Status Under the Federal Reserve Act*

The applicability of the affiliate transaction restrictions in the Federal Reserve Act also turns on similar control tests as applied under the Bank Holding Company Act.[57] This test determines whether the securitization vehicle will face restrictions on transactions with the sponsoring banking organization.[58] However, the regulations under the Federal Reserve Act also include a "sponsor and advise" test to determine whether entities are deemed to be bank affiliates. Under this test, any "investment fund" that is advised by a banking entity and in which the banking entity owns five percent or more of such fund's voting securities or similar interest is deemed to be an affiliate of the bank.[59]

Are securitization vehicles bank "affiliates" under this sponsor and advise test? There is no definitive legal authority or even guidance from the Board on this question, and the answer is unclear as a matter of law. In fact, the Board intentionally punted on the question in one of its rulemakings on affiliate status. The Board stated its intention to not apply a *per se* rule on the application of the sponsor and advise test to securitization vehicles.[60] The Board determined that, "[d]ue to the complexities of this issue," it would defer ruling on the status of securitization special purpose entities as "affiliates."[61] The Board has never returned to the matter in formal administrative materials.

In practice, however, market participants, advised by private legal counsel, act as if securitization vehicles are not bank "affiliates" under the Federal Reserve Act, and the Board does not challenge these determinations.[62]

(2011). One exception is that consolidated VIEs may now be considered bank "affiliates." FIN. ACCT. STANDARDS BD., SUMMARY OF INTERPRETATION NO. 46 (2003), https://www.fasb.org/page/PageContent?pageId=/reference-library/superseded-standards/summary-of-interpretation-no-46.html&bcpath=tff [https://perma.cc/4D9J-NFHD]. The Board directly addressed the question of control of VIEs in a 2020 rulemaking. Control and Divestiture Proceedings, 85 Fed. Reg. 12398, 12413. The rule stated that a presumption of control is not established solely based on economic exposure to a VIE. *Id.* at 12409. The rule creates a presumption of control only when accounting rules require consolidation under the VIE standard, which only occurs where a company has a substantial ability to direct the activities of the VIE in addition to significant economic exposure. *Id.* at 12413.

[57] An affiliate under the Federal Reserve Act is "any company that *controls* the member bank and any other company that is controlled by the company that *controls* the member bank." 12 U.S.C. § 371c(b)(1)(A) (emphasis added). Affiliate also includes certain other categories, including any investment fund with respect to which a member bank or affiliate is an investment adviser. 12 U.S.C. § 371c(b)(1)(D); *see also* Omarova, *Unfulfilled Promise*, *supra* note 6.

[58] *See infra* notes 124–26 and accompanying text.

[59] The Board's implementing regulation for sections 23A and 23B, Regulation W, added to the definition of "affiliate" any "investment fund" that is advised by a bank or affiliate thereof and in which the bank or any affiliate owns five percent or more of such fund's voting securities or similar interest. 12 C.F.R. § 223.2(a)(6)(ii) (2023).

[60] KRAVITT & VINCENT, *supra* note 43, § 13.04 (describing the sponsor and advise test).

[61] 67 Fed. Reg. 76559, 76568 (Dec. 12, 2002). The Dodd-Frank Act eliminated the "sponsored and advised" language from the statutory definition of affiliate in section 23A of the Federal Reserve Act. However, the Board has not taken any action to change the sponsor and advise test in its implementing regulations.

[62] For example, a leading treatise on securitization has taken the position that, unless a special purpose entity meets each of the following three conditions, it is not an "affiliate": (1) the special purpose entity receives

C. Shadow Banks as Investment Companies

Why do securitization programs invest primarily in debt securities and often use a trustee structure? This Part shows how these aspects of transactional design are necessary to avoid triggering regulation under the investment company laws.

Virtually all securitization vehicles are "investment companies" under existing interpretations of the general definition in the Investment Company Act of 1940 by the Securities and Exchange Commission (SEC) staff.[63] Securitization programs accept money from investors and are primarily engaged in the business of investing that money on behalf of others. For purposes of the 1940 Act, the SEC staff have interpreted the term "securities" broadly to include many debt assets, including mortgages and other consumer debt assets.[64]

investment and administrative services on a contractual basis from a bank; (2) the special purpose entity's trustees or managers are selected by the bank; *and* (3) the special purpose entity bears a name similar to that of the bank. Accordingly, securitization vehicles do not adopt names similar to their sponsoring banks, avoiding the risk that they might be deemed "affiliates" under the Federal Reserve Act. KRAVITT & VINCENT, *supra* note 43, § 13.04; *see also* Omarova, *Unfulfilled Promise*, *supra* note 6, at 1708–13 (observing that many collateralized debt obligations and other mortgage-backed security structures were not considered "affiliates" of Citibank and accordingly were not subject to the limitations of section 23A).

[63] Exclusion From the Definition of Investment Company for Structured Financings, 57 Fed. Reg. 56248 (Nov. 27, 1992) (stating that "[s]tructured financings fall within the definition of investment company under section 3(a)"). Sections 3(a)(1)(A) and 3(a)(1)(C) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3(a)(1), set forth separate tests to determine investment company status. The former test asks whether an entity is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. The latter test, the 40% investment securities test, asks whether an entity that is engaged in, or proposes to engage in, the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of its total assets. Some securitization vehicles, including issuers of simple mortgage-backed securities, were able to rely on an exemption in section 3(c)(1) or 3(c)(5) of the Investment Company Act, but many others could not do so, largely depending on the nature of the assets securitized.

[64] Section 2(a)(36) of the Investment Company Act of 1940 defines "security" to mean, unless the context otherwise requires, any note or stock, among other items in a laundry list of financial instruments. 15 U.S.C. § 80a-2(a)(36). The SEC staff has taken the position that the proviso "unless the context otherwise requires" in the definition of "security" under the Investment Company Act of 1940 requires that the definition of "security" is interpreted to be broader than the definition of "security" in the Securities Act of 1933 and in the Securities and Exchange Act of 1940. *See, e.g.*, Harrell Int'l Inc., SEC No-Action Letter, 1989 WL 246259 (May 24, 1989) (finding a commercial note to be a security under the 1940 Act even if it was not a security for purposes of the 1933 or the 1934 Acts). The staff has stated that "for purposes of the 1940 Act (that is, the regulation of a pool of portfolio securities), it makes no difference that the securities are commercial instruments except as otherwise specifically provided in the 1940 Act." Bank of America Canada, SEC No-Action Letter, 1983 WL 29858 (July 25, 1983) (taking the position that notes evidencing loans are securities under the 1940 Act even if they are not securities under the 1933 or 1934 Acts). In this letter, the staff pointed to several provisions of the 1940 Act that suggest that short-term paper is a security under the 1940 Act, even though it is defined in the Act as having a "commercial rather than an investment character." *Id.* In evaluating whether an instrument is a "security," the Securities and Exchange Commission staff has focused on whether the instrument was acquired and held for investment or for commercial purposes and whether the investors in a company or pool holding those instruments bear a meaningful investment risk that requires the protections of the 1940 Act. These positions are consistent with the Supreme Court's interpretation of "security" for the purposes of the Securities Act of 1933 to the extent that the *Reves* test looks, in part, at the motivation of both the buyer and the seller of the note. Reves v. Ernst &

There is no doubt that securitization vehicles are structured to avoid regulation under the Investment Company Act of 1940. This point is easily established by observing that all securitization deals require a legal opinion stating the view that the vehicle is not an "investment company" subject to the requirements of the Act. It is routinely acknowledged by regulators and market participants alike that structured financings cannot operate under the Investment Company Act's requirements.[65]

To avoid investment company regulation, securitization vehicles rely on one of the asset-based exemptions from the definition of "investment company." For many securitization vehicles, especially the most complex and risky ones, this exemption is Investment Company Act Rule 3a-7.[66] This rule exempts virtually all securitization vehicles from the definition of "investment company.

The conditions necessary to receive an exemption from the Investment Company Act, thus, indirectly regulate the securitization industry by establishing the rules under which securitization programs can operate. To qualify for the exemption in Rule 3a-7, the issuer must primarily issue securities that entitle their holders to receive payments that depend primarily on the cash flow of debt assets; not make a public offering of non-investment grade securities; and deposit assets not needed for operational purposes with a trustee.[67] Anyone who is familiar with securitization can recognize that the securitization industry is characterized by these restrictions in important respects.

II. Traditional Banks Owned, Controlled, and Backstopped Shadow Banks in 2008

This Part sets forth data showing that the securitization industry was largely an instrument of the traditional banking sector before and during the 2007–2009 financial crisis.

A. Ownership Interests in Securitization Vehicles by Banking Entities: Evidence from Financial Statements and Federal Reserve Board Data

1. Unconsolidated Variable Interest Entities

Generally, banking entities designed their sponsored securitization vehicles to avoid the need to consolidate them from an accounting perspective. Once the Financial

Young, 494 U.S. 56, 66–67 (1990). An argument in favor of this position is that a contrary interpretation that did not deem mortgages and receivables to constitute "securities" would make the statutory exemptions provided by Congress in section 3(c)(5) irrelevant. *See infra* note 163.

[65] Exclusion from the Definition of Investment Company for Structured Financings, 57 Fed. Reg. 56248, 56248 (Nov. 27, 1992); *see also* KRAVITT & VINCENT, *supra* note 43, § 12.01 ("It would be impractical for an issuer in a typical securitization transaction to comply with the provisions of the 1940 Act.").

[66] 17 C.F.R. § 270.3a-7 (2023). This rule is discussed further *infra* Part III.D.

[67] *Id.*

Accounting Standards Board passed FIN 46-R in 2004,[68] this outcome became more difficult. Nevertheless, a critical wrinkle in the FIN 46-R consolidation test was that the test analyzed economic exposures under assumptions of *expected* losses and residual returns.[69] This permitted entities to own economic exposures to *unexpected* losses and residual returns without necessarily requiring consolidation. As Citigroup put it in its 2008 third quarter 10-Q, "[c]ertain variable interests may absorb significant amounts of losses or residual returns contractually, but if those scenarios are considered very unlikely to occur, they may not lead to consolidation of the VIE."[70]

The market response to FIN 46-R was to sell a controlling stake in an expected loss tranche to nonbank third parties, often hedge funds.[71] This enabled securitization sponsors to maintain significant exposures to residual and subordinated risks and returns while still ensuring that a third party consolidated the VIE or that no one had to consolidate the VIE at all.[72] Where debt assets had predictable and low historical rates of losses, like in the case of many mortgage-backed securities, the size of the expected loss tranche that needed to be sold to avoid consolidation was often trivial.[73]

Table 1 presents data about exposures to unconsolidated VIEs from the financial statements of the four largest banking organizations as of the third quarter of 2008. It shows that the four largest bank holding companies had loss exposures of almost $250 billion to unconsolidated VIEs that supported about $540 billion of assets at the end of the third quarter of 2008, exposed to total losses representing 59% of the capital stack of unconsolidated VIEs in the aggregate.[74] Many of these VIEs were actively managed investment vehicles with a banking entity acting as investment advisor and manager.[75] The

[68] CONSOLIDATION OF VARIABLE INTEREST ENTITIES, Fin. Acct. Standards Bd. Interpretation No. 46 (FIN. ACCT. STANDARDS BD. 2004).

[69] *Id.*

[70] Citigroup Inc., Quarterly Report (Form 10-Q) 63 (Oct. 31, 2008).

[71] ROBERT L. TORTORIELLO, DEREK M. BUSH & HUGH C. CONROY, JR., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES § V-16 (21st ed. 2016) (describing "common approaches to conduit restructurings" after FIN-46, including consolidations, sales of expected loss tranches, and establishments of joint ventures where no party would be the primary economic beneficiary).

[72] *See, e.g.*, Citigroup Inc., Quarterly Report (Form 10-Q) 72 (Nov. 5, 2007) ("To comply with FIN 46-R, many of the conduits issued 'first loss' subordinated notes such that one third-party investor in each conduit would be deemed the primary beneficiary and would consolidate the conduit.").

[73] Consider one example from Citigroup's 10-Q from the third quarter of 2008. Citigroup Inc., *supra* note 70. Citigroup describes administering several unconsolidated multi-seller conduits that held $63 billion in assets in total. *Id.* at 64. An asset-backed commercial paper conduit is a securitization vehicle that holds debt securities and issues short-term debt, typically with maturities of less than 45 days. *Id.* at 67. Citigroup monitored these conduits like an investment fund manager, selecting and structuring the financial assets purchased by the conduit. *Id.* at 67. The subordinate loss notes and equity had a notional amount of only $81 million compared to total assets of $63.5 billion held by the conduits. *Id.* at 64, 67.

[74] As in the case of consolidated VIEs, the financial statements of bank holding companies clarify that the unconsolidated VIEs at issue are primarily securitization vehicles.

[75] Citigroup Inc., *supra* note 70, at 67:

> As administrator to the conduits, the Company is responsible for the selection and structuring of assets purchased or financed by the conduits, making decisions regarding the funding of the conduits,

exposures to loss reported in Table 1 do not differentiate between exposure to senior interests in a VIE and subordinated interests. However, descriptions of exposures to unconsolidated VIEs show that at least some significant portion of this reported exposure involved subordinated exposures. For example, only 1% of Citigroup's exposures to collateralized loan obligations in the third quarter of 2008 were to securities rated A or higher and almost a quarter of the exposure was to unrated interests.[76]

Table 1. Data from Financial Statements on Exposures to Unconsolidated VIEs[77]

Bank Holding Company	Total Assets: Unconsolidated VIEs ($ billions)	Maximum Exposure to Loss: Unconsolidated VIEs ($ billions)
Citigroup[78]	324.3	130.8
JPMorgan[79]	43.1	60.8
Bank of America[80]	40.0	52.0
Wells Fargo[81]	8.0	2.8
Combined Amount	415.4	243.6

Citigroup had the highest exposure to unconsolidated VIEs, followed by Bank of America and JPMorgan. Also, as in the case of consolidated VIEs, Wells Fargo had minimal exposure to unconsolidated VIEs.[82]

Using data collected from periodic reports filed with the SEC, a time series figure of Citigroup's maximum exposure to loss in unconsolidated VIEs is presented in Figure 2. Other large banking entities had similar trends. Like Citigroup, exposure to loss in unconsolidated VIEs tended to peak around the third quarter of 2007. JPMorgan Chase's

including determining the tenor and other features of the commercial paper issued, monitoring the quality and performance of the conduits' assets, and facilitating the operations and cash flows of the conduits.

[76] *Id.* at 70.

[77] Table 1 presents data from unaudited financial statements in SEC filings on the total assets in consolidated VIEs and the total assets and each entity's maximum exposure to loss in unconsolidated VIEs for the four largest bank holding companies in the United States. Dollar amounts in billions.

[78] Citigroup Inc., *supra* note 70, at 116–17.

[79] JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 131 (Nov. 7, 2008). JPMorgan Chase & Co.'s maximum exposure to loss exceeds the total assets in unconsolidated VIEs by $17.7 billion. The difference appears to emerge from unfunded commitments to provide credit to clients of JPMorgan Chase & Co. that participate in the unconsolidated VIEs.

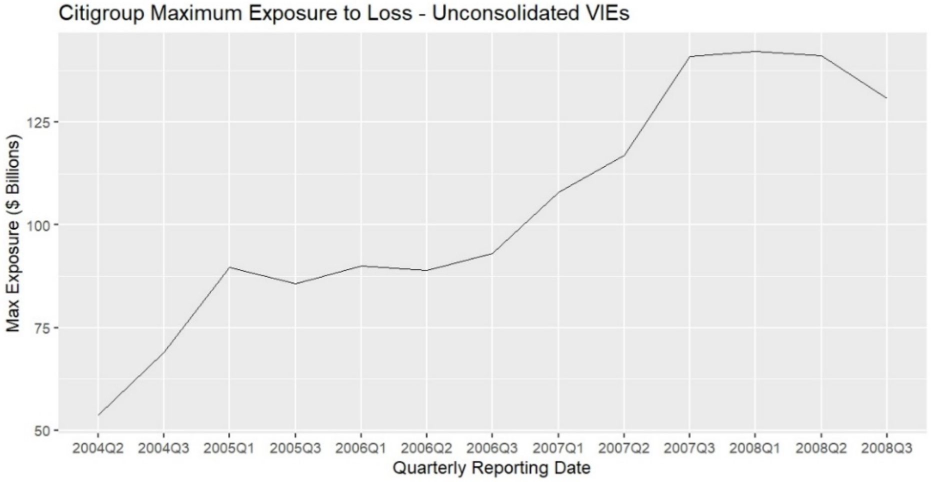
[80] Bank of Am. Corp., Quarterly Report (Form 10-Q) 27 (Nov. 6, 2008). Bank of America's financial statements do not explain why the maximum exposure to loss in unconsolidated VIEs exceeds the total amount of assets in those VIEs. These numbers may reflect the fact that the assets in the VIEs had already been written down, but Bank of America had not yet completed its commitments to provide credit support or otherwise realized a charge as an accounting matter.

[81] Wells Fargo & Co., Quarterly Report (Form 10-Q) 53 (Oct. 30, 2008).

[82] *See also* Arthur E. Wilmarth, Jr. *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 99–101 (2014) (describing off-balance sheet exposures of Citigroup to CDOs).

exposure to loss increased 58% from the first quarter of 2006 to the third quarter of 2007, from $61 billion to $96 billion. Bank of America's exposure to loss jumped 155%, from $28 billion to $71 billion. Wells Fargo had de minimis exposure to consolidated VIEs.

Figure 2. Time Series Figure of Citigroup's Maximum Exposure to Loss in Unconsolidated VIES[83]



2. *Puts to Asset-Backed Commercial Paper Conduits*

This Part focuses on the design features of bank-sponsored asset-backed commercial paper conduits. According to some accounts, these vehicles played a central role during the 2007–2009 financial crisis.[84]

Because FIN 46-R keyed consolidation determinations to holders of *expected losses*,[85] a banking entity could hold (or write) out-of-the-money options on the residual and subordinated cash flows of an entity without necessarily compelling a consolidation conclusion. This Part presents evidence showing that banking entities actually engaged in this investment strategy by writing out-of-the-money put options on asset-backed commercial paper conduits.[86] Others have already documented that banking entities used

[83] Figure 2 reports the maximum exposure to loss in unconsolidated VIEs in billions of dollars reported by Citigroup in its quarterly filings with the SEC.

[84] *See, e.g.*, Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007–2009*, 24 J. ECON. PERSPS. 29, 29 (2010) (describing the role of asset-backed commercial paper conduits in the financial crisis).

[85] CONSOLIDATION OF VARIABLE INTEREST ENTITIES, Fin. Acct. Standards Bd. Interpretation No. 46 (FIN. ACCT. STANDARDS BD. 2004).

[86] To be sure, these banking organizations had co-investors in credit enhancements—primarily risk-seeking hedge funds and financial guarantors—like American Insurance Group, which needed its own bailout involving more than $182 billion in financial assistance. William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. &

liquidity facilities to maintain exposure to asset-backed commercial paper conduits.[87] The contribution of this Part is to confirm this result with a previously unused regulatory data source and to show precisely how this practice exploited accounting and regulatory frameworks.

The most important economic feature of asset-backed commercial paper conduits for investors and the rating agencies was the liquidity facilities provided by their sponsors.[88] The facilities required the provider of the facility to step in if commercial paper investors refused to maintain their investment by rolling over their short-term paper when it matured. The facility provider would be required to purchase impaired assets from the conduit or purchase the commercial paper directly. In short, commercial paper investors effectively had the option to dump their paper on the facility provider and redeem it for par value. This put option embedded in the commercial paper is what made it possible for AAA-rated investors to purchase what was effectively a risk-free bond in asset-backed commercial paper conduits, even ones that held substantial amounts of subprime mortgages and toxic mortgage-backed securities.[89]

The clever design of asset-backed commercial paper conduits from a regulatory arbitrage perspective is how they managed to issue what were redeemable securities in substance while still avoiding regulation as investment companies. Most of these conduits relied on the exemption in Rule 3a-7 to avoid investment company regulation. A condition of reliance on this rule is that the issuer may not issue "redeemable securities . . ."[90] A simple way to comply with this restriction while still effectively giving investors some of the comfort provided by a redeemable security is to issue commercial paper with a very short maturity combined with a third-party guarantee by a banking entity.

According to self-reported data to the Board, bank holding companies reported unused liquidity commitments to asset-backed commercial paper conduits in excess of $300 billion as of September 30, 2008.[91] On top of this liquidity support, banking entities provided at

LEE L. REV. 943, 945 (2009)*; see generally* Steven L. Schwarcz, *Regulating Financial Guarantors*, 11 HARV. BUS. L. REV. 159, 159–92 (2021) (arguing that financial guarantors suffered from a cognitive defect he calls "abstraction bias" in which guarantors underweighted risks because of the complexity and contingent nature of credit enhancements).

[87] The descriptive statistics on credit enhancements I report are largely consistent with the results reported by Acharya, Schnabl & Suarez, *supra* note 10. Bank credit enhancements to securitization vehicles are also discussed in Benjamin H. Mandel, Donald Morgan & Chenyang Wei, *The Role of Bank Credit Enhancements in Securitization*, ECON. POL'Y REV., July 2012, at 35, 44.

[88] ZOLTAN POZSAR ET AL., FED. RSRV. BANK OF N.Y. STAFF REP., NO. 458, SHADOW BANKING 21 (2012) (describing private credit risk repositories that provided credit put options to securitization vehicles).

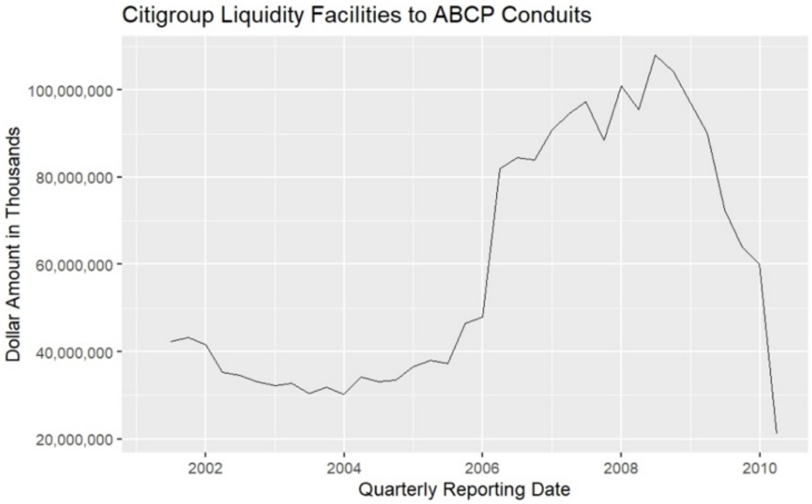
[89] Federal Deposit Insurance Corporation Risk-Based Capital Guidelines, 69 Fed. Reg. 44908, 44908–09 (proposed July 28, 2004) (codified at 12 C.F.R. pt. 208; 225).

[90] 15 U.S.C. §§ 80a-2(a)(32), 3(c)(5). This restriction also applies to entities relying on section 3(c)(5).

[91] Schedule HC-S of Form FR Y-9C requires bank holding companies to report at a consolidated level the aggregate amounts of unused liquidity commitments and credit enhancements to asset-backed commercial paper conduits. The instructions to Form FR Y-9C state that, typically, such liquidity commitments take the form of a loan agreement providing backstop liquidity to the conduit *or* an asset purchase agreement with the conduit. The backstop line functions like a letter of credit in which the bank holding company advances funds to the conduit when a draw is required, and the funds are secured by the cash flows of the securitized assets. Under the asset

least $20 billion in credit enhancements to asset-backed commercial paper conduits.[92] In addition to Citigroup, JPMorgan Chase & Co., and Bank of America, the other bank holding companies that reported at least $1 billion in unused liquidity enhancements to asset-backed commercial paper conduits at the same time included Wachovia, Taunus Corporation (Deutsche Bank), HSBC North America Holdings, PNC Financial Services Group, and Zions Bancorporation.

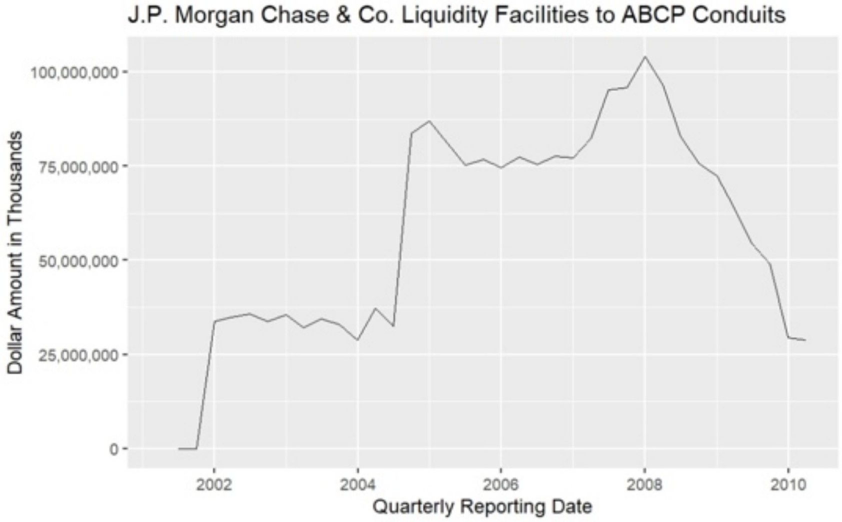
Figure 3. Times Series Figures of Liquidity Enhancements to Asset-Backed Commercial Paper Conduits at the Bank Holding Company Level by Citigroup, JPMorgan Chase & Co., and Bank of America Corporation[93]



purchase agreement, the reporting institution has to purchase a specific pool of assets from the conduit when a draw is required under the liquidity facility, usually following indications of deterioration in the quality of the securitized assets. *See, e.g.*, Federal Deposit Insurance Corporation Risk-Based Capital Guidelines, *supra* note 89, at 44910 ("For example, an ABCP program may require a liquidity facility to purchase assets from the program at the first sign of deterioration in the credit quality of an asset pool, thereby removing such assets from the program.").

[92] Mandel, Morgan & Wei, *supra* note 87, at 38.

[93] The y-axis reports the dollar amount in thousands of liquidity facilities provided by the specified bank holding company to asset-backed commercial paper conduits. The x-axis contains quarterly reporting dates.



In each figure reported in Figure 3, a sharp increase in the exposure of the relevant bank holding company is observed starting in the second half of 2007. Between the end of 2006 and the end of 2007, liquidity facilities provided by Citigroup, Bank of America, and JPMorgan Chase to asset-backed commercial paper conduits increased by about $18 billion, $35 billion, and $27 billion, respectively.

After the panic peaked around the third quarter of 2008 when Lehman Brothers declared bankruptcy, Citigroup's unused commitments to purchase liquidity to asset-backed commercial paper conduits plunged from a high of $108 billion at the end of 2008 to $20 billion at the end of the first quarter of 2010. Bank of America's unused liquidity commitments to asset-backed commercial paper conduits dropped from $69 billion to $4 billion and JPMorgan Chase & Co.'s unused liquidity commitments fell from $83 billion to $29 billion over the same time period.

These liquidity guarantees from banking entities covered a substantial amount of asset-backed commercial paper outstanding at the height of the financial crisis.[94] Matching the data on subordinated exposures self-reported by banking entities to the Board with the transaction-level data presented by Professor Acharya and co-authors show that banking entities guaranteed most of the asset-backed commercial paper from the conduits they

[94] The analysis only covers sponsorship by U.S. banking organizations. Acharya, Schnabl & Suarez provide evidence that foreign banking organizations also sponsored asset-backed commercial paper conduits and extended liquidity puts to those conduits. Acharya, Schnabl & Suarez, *supra* note 10, at 522 tbl.1.

sponsored through subordinated liquidity facilities.[95] Moreover, commercial bank-sponsored asset-backed commercial paper dominated the whole market.[96]

The exposures of banking entities to asset-backed commercial paper conduits were of particular concern during the 2007–2009 financial crises because they were exposed to some of the most toxic assets.[97] The actively managed structures that caused some of the greatest concern during the 2007–2009 financial crisis—market value collateralized debt obligations and structured investment vehicles—issued asset-backed commercial paper.[98]

Another concern with asset-backed commercial paper conduits is that they engaged in cross-purchases of other conduits and securitization vehicles. Through a cross-purchase, a collateralized debt obligation or structured investment vehicle would purchase subordinated debt securities from other asset-backed issuers. These vehicles were not directly backed by debt assets like mortgages or car loans but, rather, by bonds and subordinated debt from other asset-backed issuers. These cross-purchases of securities have been called "pyramiding" in other contexts, and a discussion of them is returned to in the section on the Investment Company Act of 1940.[99]

Cross-purchases contributed to at least two problems during the financial crisis. First, cross purchases distorted market pricing of asset-backed securities by removing an external market check from deal-making. According to the Financial Crisis Inquiry Commission,

[95] *Id.* at 522 tbl.1 (showing outstanding asset-backed commercial paper of $92.7 billion, $45.7 billion, and $42.7 billion for conduits sponsored by Citigroup, Bank of America, and JPMorgan, respectively).

[96] *Id.*at 531 tbl.8 (showing that commercial banks sponsor more than $1 trillion of the outstanding asset-backed commercial paper as of July 1, 2007, compared to around $360 billion sponsored by structured finance, mortgage lenders, or other sponsors in the aggregate).

[97] In one example of the types of assets held by collateralized debt obligations, an Office of the Comptroller of the Currency report describing one of Citigroup's collateralized debt obligations stated that:

> Subprime ABS exposure in these positions was generally around 70%, with a typical split of 40% in ABS bonds and 30% in ABS CDOs. Around 15% of the collateral was the riskiest 06/07 vintages through either bonds or CDOs holdings, with some variation across deals in amount of ABS and 06/07.

Letter from Michael Sullivan, RAD and Ron Franke, NBE, to John Lyons, Examiner-in-Charge, Citibank, N.A., (Jan. 17, 2008), https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-01-17_OCC_Letter_from_Michael_Sullivan_and_Ron_Frake_to_John_Lyons_Re_Subprime_CDO_Valuation_and_Oversight_Review_Conculsion_Memorandum.pdf [https://perma.cc/7CWD-3F2B].

[98] Market value collateralized debt obligations were periodically marked-to-market and the portfolio manager had to use these values to comply with certain asset coverage requirements. Structured investment vehicles were special purpose entities designed to profit from the spread between incoming cash flows from the principal and interest payments on the assets in the vehicles and the interest payable on the commercial paper issued by the vehicle. A key feature of many of the market value collateralized debt obligations and structured investment vehicles that experienced stress in the financial crisis is that they initially did not include liquidity facilities covering 100% of the outstanding asset-backed commercial paper. These entities had standby lines of credit, but these lines did not cover the full amounts of commercial paper outstanding. This created a vulnerability—if all investors refused to roll over their commercial paper at once, the securitization vehicles would not have enough cash to buy out investors.

[99] *See, e.g.*, Alfred Jaretzki Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 325 (1941) (describing the Investment Company Act as "put[ting] an end to future pyramiding of investment companies with their attendant evils," including, among other evils, "the possibility of excessive volatility in the securities of the top company through pyramiding leverage upon leverage . . . ."). *See infra* note 132 and accompanying text.

when securitization sponsors increasingly found it hard to sell tranches of securitization vehicles rated less than AAA, the solution was to "create the investor."[100] Securitization sponsors sold the subordinated tranches of the asset-backed securitization vehicles they sponsored to new collateralized debt obligation investment vehicles that they also created and controlled.[101] The collateralized debt obligations, in turn, would issue new asset-backed securities with their own waterfall structure.[102] In some cases, other collateralized debt obligations would purchase the subordinated tranches of the first collateralized debt obligation.[103]

The second concern with cross-purchases is that they were used to "leverage up" the securitized financing industry, increasing the aggregate leverage of investment companies and creating systemic risks.[104] By employing levered money to pay in the capital of securitization vehicles that are already levered, cross-purchases concentrate risk and return even farther down a securitized financing chain, creating leverage and information frictions with each step in the chain.

3. Contingent Consolidation Events

Accounting rules related to VIEs require reporting entities to reconsider whether they need to reconsolidate VIEs upon certain reconsolidation events. If banking entities were writing out-of-the-money put options on securitization vehicles, one prediction is that we should have observed banking entities consolidating securitized assets or entire vehicles when credit quality deteriorated in 2007 and 2008. That is exactly what was observed.

In a 10-Q filing with the SEC, Citigroup disclosed that it had purchased all of the outstanding commercial paper issued by a collateralized debt obligation investment vehicle that Citigroup sponsored and administered—$25 billion worth of commercial paper during the second half of 2007.[105] When investors refused to roll over the collateralized debt obligation's debt because they viewed it as too risky, Citigroup stepped in and brought all the risk onto its books.[106] Citigroup's purchases meant that $25 billion of potentially toxic assets were taken off the books of capital markets investors and onto the books of Citigroup, one of the largest bank-holding companies with access to the federal safety net for banking organizations. Citigroup wrote off more than $5 billion in pretax losses from these assets.[107]

These commercial paper purchases by Citigroup from the collateralized debt obligation that it sponsored and administered were made in connection with contractual

[100] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011).

[101] *Id.*

[102] *Id.*

[103] *Id.*

[104] TOBIAS ADRIAN & HYUN SONG SHIN, FED. RSRV. BANK OF N.Y. STAFF REP. NO. 382, THE SHADOW BANKING SYSTEM: IMPLICATIONS FOR FINANCIAL REGULATION (2009).

[105] Citigroup Inc., *supra* note 70, at 70.

[106] *Id.*

[107] *Id.*

commitments of Citigroup tied to the credit quality of the assets underlying the collateralized debt obligation. Citigroup disclosed that it purchased the commercial paper "[t]o pre-empt the formal exercise of liquidity puts provided by [Citigroup entities] to its CDO structures . . . ."[108] Citigroup described the contingent consolidation of these asset-backed commercial paper conduits:

> Because of these purchases [of commercial paper], which are deemed to be FIN 46-R reconsideration events, and because the value of the CDOs' commercial paper and subordinated tranches were deteriorating as the underlying collateral of the CDOs (primarily residential mortgage-backed securities) was being downgraded, the Company concluded that it was the primary beneficiary of these entities and began consolidating them in the fourth quarter of 2007.[109]

In a separate incident in the fourth quarter of 2007, Citigroup reported that it became the "primary beneficiary" of structured investment vehicles with $58.5 billion in assets after committing to backstop these vehicles following a "ratings review for a possible downgrade announced by two rating agencies of the outstanding senior debt of the [structured investment vehicles]."[110] Due to its new commitments, Citigroup had to consolidate these vehicles containing $58.5 billion on its balance sheet.[111]

In still another incident, Citigroup also reported that it purchased other interests from collateralized debt obligations in the third quarter of 2008.[112] After the purchases, Citigroup was required to consolidate the collateralized debt obligations with assets of $9.3 billion in its financial statements, resulting in a $4.5 billion book loss.[113]

All of these managed investment vehicles had always been backstopped by Citigroup, but accounting rules did not require Citigroup to actually consolidate the investment vehicle until credit losses to the underlying assets actually occurred.

The story looked similar for other large commercial banks. In the third quarter of 2007, Wachovia was one of the five largest banking organizations in the United States. Wachovia disclosed that:

> In the third quarter of 2007, as a result of the fixed income market disruption, [Wachovia] purchased certain . . . . commercial paper [from a structured lending vehicle administered by Wachovia] and disposed of certain variable interests in connection with the sale of assets . . . . As a result, a conclusion was reached that [Wachovia] is the primary beneficiary, and accordingly, [Wachovia] consolidated the [structured lending vehicle] as of September 30, 2007, adding $4.9 billion of assets to the consolidated balance sheet.[114]

[108] *Id.*

[109] *Id.*

[110] Citigroup Inc., Annual Report (Form 10-K) 94 (Feb. 2, 2008).

[111] *Id.*

[112] *Id.* at 71.

[113] *Id.*

[114] Wachovia Corp., Quarterly Report (Form 10-Q) Exhibit 19, at 80 (Nov. 9, 2007).

Separately, in the fourth quarter of 2007, Wachovia purchased $656 million of residential subprime mortgage assets from one of its asset-backed commercial paper conduits pursuant to its obligations under a liquidity facility, leaving Wachovia with maximum exposure to loss of $26.1 billion remaining even after the purchases.[115] Also in 2007, Wachovia purchased $798 million of assets from other securitization vehicles under similar contractual commitments pursuant to a liquidity facility with $11.5 billion notion of written put options remaining outstanding.[116] Finally, Wachovia purchased $1.6 billion in assets in connection with its liquidity commitments to third party conduits and other securitization deals with notional outstanding of $10.8 billion under the commitments.[117] In each case, the liquidity facilities at issue required Wachovia to purchase assets from conduits at par value plus interest when outside investors were unwilling the buy the conduit's commercial paper.[118] Even after removing billions of dollars of troubled assets from these securitization vehicles, Wachovia still reported maximum exposures to loss of $26 billion in exposures to its self-sponsored asset-backed commercial paper conduit and $7.3 billion to third party securitization vehicles that issued commercial paper.[119] Wachovia only had $43.5 billion of Tier 1 capital at the time.[120] The next year, Wachovia failed. Wachovia initially agreed to sell itself to Citigroup at the first-sale $1 per share in a deal subsidized by the Federal Deposit Insurance Corporation which would cap Citigroup's losses.[121] Ultimately, Wells Fargo acquired Wachovia at a slightly higher price.[122]

Other banking entities wrote similar out-of-the-money put options on collateralized debt obligations, structured investment vehicles, and other asset-backed commercial paper conduits.[123]

In each case, a commercial banking entity purchased billions of dollars in distressed assets from an investment vehicle holding securitized assets and issuing commercial paper. In each case, the purchases were made pursuant to pre-arranged contractual commitments under liquidity facilities and other credit enhancement commitments.

4. *Consolidated Variable Interest Entities*

Table 2 reports data from financial statements of the four largest U.S. banking organizations in SEC filings on consolidated VIEs. Data is presented as of the end of the

[115] Wachovia Corp., Annual Report (Form 10-K) Exhibit 13, at 37 (Feb. 28, 2008).

[116] *Id.*

[117] *Id.*

[118] *Id.*

[119] *Id.* at 92.

[120] Wachovia Corp., *supra* note 114, at 64.

[121] Eric Dash & Ben White, *Wells Fargo Swoops in*, N.Y. TIMES (Oct. 3, 2008), https://www.nytimes.com/2008/10/04/business/04bank.html [https://perma.cc/35BS-DJFE].

[122] *Id.*

[123] As a final example, Bank of America reported in the third quarter of 2008 the acquisition of almost $5 billion in assets in connection with liquidity support to collateralized debt obligation vehicles. Bank of Am. Corp., Quarterly Report (Form 10-Q) 27 (Oct. 31, 2008). Bank of America wrote-off $3 billion in assets from collateralized debt obligations that quarter. Reuters, *Bank of America Sees $3 Billion Debt Write-Down*, REUTERS (Nov. 13, 2007), https://www.reuters.com/article/us-bankofamerica-writedowns-idUSWEN253120071113 [https://perma.cc/4C9U-3TD2].

third quarter of 2008 because of its proximity to the failure of Lehman Brothers, which is commonly understood as a moment of severe financial stress. At least some of these consolidated entities were managed investment vehicles.[124]

Table 2. Total Assets in Consolidated VIEs for Four Largest Bank Holding Companies in the United States[125]

Bank Holding Company	**Total Assets: Consolidated VIEs ($ billions)**
Citigroup	81.8[126]
JPMorgan	18.2[127]
Bank of America	30.6[128]
Wells Fargo	4.3[129]
Combined Amount	134.4

The data in Table 2 shows that the four largest bank holding companies had determined that they held a controlling financial interest in VIEs with assets of more than $134 billion just as the financial crisis was peaking. Recall that accounting rules only require consolidation of VIEs for the entity that possesses a "controlling financial interest."[130] By accounting definition, sponsors held, at a minimum, the majority of the expected risks and returns of the securitization vehicles. Generally, the banking entity sponsor of these consolidated vehicles earned a spread between the interest rate the vehicle had to pay to more senior investors and the interest rate paid by mortgage or other debt borrowers. The banking entity sponsor also accepted the risk of residual losses if cash flows from the underlying assets were less than expected.

Not included in Table 2 are banking entity exposures to other securitization vehicles that they would have had to consolidate but for an exception to consolidation. If structured as a "qualified special purpose entity," the banking entity sponsor could absorb all the

[124] Bank of Am. Corp., *supra* note 123, at 29 ("Other consolidated VIEs at September 30, 2008 and December 31, 2007 consisted primarily of securitization vehicles, including . . . managed investment vehicles that invest in financial assets, primarily debt securities.").

[125] Table 2 presents data from unaudited financial statements in SEC filings on the total assets in consolidated VIEs and the total assets and each entity's maximum exposure to loss (in billions of dollars) in unconsolidated VIEs for the four largest bank holding companies in the United States.

[126] Citigroup Inc., *supra* note 70, at 118.

[127] JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 135 (Nov. 7, 2008).

[128] Bank of Am. Corp., *supra* note 123, at 27.

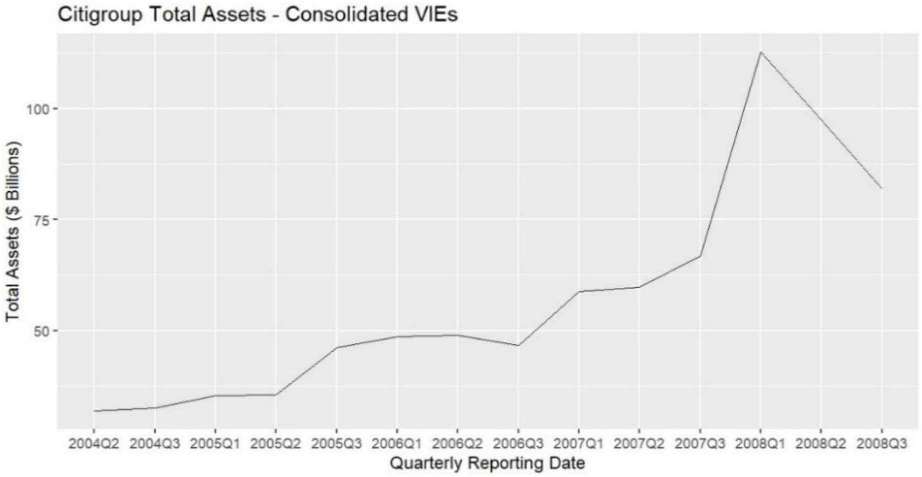
[129] Wells Fargo & Co., Quarterly Report (Form 10-Q) 53 (Oct. 30, 2008).

[130] For a discussion of the "controlling financial interest" standard, see *supra* note 41 and accompanying text; *see also* Bank of Am. Corp., *supra* note 123, at 27 ("[Bank of America Corporation] consolidates VIEs when it is the primary beneficiary that will absorb the majority of the expected losses or expected residual returns of the VIEs or both.").

subordinated risk and rewards without having to consolidate the vehicle.[131] To qualify, a vehicle could not have active management of its underlying assets, among other requirements.[132] Banking entities reported hundreds of billions of dollars of exposures to qualified special purpose entities in 2007 and 2008. Wells Fargo, for example, reported $1.5 trillion of assets in qualified special purpose entities in the fourth quarter of 2008.[133]

As the financial crisis developed from 2007 to 2008, the amount of VIE assets consolidated by banking entities increased, peaking at the end of 2007 and the beginning of 2008. As an example of the time series trend, Figure 4 presents descriptive statistics for the total assets in VIEs consolidated by Citigroup.

Figure 4. Total Assets in Consolidated VIEs by Citigroup[134]



The magnitude of consolidated assets across time was significant. Consolidation of VIEs by Citigroup nearly doubled between the end of 2006 and the beginning of 2008, right as the "runs" on asset-backed commercial paper conduits were occurring.[135] Citigroup had determined that it was the primary beneficiary of VIEs holding more than

[131] *See, e.g.*, JPMorgan Chase & Co., Annual Report (Form 10-K) 108 (Feb. 29, 2008) (stating that entities that meet the criteria for a qualified special purpose entity are not consolidated by a transferor when the transferor does not have the unilateral ability to liquidate or to cause the entity to no longer meet the QSPE criteria).

[132] *Id.*

[133] Wells Fargo Corp., Annual Report (Form 10-K) exhibit 13, 56 tbl.11 (Feb. 26, 2009).

[134] Figure 4 reports the total assets in consolidated VIEs (in billions of dollars) reported by Citigroup in its quarterly filings with the SEC.

[135] JPMorgan, on the other hand, appeared to begin a process of unwinding its consolidated VIEs at the beginning of 2006. The total assets in JPMorgan's consolidated VIEs peaked at $55 billion in the first quarter of 2006 and steadily declined to around $19 billion by the end of the third quarter of 2008. JPMorgan Chase & Co., *supra* note 131, at 135. Wells Fargo never really got into significant involvement with VIEs. Wells Fargo reported total assets of less than $7 billion in consolidated VIEs in all reporting periods collected. Wells Fargo & Co., *supra* note 129, at 53.

$110 billion in assets around the beginning of 2008, declining to around $81 billion by the third quarter of 2008.[136] Bank of America's exposure to consolidated VIEs tells a similar story. Total assets in Bank of America's consolidated VIEs increased more than 450% between the first quarter of 2006 and the fourth quarter of 2007, increasing from $8 billion to $36 billion.[137] Based on its financial reports, JPMorgan Chase appears to have begun restructuring consolidated VIEs almost immediately after FIN 46, as its reported volume of assets in consolidated variable interest entities began a declining trend beginning in 2004. Total assets in their consolidated VIEs declined from $48 billion in the third quarter of 2004 to under $20 billion in the fourth quarter of 2007.[138] Wells Fargo never had significant assets in consolidated VIEs, appearing to opt for investments in qualified special purpose entities that did not have to be consolidated by accounting rules.

The aggregate exposure of banking entities to VIEs at the height of the financial crisis was economically significant. Table 3 shows that loss exposure to *unconsolidated* VIEs alone was significant enough to create safety and soundness concerns in the regulated banking sector. In Citigroup's case, exposures to unconsolidated VIEs amounted to 136% of its Tier 1 capital. On the assumption that Citigroup was exposed to additional losses equal to 50% of its consolidated VIE assets, Citigroup's aggregate exposure to loss from consolidated and unconsolidated VIEs amounted to 178% of its Tier 1 Capital.

Table 3. Tier 1 Capital and the Ratio of Loss Exposure to Unconsolidated VIEs[139]

	Citi	JPM	BoA	Wells
Consolidated VIE Assets	81.8	18.2	30.63	4.3
Exposure to Loss – Unconsolidated VIEs	130.8	60.8	51.96	2.8
Tier 1 Capital	96.3	111.6	100.2	45.2
Ratio Exposure to Loss from Unconsolidated VIEs / Capital	**136%**	**54%**	**52%**	**6%**

B. Banking Entity Control Over Securitization Vehicles

Some shadow banking accounts make it seem as if securitization vehicles operate in the shadows with anonymous owners and uncertain origins. But securitization vehicles are organized by their sponsors. The sponsors pay lawyers to draft agreements; file the organizing documents; identify the assets; negotiate a purchase agreement; and solicit

[136] Citigroup Inc., Quarterly Report (Form 10-Q) 64 (Oct. 31, 2008).

[137] Bank of Am. Corp., Annual Report (Form 10-K) 113 (Feb. 28, 2008).

[138] JPMorgan Chase & Co., Annual Report (Form 10-K) 154 (Feb. 29, 2008).

[139] Table 3 reports the Tier 1 capital and the ratio of loss exposure to *unconsolidated* VIEs to Tier 1 capital for certain bank holding companies as of September 30, 2008 (in billions of dollars). The table reports data for Citigroup, JPMorgan, Bank of America, and Wells Fargo. Data on exposures to VIEs is from SEC filings. Tier 1 Capital data is reported to the Board Form FR Y-9C.

investors. Sponsors exert the control that is necessary to protect and advance their own interests.

Sponsors exert control over securitization vehicles in multiple ways when they organize the vehicle. First, sponsors make almost all the decisions and make all the effort that will decide whether a securitization investment will succeed or fail, including the selection of assets that will be purchased by the securitization vehicle. Second, sponsors make capital structure decisions including how much debt the entity assumes, and who invests in which parts of the capital structure. Third, sponsors cause the securitization vehicle to transact with the sponsor (or affiliates of the sponsor). Among other transactions, sponsors provide credit and liquidity support to securitization vehicles; enter into agreements with sponsors to provide fees in exchange for administering the vehicle, such as by servicing the underlying assets or providing investment advice;[140] and enter into underwriting or placement agreements with sponsors by which the asset-backed securities are sold to investors.

Where it's important to protect their interests, sponsors allocate ongoing control rights to themselves. These control rights are typically contractually assigned. For example, under a standard servicing agreement with an issuer of mortgage-backed securities, the sponsor (or an affiliate) is given the right to veto changes to the property of securitized assets, such as alterations or improvements on the property or prior to transferring their interests in the mortgaged property.[141] Sponsors also typically assign themselves the right to oversee troubled loans and are often granted rights to select the special servicer, usually selected to have interests that align with the certificate holders.[142] In more complex, managed vehicles (like collateralized debt obligations) ongoing control rights are contractually allocated to a collateral manager. However, control of these managed vehicles often ultimately rests with the securitization sponsor through a right to remove the collateral manager for cause.

In summary, sponsors of securitization vehicles make almost all the decisions and take almost all the actions that will determine whether a securitization investment succeeds or fails. The majority of other investors are passive, senior debt-holders. Even co-investors in the subordinated part of the capital stack are generally not engaged in investment decisions or administrative efforts.

III. REGULATORY REFORM

The key problem identified in this Article is that securitization provided *traditional banks* with a vehicle to conduct maturity transformation activities outside of the safety and soundness restrictions of the banking and investment company laws. The key regulatory challenge, therefore, is to bring securitization activities back inside the regulatory

[140] Citigroup, Inc., Annual Report (Form 10-K) 63, 72–73 (Feb. 28, 2005) ("The Company may also provide other financial services and/or products to the VIEs for market-rate fees. These may include: the provision of liquidity or contingent liquidity facilities, interest rate or foreign exchange hedges and credit derivative instruments, as well as the purchasing and warehousing of securities until they are sold to the SPE."). Banking sponsors also caused the vehicles to enter into investment advisory agreements and management agreements.

[141] KRAVITT & VINCENT, *supra* note 43, § 16.02[*I*].

[142] *Id.* § 16.05.

perimeter. The north star of reform proposals should, therefore, be to apply the risk-reducing prudential guardrails of the banking laws and investment company laws consistently across all banking activities and investment types. This Part advances a proposal that would add an economic exposure test to determine whether an entity is a bank "affiliate" and proposes to eliminate certain asset-based exemptions from regulation under the Investment Company Act.

A. Comparing the Regulatory Environment Across Entity Type

There are two primary pillars of financial stability regulation under U.S. law, and one of them is often overlooked.

The first pillar of financial stability regulation is the banking laws. The case for special regulation of banks is two-fold. First, bank failures impose particularly severe social costs on investors and the public when losses on bank assets cause lending activities to shrink and payment systems to become disrupted.[143] Second, there is a belief that a market failure exists in the sense that market forces alone may fail to constrain and correct the information and incentive problems that produce excessive risk-taking incentives for managers of banks.[144] While all equity holders in limited liability entities have incentives to push risk

[143] XAVIER FREIXAS & JEAN-CHARLES ROCHET, MICROECONOMICS OF BANKING 308–16 (2d ed. 2008).

[144] It is well-established in the theory of banks that the limited liability of bank stockholders provides incentives for banks to assume more risk than is socially optimal, as in all limited liability entities. *Id.* These risk-seeking incentives arise from a conflict between holders of debt and equity securities in the same firm due to the fact that equity holders, as residual claimants, keep all the upside benefits of the value of a firm in excess of the value of the firm's debt, but share losses with debtors. The firm maximizes the value of the "subsidy" it receives by maximizing the amount of risk it can push off to creditors. JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 510 (2016). The classic moral hazard account models managers as having a call option on the value of the firm with a strike price at the amount of debt. The conflict between debt and equity-holders is understood as particularly problematic in the bank context where market discipline is relatively weaker. *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010) (describing the moral hazard problem in the banking context). In normal firms, the conflict between equity and debt is managed through a bargaining process with debtors. Bondholders protect their interests by pricing risk into the interest-rate they charge, bargaining for contractual protections, and continuously monitoring risk-taking by management. However, the constraints imposed by creditors on banks are believed to be weaker than for ordinary firms for two reasons. First, depositors are assumed to be more passive, less sophisticated, and more prone to collective action problems than bondholders. Second, even sophisticated bondholders in the capital markets have fewer incentives to incur costs in bargaining for contractual protections against risk-taking ex ante or monitoring and disciplining risk-taking activities by banks ex post if those creditors are aware of an actual or perceived guarantee of bank obligations by the federal government. This safety net includes federal deposit insurance, the Board's discount window, and emergency measures implemented by the Board during financial strain. It is widely believed that the federal government will not permit large, systemically important banks to fail because bank failures have traditionally led to severe economic disruptions and substantial harm to all people participating in the economy. Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions, 79 Fed. Reg. 24528, 24528 (May 1, 2014) (to be codified at 12 C.F.R. pts. 6, 2018, 217, 324) (stating that "the perception that certain companies are 'too big to fail' reduces the incentives of shareholders, creditors and counterparties of these companies to discipline excessive risk-taking by the companies"). To the extent that bank debt is mispriced because of a belief that the government will bail out banks in the event of failure, or because the bank shares part of the subsidy with the debtors in the form of supra-risk-

onto debt-holders, the conflict of interest between a bank's debt-holders and equity-holders is thought to be particularly problematic because of the unique incentive and information problems that arise in the banking context.

The second bulwark of financial stability regulation, the one frequently overlooked, is the regulation of investment companies. The two-part justification for mandatory regulation of investment companies mirrors the justification for regulation of banks.[145] First, as in the banking context, failures by investment companies can impose costs on investors and the public. In passing the Investment Company Act in 1940, Congress was quite specific on the latter point in stating in the statutory text that investment companies "are affected with a national public interest" and that they "have a vital effect upon the flow of such [national] savings into the capital markets."[146] Second, also as in the banking context, market forces alone are unlikely to resolve the information and incentive problems that give rise to the risk of harm to investors and the public when professionals manage money on behalf of others.[147] Among other concerns, the statute specifically states that the Act aims to address the adverse effects on investors and the public when managers of investment companies disclose insufficient information; act on conflicts of interest; issue inequitable or discriminatory securities; assume too much debt; and operate with insufficient assets and reserves.[148] By constraining the incentives and capacity of investment professionals to misallocate capital and take imprudent speculative bets with other people's money, the Investment Company Act combats the accumulation of systemic risk.[149]

Table 4 systematically compares the regulatory architecture that applies to banking entities, investment companies, and VIEs. The analysis shows that VIEs are subject to none of the substantive and prudential regulations to which bank affiliates and investment companies are subject—other than the restrictions that limit their assets to certain debt securities and debt-backed securities. Crucially, the differential regulatory treatment applies *even in entities that have no differences* in investment strategy, investment assets, risk-profile, or contributions to systemic risk.

adjusted yields, the mispricing creates a subsidy to bank owners that increases with the amount of risk taken, other things equal.

[145] *See* SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, REPORT OF THE DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION xvii (1992) (providing background on the regulation of investment companies).

[146] 15 U.S.C. § 80a-1(a)(4).

[147] 15 U.S.C. § 80a-1 ("It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.").

[148] 15 U.S.C. § 80a-1(b)(1)–(8).

[149] SEC. & EXCH. COMM'N, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH vii (1966) (concluding that the Investment Company Act was motivated by a Congressional finding that investment companies had been operated in the interests of their managers rather than in the interests of their shareholders).

Table 4. Comparison of Regulatory Schemes That Apply Across Entity Type

	Bank Affiliate	**Investment Co.**	**VIE**
Capital Adequacy	Yes	Yes	No
Restrictions on Affiliate Transactions	Yes	Yes	No
Investment Restrictions	Yes	Yes	Yes
Prudential Supervision	Yes	Limited	No
Source of Strength and Involuntary Receivership	Yes	No	No

1. *Capital Adequacy*

Capital rules are one of the most basic and effective tools in the arsenal of financial regulators. Capital requirements for banks and investment companies at the entity-level operate to decrease leverage in the system in a similar way that mandatory underwriting standards requiring borrowers to put down a minimum amount of equity on a mortgage do.

The banking laws impose capital adequacy standards by requiring banks and their holding companies to hold a minimum amount of capital against their liabilities. The financial economics literature has already shown how banking enterprises used differential treatment of on- and off-balance sheet entities to arbitrage capital requirements, so I do not discuss bank capital rules here.[150]

However, this Article is the first to identify an overlooked source of differential capital requirements that apply to securitization programs. Like the banking laws, the investment company laws also contain capital adequacy rules.[151] Indeed, the investment company capital rules are significantly *more* stringent than the capital rules that apply to banking entities. Borrowing by registered investment companies is restricted, and the amount of senior debt that the company can assume is capped. Generally, funds must maintain a 300% asset coverage ratio.[152]

Had the Investment Company Act capital rules applied to securitization programs, the securitized financing industry would have had much less leverage in 2007 and 2008.[153] This conclusion extends to bank-sponsored securitization programs *and* to programs

[150] *See* Acharya, Schnabl & Suarez, *supra* note 10.

[151] 15 U.S.C. § 80a-18.

[152] *Id.*

[153] There is a separate exemption from the definition of "investment company" for certain entities conducting only certain mortgage activities under section 3(c)(5)(c) of the Investment Company Act. 15 U.S.C. § 80a-3(c)(5)(C). However, this exemption would not have applied to securitization programs of non-mortgage debt and it is unlikely that this exemption would apply to many re-securitizations of mortgage-backed securities.

sponsored by investment banks such as Lehman Brothers and Bear Stearns. When investment capital left the regulated spaces in the marketplace and flooded into the unregulated securitization space, one consequence was a drastic increase in the leverage used to sustain the financial system. Thus, securitization not only arbitraged bank capital rules, as is well known, but they also arbitrated investment company capital rules.

2. Restrictions on Affiliate Transactions

Transactions between banks and their affiliates are regulated to avoid the risk that a bank may subsidize, backstop, or bail out affiliates engaged in risky investment activities that are not permitted to banks themselves.[154] Regulation of the corporate family assures that banks cannot assume excessive risks or engage in prohibited activities indirectly through affiliates. Generally, section 23A of the Federal Reserve Act limits the volume of transactions with bank affiliates.[155] Section 23B requires that any such transactions occur on arms-length, market terms.[156] Covered transactions include ones like extending a loan facility, entering into an asset purchase agreement, or providing a letter of credit—the types of transactions banking entities used to support securitization vehicles before the crisis.

Like in the banking context, investment company regulation prohibits or restricts a wide range of transactions between registered investment companies and their "affiliates."[157] Among other things, these rules limit the compensation that managers can receive from the fund, their ability to use fund assets to cross-support other affiliates, and their ability to acquire securities from an underwriting syndicate containing certain affiliates. These affiliate transaction restrictions are considered to be among the most important of the Act's many protections.[158]

However, these affiliate transaction restrictions do not generally apply to transactions between banks and securitization vehicles. Transactions with a sponsoring bank enable securitization vehicles to use the relatively cheap deposit funding held by the bank. Additionally, a perceived backstop by the bank may reduce the risk-adjusted return investors in the securitization vehicle's debt demand to compensate them for the risk they assume.

[154] These restrictions are generally set forth in sections 23A and 23B of the Federal Reserve Act and the Board's implementing regulation, Regulation Q. 12 U.S.C. § 371c (section 23A of the Federal Reserve Act); 12 U.S.C. § 371c-1 (section 23B of the Federal Reserve Act); Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q), 12 C.F.R. Part 217 (2023); *see also* Omarova, *Unfulfilled Promise*, *supra* note 6 (analyzing the application of the rules on affiliate transaction restrictions in the 2007–2009 financial crisis).

[155] *See supra* sources cited note 154 (discussing sections 23A and 23B of the Federal Reserve Act as well as Regulation Q).

[156] *Id.*

[157] 15 U.S.C. § 80a-17; 15 U.S.C. § 80a-10(f).

[158] SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION, REPORT OF THE DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION 473 (1992) ("For more than fifty years, [the restrictions on affiliate transactions in the Investment Company Act] have played a vital role in protecting the interests of shareholders and in preserving the industry's reputation for integrity; they continue to be among the most important of the Act's many protections.").

3. *Investment Restrictions*

Consistent with this foundational safety and soundness principle of banking law, national banks are subject to limitations on the types of investment securities that they might hold and the activities that they can undertake.[159] The National Bank Act authorizes national banks *only* to invest in certain securities that are investment-grade or government-backed.[160] Investment grade corporate debt securities can be held only if they are marketable, investment grade, and not predominantly speculative in nature and comply with per-borrower limitations.[161] The marketability and investment grade requirement functions as a crude proxy to limit banks to holding only relatively safe investment securities. National banks are expressly prohibited from investing in two of the riskiest asset classes—shares of stock of any corporation and real property—subject to narrow exceptions.[162]

Bank affiliates can hold a broader range of investment securities than banks can directly. However, bank affiliates face their own investment restrictions. They are generally prohibited from owning the equity securities of nonfinancial entities subject to important exceptions including merchant banking authority.[163] Any such permissible investments in equity securities must be held in separately capitalized affiliates subject to affiliate transaction restrictions, creating a firewall between the affiliate and the bank.[164]

Like banking law, investment company law also imposes investment restrictions on registered investment companies motivated by concerns about circular ownership, cross-ownership, and pyramiding. Section 12(d)(1) of the Investment Company Act limits the purchase of registered investment company securities by another registered investment company.[165] Some of these anti-pyramiding restrictions also apply to most private equity funds and hedge funds.

Most securitization vehicles also face an important investment restriction: they must primarily hold debt assets. This follows from the requirements set forth by the exemption from the Investment Company Act on which they rely.[166] Unlike banks, however, securitization vehicles are permitted to hold non-investment grade debt assets. Unlike investment companies, there are no restrictions on cross-ownership or pyramiding.

[159] National banks may *only* engage in those activities that are part of, or incidental, to the business of banking, or are otherwise authorized by federal law. 12 U.S.C. § 24(Seventh).

[160] 12 C.F.R. §§ 1.2(j), 1.2(m)(3), 1.2(n) (2020); 12 C.F.R. § 1.3(f) (2017).

[161] 12 C.F.R. §§ 1.2(*l*), 1.3(b). Borrowing by any single obligor is limited to 10% of the bank's worldwide capital and surplus.

[162] Section 24(Seventh) of the National Bank Act expressly prohibits national banks from investing in or dealing in any shares of stock of any corporation, subject to narrow exceptions. 12 U.S.C. § 24(Seventh).

[163] *See* 12 U.S.C. § 1843(k).

[164] *See* 12 U.S.C. § 24(Seventh) (prohibiting banks from holding, directly, certain amounts of stock by association).

[165] 15 U.S.C. § 80a-12(d)(1); 15 U.S.C. § 80a-20(c). The purchase limits against any individual registered investment fund are three percent of a registered investment fund's voting securities and five percent of the purchasing fund's total assets. The aggregate limit of purchases in all registered investment funds is ten percent of the purchasing fund's total assets.

[166] *See supra* note 148 and accompanying text.

Accordingly, securitization vehicles can hold the subordinated and equity-like interests of other securitization vehicles.

4. *Prudential Supervision*

Banking organizations are subject to supervisory review by the Board as the umbrella supervisor.[167] Supervision entails off-site supervision through required periodic reporting and other information reporting; on-site examinations and inspections; and supervisory and enforcement actions.[168] Bank examiners have access to the managers, books, records, and worksites of banking entities in connection with the supervisory process.[169] Bank examiners even have the authority to order a banking entity to divest of assets if they conclude that the certain assets or activities jeopardize the safety and soundness of the bank.[170]

Investment company law also provides the SEC with the authority to examine records of regulated entities and to compel compliance.[171] Moreover, investment company laws encourage examination and monitoring by shareholders. Various provisions that apply to registered investment companies—such as mandatory disclosure requirements and mandatory periodic approval of management agreements by investors—are aimed at empowering dispersed investors to curb managerial agency costs and excessive speculation by asset managers.[172]

Unregistered securitization vehicles are not subject to examination by any authority. Even if a bank examiner found a bank exposure to be excessively risky, bank examiners would have difficulties ordering a securitization vehicle to divest assets. Such an order in the securitization context raises thorny contractual issues: did investors rely on the provision of bank credit enhancements when they purchased asset-backed securities? Winding up a bank's exposure to a troubled securitization vehicle probably would be impossible without liquidating the entire vehicle.

[167] Omarova, *supra* note 56, at 119 (describing the Board as the umbrella supervisor of bank holding companies).

[168] Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, 74 VAND. L. REV. 951, 953–54 (2021) (describing the supervision authority of banking regulators).

[169] In the Dodd-Frank Act, Congress affirmed that bank supervision constituted an important pillar of bank safety and soundness regulation. Section 165(b) of the Dodd-Frank Act established enhanced prudential supervisions for "systemically important" institutions in the Dodd-Frank Act—which includes, among other things, enhanced stress testing requirements. Section 161 subject systemically important nonbank financial institutions to examinations and reporting requirements. Dodd-Frank Act § 161(a)–(b), 12 U.S.C. § 5361.

[170] 15 U.S.C. §§ 80a-30(b) (examination of records); 80a-42 (giving the SEC authority to make investigations, to compel production of records, among other enforcement authorities).

[171] 15 U.S.C. §§ 80a-8 (requiring registration of investment companies); § 80a-13 (prohibiting certain changes in investment policy without a stockholder vote).

[172] For example, the Investment Company Act requires mandatory periodic reporting by the investment company and periodic approval by the fund's beneficiaries of any management agreement, but these approvals are not required for most securitization vehicles. 15 U.S.C. § 80a-29.

5. Source of Strength and Involuntary Receivership

Banking entities are also subject to involuntary divestment of assets and receivership. Securitization technology operated to shield the assets of securitization vehicles from these forced divestments.[173]

Under banking law, the discretion of the managers of banks and banking entities is removed when they enter the zone of insolvency. These restrictions are justified as helping the bank to wind up its affairs in an orderly manner and to prevent opportunistic bank managers from externalizing risk onto the federal safety net by "gambling for resurrection." One mechanism is the prompt corrective action regime of the Federal Deposit Insurance Act. This statute requires the Federal Deposit Insurance Corporation (FDIC) to take corrective action if certain capital thresholds are not maintained.[174] Banks are also subject to involuntary receivership by the FDIC.[175] Additionally, the source of strength doctrine requires the bank holding company and its affiliates to commit all resources at its disposal to ensure the strength of its subsidiary bank.[176] Under this doctrine, the Board could require bank affiliates to sell assets in order to capitalize the bank.

However, assets in securitization vehicles are shielded from all these involuntary divestment regimes. Indeed, precisely the opposite result than the one intended by the policy occurred during the 2007–2009 financial crisis. As asset quality deteriorated, banks and their affiliates served as a source of strength to *securitization vehicles*, making good on their contractual commitments to provide liquidity and credit enhancements. As events actually turned out, banks served as a source of strength to the securitization industry in 2007 and 2008, not the other way around. This result was the one contemplated by the contractual design of securitization programs. What was left of the value of the securitized assets accrued to investors in securitization vehicles, not to the depository institutions that supported these vehicles or to the government.

B. A Typology of Shadow Banks

The analysis thus far advances our understanding of the problem of shadow banking for regulatory architecture. The term "shadow banking" is frequently used with imprecise and shifting meaning. The legal analysis in this Part provides a more useful framework for thinking about the relevant problem for financial regulatory architecture. I define shadow banks as entities that (1) are not deemed to be a banking entity and (2) are exempted from the definition of "investment company."

[173] The Dodd-Frank Act evidenced concern with this problem in a clunky way by giving prudential regulators the authority to liquidate certain nonbank financial entities. Dodd-Frank Act § 203, 12 U.S.C. § 5383 (describing the FDIC's resolution authority over certain financial companies and procedures); Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

[174] 12 U.S.C. § 1831o; *see also* Raj Aggarwal & Kevin T. Jacques, *Assessing the Impact of Prompt Corrective Action on Bank Capital and Risk*, ECON. POL'Y REV., Oct. 1998, at 23 (providing an overview of the Federal Deposit Insurance Corporation Improvement Act and the role the FDIC plays).

[175] 12 U.S.C. § 1831o(h)(3)(A).

[176] 12 C.F.R. § 225.4(a)(1) (2023).

Using the legal analytical framework above, this Part sets forth a typology of "shadow banks" in increasing order of regulatory concern: unregistered private investment companies; unregistered asset-based investment companies; and unregistered bank-sponsored investment companies.[177]

1. Unsponsored, Unregistered Governance-Based Investment Company

Investment companies that rely on a governance-based exemption from the investment company laws and that are not affiliated with banking entities, like most private equity and hedge funds, present the least amount of regulatory concern. The exemption is "governance-based" because the exemption requires an entity to limit the types, and sometimes the number, of investors that can purchase securities from the investment company.[178]

Regulatory concerns are minimal for three reasons. First, these investment vehicles go through a rigorous market check at the time they issue their securities to powerful, sophisticated investors. Second, the large institutional investors and wealthy individuals who invest in these funds generally have the incentives and the capacity to constrain imprudent investment decisions and managerial agency costs by negotiating for protections and by engaging in robust monitoring and discipline of managers. Third, systemic risk concerns are relatively lower because the entities are not backstopped by a bank. By restricting widespread dissemination to public investors, governance-based exemptions mandate a governance structure for the investment company where deep-pocketed investors who can fend for themselves monitor and constrain imprudent investment strategies and managerial agency costs. Strong private governance lessens the need for a mandatory regulatory structure.

2. Unregistered Asset-Based Investment Companies

Unregistered asset-based investment companies raise substantially greater regulatory concerns than unregistered governance-based investment companies. These entities include certain mortgage real estate investment trusts, collateralized loan obligations, and credit funds. The exemptions on which they rely are asset-based in the sense that they require a company to restrict themselves to holding certain types of debt assets.[179]

[177] In this typology, I use the word investment company broadly as that term is used in the Investment Company Act to mean any entity that issues securities to investors and that is engaged in the business of investing in securities. *See supra* note 64 (discussing the Investment Company Act and relevant regulations).

[178] There are two types of relevant exemptions. The first is a private investment company that relies on section 3(c)(1) for an exemption from the definition of "investment company." 15 U.S.C. § 80a-3(c)(1). Section 3(c)(1) is the analogue to private placements under the Securities Act of 1933. To get the exemption, an entity must have no more than 100 beneficial owners and must not make or propose to make a public offering of their securities. Section 3(c)(7) exempts an entity from regulation under the Investment Company Act as long as all holders of the entity's securities are "qualified purchasers"—certain investors with deep pockets. 15 U.S.C. § 80a-3(c)(7).

[179] Rule 3a-7, already discussed, provides an exemption for certain investment companies primarily holding virtually any type of debt assets. *See supra* note 64 and accompanying text. Other exemptions apply to vehicles

Under asset-based exemptions, there are no restrictions on the types or number of investors. Therefore, these companies can engage in public offerings of securities and can sell to unsophisticated investors without deep pockets, potentially creating the conditions for weak market discipline compared to investment companies that rely on a governance-based exemption. Corporate governance factors greatly increase the possibility of harm to investors and the possibility that misallocation of capital will contribute to systemic risk in this category.

3. Unregistered Bank-Sponsored Investment Companies

Unregistered bank-sponsored investment companies are a subset of the prior category. These are the shadow banks that create the greatest regulatory concern. These entities include bank-sponsored securitization programs and collateralized loan obligations, among others.

Risk to investors and the public in this category is high for three reasons. First, like the prior category of shadow banks, bank-owned investment companies raise all the issues that justify regulation of investment companies in the first place. When banking entities manage money on behalf of investors, information and incentives problems inevitably arise. Information problems are especially severe in large, centrally managed banking entities. Universal banks in particular, with enormous amounts of assets and a wide range of operations, face difficult governance challenges.

Second, this category also raises all of the issues that justify *banking* regulation in the first place. Unregistered bank-owned investment companies have access to the federal safety net indirectly through the contractual commitments of banks to provide credit and liquidity support. Like the shareholders and managers of banking entities, the shareholders and managers of shadow banks have powerful incentives to assume more risk than is socially optimal because they keep all the gains but can push losses off to creditors and to the federal safety net. These incentives are exacerbated if managers and bank employees value their incentive-based compensation over short-term time horizons.[180] Because of a belief that the government will not let banking organizations fail, creditors have weak incentives to monitor ongoing operations. The lack of meaningful disciplinary mechanisms from investors increases the risk that bank managers may engage in excessive risk-taking and self-dealing.

Finally, all of this is primarily important as a regulatory matter because banking failures impose severe social costs on society, as observed following the 2007–2009 financial crisis. Through its backstop to banking entities and, indirectly, the federal safety net, this category of bank-sponsored securitization vehicles creates the greatest systemic risk concerns.

primarily holding certain financing receivables, sales financing loans, and mortgages or liens on real estate, respectively. 15 U.S.C. § 80a-3(c)(5)(A)–(C).

[180] *See* Bebchuk & Spamann, *supra* note 144 (discussing the moral hazards and ethical concerns inherent in the banking industry).

C. An Economic Exposure Test for Banking "Affiliates"

The biggest problem identified in this Article is that transactional innovations in structured finance have enabled banking entities to gain residual and subordinated economic exposure to unregulated financial entities.[181] Simply put, it is bad policy to give unregulated investment companies with nearly $250 trillion in assets under management access to the federal safety net.

A better approach to regulating shadow banks would be to change the rules under the relevant holding company laws—Federal Reserve Act, the Bank Holding Company Act, and the Investment Company Act—to regulate securitization vehicles under ordinary principles of holding company regulation. Mandatory regulation of the corporate families of banks is justified as necessary to prevent the bank from assuming risks indirectly that it could not do directly. This justification applies at least as strongly to bank-owned securitization vehicles as it does to any other entities regulated as bank affiliates.

The proposal creates thorny definitional problems. However, financial regulation deals with these line-drawing problems all the time. For example, as is well known from the litigation around the definition of "security" in the Securities Act of 1933, a formalistic definition of a financial instrument creates a roadmap for avoiding regulation.[182] A functional test is necessary to effectuate the broad remedial purposes of financial regulation.

This Article proposes to add an economic exposure test to the definition of "affiliate" and related concepts throughout the banking laws, similar to the approach taken by the Financial Accounting Standards Board in defining a VIE. If a banking entity is exposed to more than 25% of any class of subordinated financial instrument, the entity issuing the financial instrument should be deemed to be a bank "affiliate."[183] If a banking entity is exposed to 5–25% of any class of subordinated financial instrument, the issuing entity should be deemed an affiliate if a facts and circumstances analysis shows that a banking entity also exercises significant control over the entity. Like the accounting consolidation rules for VIEs, the proposed affiliate test is intended to capture novel arrangements where traditional indicia of voting control do not fully characterize the economic relationships between two entities.

[181] *See also* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 971–75 (2011) (describing the exposures of financial conglomerates to structured-finance securities).

[182] *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946) (interpreting the term "investment contract" in the definition of "security" in the Securities Act of 1933).

[183] Subordinated security or financial instrument means any security or financial instrument that is not the most senior class of financial instrument in the entity and is not secured by fair market value collateral. The use of the word "financial instrument" is meant to be more stringent than the definition of "ownership interest" in the Volcker Rule. Under the Volcker Rule, an "ownership interest" is defined broadly to include an equity, partnership, or other similar interest which includes the right to participate in the selection or removal of an investment manager or similar managing individual or group The Volcker Rule's regulations expressly contemplate that a debt interest may be an "ownership interest." *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376 (2010).

Treating securitization vehicles as "affiliates" would snap all the safety and soundness protections in the banking laws onto the activities of securitization vehicles. The affiliate transaction restrictions in sections 23A and 23B of the Federal Reserve Act would limit the ability of the bank to indirectly backstop risky, speculative investments.

The greatest advantage of the proposed reform is that it does not require regulators to impose judgments on the merits of financial innovations. It simply requires regulators to apply relatively straightforward rules about economic exposure and control. The rule primarily works by removing a regulatory subsidy that is currently enjoyed by certain nonbank investment companies backstopped by banks. The proposed rule would affect deal structuring ex ante by making organizers decide about the costs of internalizing banking regulation. If a financial innovation is efficient, then banking entities and unregulated investment companies will still adopt it. Other things equal, without a bank backstop, investors would demand a greater risk-adjusted return to hold the senior debt of securitization vehicles and other debt investment funds. Such an effect would improve the pricing of debt and capital allocation decisions.

Ex post, this rule may expose banks to regulatory risks because they cannot control the actions of entities in which they have subordinated debt exposure but do not control. However, getting the ex ante rule correct is the better approach: banks simply shouldn't be making substantial subordinated investments in entities that they do not control and that are not subject to the prudential safeguards of the banking laws. Banking entities already structure all their affiliate relationships to ensure compliance with the banking laws, and they would do so with their securitization activities under the proposal.

Another advantage of the proposed rule is that it does not require the imposition of new substantive rules or regulations. Instead, it draws on well-established and time-tested regulatory frameworks under the banking laws. Banking entities would have to restructure their securitization activities to come into compliance with the rule, but the proposal would impose no new regulations or limitations on non-bank investment companies.

It should not be an objection that the proposal will prevent banking entities from selling their own assets. The proposal places no new restrictions on the ability of banking entities to sell their assets. Rather, the proposal regulates securitization programs where a sufficient amount of credit and liquidity support is extended by a banking entity that the securitization program should be deemed an "affiliate" of the bank. Imposing these affiliate restrictions would effectively expand the corporate family subject to risk-reducing banking regulations to include sponsored securitization vehicles.

Another advantage of the proposal is that it would impose fewer restrictions on banks than other leading proposals. For example, Professor Levitin, among others, has advanced a narrow banking proposal in which banks could only engage in deposit-taking and payments activities, but not lending.[184] This would radically restructure the banking and financial industry in ways that are not contemplated by the proposal here. Others have advocated for resurrecting the Glass-Steagall Act's prohibition on securities underwriting

[184] Levitin, *supra* note 24.

and dealing which would once again separate commercial and investment banking.[185] The purpose of the proposal presented here is instead to regulate principal investments by banks in *investment companies*, not to regulate underwriting or dealing in securities on the account of bank customers.

D. Reforming Investment Company Regulation

A second problem identified in this Article is that transactional innovation has outrun the regulatory architecture of the Investment Company Act. Certain unregulated debt-based collective investment vehicles have grown more complex and riskier than contemplated by the asset-based exemptions from investment company regulation on which they rely than was ever intended. The asset-based exemptions were intended to exempt small finance companies that directly loaned money to home-buyers and small businesses, but they now cover actively managed collateralized loan obligations holding billions of dollars of unrated debt.

The inadequacy of the regulatory scheme is apparent from an analysis of the rule that led to the passage of Investment Company Act Rule 3a-7—the exemption on which the shadow banks of most concern rely—by the SEC in 1992. In comments to the SEC when it was contemplating the promulgation of Rule 3a-7 in 1992, the Investment Company Institute and the North American Securities Administrators Association argued that securitization vehicles are investment companies and should be regulated as such.[186] These commenters specifically singled out asset-backed commercial paper programs—the types of programs at the heart of the collapse in 2007–2009—and showed how these commercial-paper programs could be managed in a manner similar to management investment companies.[187]

But the SEC disagreed. It acknowledged that "[s]tructured financings fall within the definition of investment company under section 3(a)."[188] Nevertheless, the SEC offered two types of arguments in justifying their policy decision to exempt securitization vehicles from investment company regulation. First, the final rule made a policy argument based on the idea that securitization was an "increasingly important form of finance."[189] The rule asserted that the growth and development of the structured financing market was "hindered" by the Investment Company Act.[190] The SEC claimed in the preamble that the

[185] NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE 210 (2010) ("So we need to go back to Glass-Steagall, and even beyond it, to a financial system in which both institutions and their activities are unbundled to make them less too big to fail and less too interconnected to fail.").

[186] Exclusion from the Definition of Investment Company for Structured Financings, 57 Fed. Reg. at 56249 n.10.

[187] *Id*. at 56253 n.59.

[188] *Id.* at 56248.

[189] *Id.* at 56249 n.10.

[190] *Id.* A contemporaneous report released by the SEC Division of Investment Management raised two additional concerns. The report also evidenced a concern that the regulatory requirements were pushing financing activities offshore. SEC. & EXCH. COMM'N, *supra* note 145, at 4. The report also evidenced concern that the

structured financing industry was important for accommodating financing to "small businesses."[191]

The second justification for the exemption offered in the preamble to the rule asserted that review of securities issued by securitization vehicles by a credit rating agency was an adequate substitute for regulation under the Investment Company Act. The final rule stated:

> The rating requirement is incorporated in the rule as a means of distinguishing structured financings from registered investment companies . . . . [R]ating agency evaluations tend to address most of the [1940] Act's concerns regarding abusive practices, such as self-dealing and overreaching by insiders, misvaluation of assets, and inadequate asset coverage.[192]

Absent from the rule is any meaningful discussion about securitization vehicles as collective investment vehicles and whether these vehicles are subject to the same information frictions and misaligned incentives that justify regulation of investment companies in the first instance. In hindsight, this statement from the SEC in the preamble to the final rule feels particularly reckless: "[n]otwithstanding its size and rapid growth, the structured finance market has been virtually free of abuse. Requiring regulation based on *theoretical concerns* would only disrupt an increasingly important form of finance."[193] The preamble to the rule contained no discussion of systemic risk considerations.

Rule 3a-7 changed the game for the securitization industry. Previously, securitization vehicles relied on an exemption to the definition of "investment company" under section 3(c)(5) before the SEC promulgated Rule 3a-7 in 1992.[194] However, these exemptions provided limited relief and did not permit cross-purchases of other asset-backed securities, which was the reason the structured financing industry lobbied for Rule 3a-7 in the first place.[195]

After the 2007–2009 financial crisis, Congress directed the SEC, through the Dodd-Frank Act, to undertake rulemakings related to asset-backed issuers.[196] In 2010, the SEC proposed rules primarily related to disclosure requirements.[197] The SEC also proposed evaluating the role of credit rating agencies, stating that "[i]n the aftermath of the recent financial crisis [rating agencies'] credit rating procedures and methodologies raised a

regulatory restrictions were causing "unproductive discussions" about whether structured financing vehicles could fit the existing exception for certain investment companies holding primarily mortgages under section 3(c)(5). *Id.*

[191] Exclusion from the Definition of Investment Company for Structured Financings, 57 Fed. Reg. at 56252

[192] *Id.*

[193] *Id.* at 56249 n.10 (emphasis added).

[194] *Id.* at 56248.

[195] *See* 15 U.S.C. § 80a-3(c)(5). Securitization vehicles relying on these exceptions are limited to holding certain financing receivables; sales financing loans; and mortgages or liens on real estate. However, these exemptions do not cover other commonly securitized assets, like leases and asset-backed securities. *Id.*

[196] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[197] SEC. & EXCH. COMM'N, DISCLOSURE FOR ASSET-BACKED SECURITIES REQUIRED BY SECTION 943 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), https://www.sec.gov/files/rules/proposed/2010/33-9148.pdf [https://perma.cc/8WHM-NVC8].

number of concerns . . . . "[198] The SEC said that potential amendments to Rule 3a-7 could include replacing the role of credit ratings with conditions that are designed to address Investment Company Act-related concerns.[199] These proposed rules were never finalized, leaving the status quo from before the 2007–2009 financial crisis unchanged. The SEC ought to revisit these proposed rules.

Systemic risk, safety, and soundness considerations call for a discussion about whether the vast nonbank credit market, often called the shadow banking sector, is appropriately regulated under the Investment Company Act. This Article tentatively proposes eliminating Rule 3a-7 entirely. If investment companies want to speculate on large corporate and asset-backed securities, they should do so as a regulated investment company or under one of the governance-based exemptions under section 3(c)(1) or section 3(c)(7). The exemptions in section 3(c)(5) should be analyzed by Congress and narrowed appropriately to ensure that only nonbanking entities that actively engage in the business of lending, in addition to holding investment securities, qualify.

Given the enormous growth of the unregulated credit sector, this proposal would fundamentally reshape global financial markets. Any reform should be carefully considered. A relatively more modest proposal would be to increase the conditions necessary to receive the exemptions under Rule 3a-7 and section 3(c)(5). The financial crisis points to a few restrictions that might have an outsized impact. A good starting point would be to prohibit such entities from issuing redeemable securities and deeming arrangements like liquidity facilities to support short-term commercial paper conduits and similar schemes as prohibited redeemable securities. A second prudent reform would be to apply the cross-ownership and circular ownership rules to funds relying on these exemptions, like they already apply to private equity funds and hedge funds that rely on section 3(c)(1) and section 3(c)(7). Had these rules been in place, it would have stopped the resecuritization transactions that leveraged up the securitized financing industry and provided a dumping ground for toxic assets as systemic risk quietly accumulated.

The proposed reforms would be less restrictive than a prominent proposal by Professor Morgan Ricks. That proposal would prohibit entirely short-term debt issuance by nonbank financial intermediaries.[200] This proposal would prevent the centuries-old practice of certain institutions issuing commercial paper. Under this Article's proposal, nonbanks could issue short-term commercial paper as long as they complied with the regulations under the Investment Company Act or relied on a governance-based exemption from regulation.

[198] Treatment of Asset-Backed Issuers Under the Investment Company Act, 76 Fed. Reg. 55308, 50309 (Sept. 7, 2011).

[199] *Id.*

[200] RICKS, *supra* note 2, at 235 (proposing to prohibit the large-scale issuance, by anyone other than a member bank, of instruments that are checkable deposits or their close substitutes—generally debt with a maturity of less than one-year and that is backed by financial collateral).

CONCLUSION

This Article provides evidence that the traditional banking sector owned, controlled, and backstopped the securitization industry before and during the 2007–2009 financial crisis. It argues that the securitization transactional design under current practices is best explained as a means for banking entities to maintain economic exposure to an investment company without triggering a conclusion that the company is a regulated investment company or bank "affiliate." The purpose of this structuring was to enable banking entities to engage in hundreds of billions of dollars of investment activities outside of the regulatory perimeter.

The solution is to reform the tests that determine the application of banking laws and investment company laws to eliminate the gaps in regulatory architecture that are exploited by transactional designers. This Article proposes an economic test for the definition of bank "affiliate": any "investment company" to which the bank is exposed to more than 25% of any class of subordinated financial instrument should be deemed to be a bank "affiliate." This Article also proposes to reform the exemptions from the Investment Company Act that were intended to remove small financing companies from regulation, but that are now used to remove investment funds holding billions of dollars of complex securities and structured financial products.

This Article stands for the proposition that effective safety and soundness regulation of the banking sector is critical to effectuate its broad remedial purpose: protecting the real economy from negative externalities when payment and lending systems are disrupted. This Article challenges the conventional wisdom on "shadow banks." The 2007–2009 financial crisis should not be understood as a case study in the financial stability risks of nonbank financial intermediaries, but in the risks of allowing traditional banks to engage in financial intermediation without the safety and soundness guardrails of the banking laws. The shadow banking sector has only grown since the 2007–2009 financial crisis. Systemic risk and safety and soundness considerations demand the uniform application of banking laws and investment company laws across these unregulated investment companies.